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INFLATION IN THE PHILIPPINES?

Arthur B. Hersey

The Philippine Republic now has the hope of entering a period of rapid economic development and, unlike many other Asiatic countries, it has the financial resources with which to make a start. Its total foreign exchange resources are nearly $450 million. The magnitude of this sum can be realized by comparing it with the total Philippine money supply, about $550 million at the end of 1947, and with the Philippine annual gross national product which is now about $1.6 billion. Moreover, the United States is committed to assisting the Philippines in the initial task of repairing war damage. Part of this assistance takes the form of construction planned and carried out by U.S. Government agencies, though much the larger part consists of cash payments to individual claimants. Substantial amounts also have been paid to the Philippine Government (1) to liquidate inter-government obligations dating from before or during the war and (2) as a loan to assist in ordinary budget financing. In addition, the United States is making certain military and Veterans' Administration expenditures in the Philippines. Whatever the form and purpose of the expenditures, additional foreign exchange resources are being supplied to the Philippine economy.

But the availability of foreign exchange resources to the economy as a whole is only one of the prerequisites for rehabilitation and development.

Another is taxation or credit mechanisms to channel these resources into desirable uses. Still a third, too little considered in most discussions of the Philippine problem, is internal financial stability. By its very nature, any program of accelerated development is likely to have inflationary implications. This note is intended to show, in terms of bare statistics of currency circulation and bank deposits, how serious is this threat of inflation even now, before real progress has yet been made in stimulating new investment.

The expansive factors include exports, U.S. Government expenditures in the Philippines, and the growth of bank loans and investments. Balancing factors on the other side include imports and the outflow of Philippine profits. Clearly these two contractive forces are already playing a significant role, but their power to drain money out of circulation in the period ahead is not easy to assess. No move toward controlling the outflow of capital is to be expected for a long time to come.1/ On the other hand, the Philippine Administration has already proposed that checks be placed on excessive imports of nonessentials. Any forced contraction of imports will tend to create greater inflationary pressures in the domestic economy.

Table I sums up the Philippine balance of payments as it now looks for 1948, with comparisons for 1946 and 1947. Exports exceeded all expectations in 1947, mainly because of the very strong market for copra. Sugar, the leading export before the war, was not being shipped last year. In the absence of a sharp drop in world agricultural prices--an assumption that seems reasonable for this year--the volume and value of Philippine exports will rise again in 1948. U.S. Government payments will be at their peak. Although exports and U.S. payments failed to produce a surplus in the balance of payments through 1947, a substantial net rise in monetary reserves and in currency and deposits seems practically certain to occur in 1948. Imports and other outpayments (current and capital) will doubtless continue at high levels, but imports in 1947 were abnormally high in relation to national income (over 30 per cent as compared with a prewar average of about 20 per cent) and it seems most unlikely, now that pipelines have been filled, that imports will exceed the 1947 total in the coming year.2/ The volume of imports was extremely large in the first half of 1947. Preliminary information suggests that imports in the second half of 1947 were at an annual rate of 1,050 million pesos. The projection for 1948 is slightly above that rate.

On top of the increase in currency and deposits which will result from a favorable balance of payments in 1948, there is a further growth to be expected because of bank credit expansion. A sharp growth in loans and investments, starting, of course, from a very low level at the end of 1945, has already occurred in 1946 and 1947. The part not financed

1/ Under the executive agreement reached pursuant to the Philippine Trade Act (Bell Act) exchange controls may not be imposed "except by agreement with the President of the United States."

2/ Unless a substantial volume of capital goods imports is financed by an additional inflow of capital or by use of Central Bank assets to be loaned to the Government. Imports so financed would not affect the projected growth of the money supply attributable to a favorable balance of payments.

Table I
Balance of Payments on Current and Capital Account
(In million pesos--1 peso = 50 cents)

	Actual 1946	Estimated a/ 1947	Projected b/ 1948
Receipts			
Exports	128	500	600
U.S. Government payments	672	700	750
Other	245 c/	100	100
	1,045	1,300	1,450
Payments			
Imports (c.i.f.)	770	1,150	1,100
Other (including residual)	201	150 d/	200
	971	1,300	1,300
Increase in Currency Reserves Abroad and Banks' Net Short-term Foreign Assets	+ 74 e/	0	+ 150

a/ The items shown are not likely to be in error by more than 50 million pesos.
b/ The margin of error for some of the items -- but probably not for the net balance -- may be as great as 100 million pesos.
c/ Includes repatriation of Philippine Treasury general funds, estimated at 156 million pesos. There may be some duplication (perhaps 20 or 30 million pesos) between this estimate of repatriated funds and the figure for U.S. Government payments. If so, both "other receipts" and "other payments (including residual)" should be reduced.
d/ Includes outward transfer of Philippine Treasury general funds of the order of magnitude of 20 million pesos.
e/ Partly estimated.

by savings and time deposits is estimated at about 200 million pesos (Table II, pp.5-6). Although limits to the expansion of bank credit may eventually be set by the banks' reserve position, this will not be a decisive factor in 1948. It is difficult, of course, to estimate needs and demands for bank credit. Total loans and investments are still well below prewar in relation to the value of gross national product. Accordingly it does not at all go out of the bounds of probability to estimate a further growth in 1948 of 100 million pesos of bank credit not financed by time deposits, new capital, etc.

At the end of 1946 the commercial banks' peso reserve position was very easy. Although excess reserves were not quite as large as the banks had been accustomed to holding in prewar years, total peso reserves were still well over double the legal requirements.1/ Moreover, the banks

1/ Eighteen per cent on demand deposits and 5 per cent on savings and time deposits in excess of security holdings.

held very large foreign exchange assets at the end of 1946. Among individual banks the only ones whose combined peso cash and net foreign balances were less than three-fourths of their individual demand deposits and deposits of public funds1/ were the British and Dutch banks (who were net debtors in foreign exchange) and one small domestic bank.

During 1947 the banks' peso cash has changed very little on the whole and they have reduced their holdings of foreign exchange. Since the balance of payments has been approximately neutral, this moderate shrinkage in total bank reserves can be ascribed to the increase of currency in circulation outside banks, which includes a considerable increase in government cash holdings. Bank deposits have increased a good deal less than the banks' earning assets.

Bank reserves would have fallen more than they did in 1947 had the Philippine Treasury not made two new issues of currency unmatched by fresh accessions to the currency reserves. These issues, totaling 72.5 million pesos, did not constitute legal exceptions to the 100 per cent reserve principle. One issue was justified by counting the Philippines' domestic currency subscription to the International Monetary Fund as a reserve asset. The other was to replace currency that had been lost or destroyed. Exchange of prewar Treasury certificates for the postwar currency is still incomplete, but the Treasury was authorized to act on an advance estimate of the minimum amount of old certificates which would not be turned in.

In 1948 the favorable balance of payments will provide fresh banking reserves, at least potentially. Actually, the growth of currency in circulation and of government currency holdings (or deposits at a new Central Bank) may absorb these new funds. Nevertheless, with some further shift of bank reserve funds out of foreign exchange into peso cash the commercial banking system should easily maintain total peso reserves equal to twice its legal requirements. (See Table III, pp. 6-7.)

The calculations of Table II, supported by those of Table III, show that the consequence of the developments sketched out here is a total effective money supply of 1 billion pesos by the end of 1948. This is five and one-half times the prewar figure of approximately 180 million pesos. In contrast, real gross national product in 1948 and 1949 will barely exceed the prewar level, though U.S. Government transfer payments (which add to national income without involving current production) are much larger than before the war. If the price structure could be maintained at its present general level somewhat under three times prewar,2/ total national income would not exceed three and one-half times prewar. One need not accept any extreme view of the influence of changes in the money supply upon prices to recognize that the pressures for higher prices, in an economy relatively free of controls, will be very strong in 1948.

In line with the June 1947 recommendations of the Joint Philippine-American Finance Commission, President Roxas appointed a "Central Bank Council" which is drafting legislation for submission to the Philippine Congress at its present session. In the foregoing analysis it has been

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1/ Not all deposits of public funds are demand deposits.
2/ Prices of some important agricultural products are much higher than this.

assumed that a Central Bank will be created but that it will remain inactive in 1948, except for simple restrictive actions such as asking the Treasury not to increase its deposits at commercial banks.

Whether the threat of inflation will persist, and perhaps materialize in a rise in cost-prices which will greatly complicate the problem of eventual adjustment to reduced U.S. Government expenditures and reduced copra export sales, will depend to a great extent on the actions of the Central Bank in the next two or three years. The balance of payments will become less favorable, but demands for bank credit will persist. If the commercial banks can be persuaded to use up part of their excess reserves and look to the Central Bank for relief and assistance in the future event of a foreign exchange crisis, many legitimate credit needs can perhaps be met without substantial expansion of Central Bank credit. Small amounts of Central Bank loans and investments, giving the Treasury and the Rehabilitation Finance Corporation direct and indirect aid, would also help to stabilize the commercial banks' reserve position. Much more dangerous, of course, would be Central Bank assistance to the Government on such a scale as to keep the banking system overflowing with liquidity. A first test will be the use of the initial loan of 200 million pesos which the Joint Finance Commission suggested might be made by the Central Bank to the Government. The Commission suggested retirement of foreign debts as one use of this credit. Another might be the purchase of capital equipment from abroad. It is to be hoped that the Commission's recommendation, that "under no circumstances should the fund be used in the domestic economy except for productive purposes", will be interpreted as narrowly as possible.

Table II
Analysis of Increase in Money Supply

Item 1 in this table is the counterpart of the increase in currency reserves abroad and banks' net foreign exchange, Table I. Item 2 is the increase in total currency in circulation (or Central Bank deposit liabilities) in excess of the increase in currency reserves abroad. (In the calculation of item 2 some slight approximations are made: e.g., no change is allowed for coins in circulation.) Item 3 is the increase in demand deposits and deposits of public funds in excess of (a) the increase in banks' net foreign exchange and (b) the increase in banks' peso cash. (Item 3 can also be defined as the counterpart of the increase in bank assets other than peso and foreign exchange reserves, in excess of the increase in bank liabilities other than demand and public fund deposits.) It follows from these definitions that the sum of items 1 to 3 is the increase in currency outside banks plus the increase in demand deposits and deposits of public funds, i.e., in the meaning here assigned, "the increase in total money supply."

The projection of item 3 for 1948 is based on comparisons of outstanding assets and liabilities against prewar data as well as on extrapolation of the 1946-47 trend. This projection does not allow for full recovery either of bank loans and investments or, on the liability side, of savings deposits to their prewar relations to gross national product. It assumes also that bank capital ratios will remain much below prewar.

The projected amount of government money holdings at the end of 1948, which is subtracted from "Total Money Supply" to arrive at "Effective Money Supply", is based on the prewar (1938) relation to national income. The breakdowns of government money holdings and "Effective Money Supply" between currency (and Central Bank deposits) and commercial bank deposits are included here for use in Table III. The proportion of about 50:50 for government holdings at the end of 1948 differs from the prewar (1938) proportion of about 30:70 because of the expected creation of a Central Bank. The proportion of 60:40 for currency outside the banks and Treasury versus individual demand deposits is approximately the same as prewar.

	Actual 1946	Estimated 1947	Projected 1948
	(In million pesos)		
Increase in:			
1. "Money of External Origin"	+ 74	0	+150
2. "Central Bank Credit Money"	0	+ 73	0
3. "Commercial Bank Credit Money"	+ 96	+100	+100
	+170	+173	+250

Year-end:	1945	1946	1947	1948
"Total Money Supply[a/]"	757	927	1,100	1,350
Government Holdings	89	223	300	350
Currency (& Cen.Bk. dep.)	(3)	(47)	(120)	(170)
Deposits	(86)	(176)	(180)	(180)
"Effective Money Supply"	668	704	800	1,000
Currency	(483)	(444)	(500)	(600)
Demand deposits	(185)	(260)	(300)	(400)

a/ Excludes savings and time deposits, except time deposits of public funds.

Table III
Analysis of Banking and Currency Reserves

The familiar Federal Reserve analysis of "sources and uses of reserve funds", in highly condensed form, is applied to Philippine data in lines 1 to 3 of this table. The only departure from U.S. practice is inclusion of commercial banks' net foreign exchange. Item 1 is equal to the sum of items 1 and 2 of Table II. Item 2 is equal to the change from one year-end to the next of the sum of the two currency sub-items in Table II.

	Actual 1946	Estimated 1947	Projected 1948
		(In million pesos)	
Increase in:			
1. "Money of External Origin" plus "Central Bank Credit Money"	+74	+ 73	+150
2. Total currency outside banks[a/]	+ 5	+129	+150
3. Total bank reserves	+69	- 56	0

Year-end:	1945		1946		1947		1948	
Total bank reserves	301		370		314		314	
Net foreign exchange[b/]	168		191		134		111	
Peso cash	133		179		180		203	
(Reserve ratio)[c/]		(49%)		(41%)		(37.5%)		(35%)
Currency reserves[d/]	634		685		742		915	
Total foreign exchange reserves	802		876		876		1,026	
(Reserve ratio)[e/]		(106%)		(94%)		(80%)		(76%)

a/ Including Treasury deposits at a Central Bank when one is established.

b/ Including dollar currency notes. For end of 1945, partly estimated.

c/ Ratio of peso cash based on individual demand deposits plus deposits of public funds (two sub-items given in Table II). Official computations give slightly higher reserve ratios because public funds include some time deposits and because dollar currency notes are legal reserves.

d/ Approximate. Equals the sum of the two currency sub-items in Table II, plus banks' peso cash, minus total coins in circulation (arbitrarily assumed constant at 68 million pesos) -- i.e., thus far, total 100 per cent reserves against Treasury certificates and/or Central Bank note and deposit liabilities -- plus Exchange Standard Fund assets (including coins at bullion value) estimated approximately as 33 million pesos, plus (at end of 1945 and 1946) 50 million pesos of reserves still held then against currency lost or destroyed, and minus (at end of 1947 and 1948) 22.5 million pesos domestic currency subscription to the International Monetary Fund legally counted as reserve asset but not actually foreign exchange.

e/ Ratio of total foreign exchange reserves based on "Total Money Supply" (Table II).

BRITISH PAYMENTS AGREEMENTS AND STERLING AGREEMENTS SINCE AUGUST 20, 1947

Florence Jaffy

When on August 20, 1947, the United Kingdom terminated the automatic right granted to various foreign monetary authorities to exchange sterling into dollars, it was confronted with the task of revising the entire structure of its payments agreements,1/ insofar as these had been adjusted to fit the pattern of convertibility. During the past five months, Britain has been engaged in this effort, and also has reached new agreements with a few countries to which convertibility privileges never had been extended. Agreements also have been negotiated, or are in process of negotiation, with sterling area countries. These were not directly affected by the August 20 action, but some understanding must be reached as to the use of their accumulated sterling balances.

While the texts of some of these agreements have not been published and others have not yet become available, Tables I and II attempt to summarize the facts as far as they can now be ascertained.

Payments Agreements with Countries Outside the Sterling Area

Table I indicates the reported terms of payments agreements which the United Kingdom has reached with eleven countries outside of the sterling area since August 20, 1947. It will be seen that three countries (Belgium, Canada, and Portugal) have been removed from the list of Transferable Accounts, while five have remained on, or have been added to the list (Egypt, Iran, Siam, Sweden, and the U.S.S.R.). The agreement with Finland has not been published and its position in this respect is not known.

Countries which had Transferable Accounts as of July 15, 1947, but with which revised agreements have not yet been announced include Argentina, Brazil, Czechoslovakia, Ethiopia, Italy, Netherlands, Norway, Spain, and Uruguay.

The degree of freedom with which sterling in Transferable Accounts can be transferred beyond the sterling area at the present time is not always explicit in the published agreements. In principle, free transfer to the Transferable Accounts of other countries (not, of course, to American accounts) is granted only to a country which will itself accept sterling freely. The general pattern of the new agreements is to eliminate two clauses, both found in previous agreements, which barred restrictions on transfer of sterling to other Transferable Accounts, and which guaranteed free acceptance of sterling. Thus, the way is left open for a greater or lesser degree of restriction. This is especially true when, as in the cases of Belgium and Sweden, transfers of sterling to third countries are specifically made subject to further agreement between the contracting Governments. In this connection it is interesting to note that the provisions with respect to sterling receipts and payments are identical in the Swedish and Belgian agreements, although the former remains, and the latter is no longer, a Transferable Account country.

1/ See this Review, April 8, 1947.

A different formula is followed in the case of the Egyptian agreement, where the United Kingdom agrees specifically not to restrict the transfer of sterling for current payments to other Transferable Accounts. The release of £21 million to Egypt and the sale of about $4 million in gold against sterling will reduce its accumulated sterling balances, which are now in the neighborhood of £320-£350 million, by about £22 million. From the sum released, Egypt may draw in U.S. dollars the equivalent of £6.25 million ($25 million), which are in addition to its own dollar earnings. Egypt is specifically permitted to use sterling in payment for nitrates imported from Chile, for British oil sold in Egypt by American subsidiaries, and for oil equipment imported by the Anglo-Egyptian Oilfields and the Shell companies. To the extent that these payments involve conversion to dollars, they will come out of the stipulated dollar allotment.

There was a lag of two months between the completion and signing of the agreement with Belgium, presumably due to further discussions of its terms necessitated by the rapid accumulation of Belgian sterling up to the agreed ceiling of £27 million during September and October.

The special provision for reducing the amount of sterling in Portugal's current account is to avoid the need for gold payments by the United Kingdom. By the terms of a 1945 agreement, the proceeds of certain British exports were earmarked for the reduction of Britain's wartime debt to Portugal held in the form of blocked sterling balances. Later agreements set up a current sterling account, the ceiling for which was set at £5 million, beyond which payment was to be made by the United Kingdom in gold. At the time of negotiation of the present agreement the current account ceiling had been reached. While the present arrangement does nothing to alter the £5 million ceiling, in effect it redirects the British export proceeds so as to reduce the current account sterling balances, rather than the blocked balances as formerly.

The Bizonal Area of Germany, and Japan, are in a special category, due to U.S. participation in their governments. Although transferable account arrangements do not apply, sterling is convertible to dollars: The agreement with Japan sets up a sterling account with the Bank of England in the name of S.C.A.P., into which are paid all sterling proceeds of private trade with specified parts of the sterling area, and from which all sterling payments to these areas are made. The agreement is a six-month interim arrangement, at the end of which the net sterling balance of this account will be convertible to dollars. As of November 20, participants included the United Kingdom, its colonies, mandates, and protectorates, Australia, and New Zealand.

The Anglo-American agreement regarding the Bizonal Area of Germany sets up a #1 sterling account in the name of the Joint Foreign Exchange Agency, for trade between Bizonal Germany and the sterling area, with maximum credit and debit balances of £1.5 million. Conversion from sterling to dollars or vice versa is to be made to keep the balance within the stipulated limits. Furthermore, minimum balances of $20 million (or the sterling equivalent) are set for both the dollar accounts and sterling accounts other than the #1 account of the J.F.E.A. The United Kingdom recognizes a "continuing liability" to convert sterling from these amounts into dollars, so as to maintain the stipulated minimum balance in the dollar accounts of the J.F.E.A.

Table I

Countries with Payments Agreements Outside Sterling Area Negotiated by the United Kingdom since August 20, 1947

Country	Date of Agreement	Maximum Reciprocal Holdings	Settlement of Excess Balances	Sterling Transfer Provisions	Gold or Exchange Guarantee	Miscellaneous
Belgium	11-17-47	£12 million. Belgium to hold additional sum fixed provisionally at £15 million.	Gold. Belgium not to request conversion except as necessary for current transactions.	Payments for current transactions to third countries[a] subject to agreement of contracting governments. Belgian receipts of sterling from third countries may be restricted.	Reciprocal exchange guarantee covering up to £12 million.	Taken out of Transferable Accounts group as of 9-10-47.
Canada & Newfoundland	No formal agreement, but as of August 21, 1947, ceased to belong to Transferable Accounts group.					
Egypt	1-5-48	21 million pounds sterling released for current transactions, of which £6.25 million payable in dollars. Working balance raised from £12 million to £23 million.		Egypt remains in Transferable Account system. Payments to other Transferable Accounts unrestricted for current transactions.		United Kingdom to sell Egypt approximately $4 million gold against sterling to cover increased Fund and Bank quotas.
Finland	Sept. 1947	Terms have not been made public.				
Germany (Bizonal area)	12-17-47	£15 million in #1 sterling account of J.F.E.A.	Dollars.	All trade with sterling area to be in sterling. Unlimited convertibility to dollars whenever dollar balance of J.F.E.A. falls below $20 million. U.S. to limit conversions to $40 million in 1948.		

a/ "Third countries" as used in this table means countries outside the monetary areas of the signatories.

Table I (continued)

Country	Date of Agreement	Maximum Reciprocal Holdings	Settlement of Excess Balances	Sterling Transfer Provisions	Gold or Exchange Guarantee	Miscellaneous
Iran	9-30-47			Remains in Transferable Accounts system. Bank of England will approve transfers to American accounts for current payments for essential goods which cannot be obtained on equivalent terms against sterling.	Guarantee against depreciation of balances against gold.	
Japan (SCAP)	11-15-47		Dollars.	Sterling acceptable from private traders of, and freely payable to, specified parts of sterling area. Balance convertible to dollars at end of six months.		
Portugal	Nov.1947	£15 million ceiling of April 1946 agreement holds.	Gold. Proceeds of certain exports from United Kingdom to Portugal previously used to reduce old Portuguese balances, to be applied against current imports.	Withdraws from Transferable Accounts system.		
Siam	Oct.1947			Enters Transferable Accounts system.		
Sweden	11-24-47	Unlimited to 4-30-48; £8 million to 12-30-49; £15 million after 12-31-49, or after 12-31-48 if agreement terminated in 1948.	Gold.	Payments for current transactions to third countries subject to agreement between contracting governments. Swedish receipts of sterling from third countries may be restricted. Remains in Transferable Accounts system.	Reciprocal exchange guarantee covering current account balances.	Sterling in blocked account (£25 million) unchanged.

Table I (continued)

Country	Date of Agreement	Maximum Reciprocal Holdings	Settlement of Excess Balances	Sterling Transfer Provisions	Gold or Exchange Guarantee	Miscellaneous
U.S.S.R.	12-27-47			Enters Transferable Accounts system. Payments for current transactions permitted to such third countries as may be agreed. U.S.S.R. not to restrict acceptance of sterling for current payments from such third countries as may be agreed.		Repayment provisions on 1941 loan from United Kingdom: Interest reduced from 4 to ½%. Repayment period on one-half outstanding balances and on all new advances to extend over 12 years; repayment to begin 4 years from 5-1-47 in case of outstanding balances, and 4 years from date of new advances. Remainder of old balances to be repaid on original terms.

Table II
Agreements with Sterling Area Countries Since August 20, 1947

Country	Date of New Agreement	Hard Currency Releases	Further Provisions
Eire	11-4-1947	Not to exceed £14 million (over own dollar earnings) for nine-month period ending June 30, 1948.	
Iraq	11-17-1947	£5.3 million released for period from October 1, 1947, to June 30, 1948, for current payments to specified territories, of which not over £1 million to the Belgian monetary area, and £4.3 million to other specified areas. Figures inclusive of any Iraqi dollar earnings.	Specified territories include: (a) American account area, Portuguese and Belgian monetary areas; (b) Canada and Newfoundland; (c) Switzerland and Lichtenstein; (d) Argentina; (e) Sweden; (f) Japan.
South Africa	10-9-1947		South Africa is to cover its own hard currency requirements by selling gold to the United Kingdom in the equivalent of the net payments made by South African residents through the United Kingdom to countries outside the sterling area.

Agreements with Sterling Area Countries Since August 20, 1947

Of the three agreements negotiated (Table II), none provide for final disposition of accumulated sterling balances. Under their provisions Eire and Iraq will obtain hard currencies against sterling; South Africa, which has no accumulated sterling, will continue to acquire sterling and dollars against gold.1/

Eire may draw from its sterling balances a net sum of £14 million in equivalent hard currencies over and above its own dollar earnings. On the other hand, in the case of Iraq the figure stipulated is a ceiling on gross dollar payments: Iraq may draw hard currencies in an amount equal to the differences between its own receipts and maximum payments of £5.3 million ($21.2 million). The South African agreement is primarily a gold loan agreement, with payments provisions. Unlike the cases of Eire and Iraq, South Africa is required to pay gold for its net acquisitions of hard currencies from the United Kingdom.

It is understood that Iraq's accumulated sterling balances were in the neighborhood of £60 million in August 1947, and that those of Eire stood at approximately £400 million around the middle of 1947.

Conversations are now taking place in regard to India's sterling balances. The discussions will presumably concern sterling releases for a period beginning January 1948, since the last release covered the period from July 31 to December 31, 1947. The negotiations will also involve the distribution of the amount of sterling released between India and Pakistan.

1/ See this Review, December 30, 1947.

EUROPEAN MULTILATERAL CLEARING

Robert W. Bean

On January 15, the Bank for International Settlements announced that seven European countries and the French zone of Germany had participated in the first actual operations under the Agreement for Multilateral Monetary Compensation signed in Paris on November 18, 1947. "Although the first compensation was on a modest scale," according to the official statement, "it produced valuable experience for the conduct of future operations," which are to take place each month. This article reviews the history, the theoretical possibilities, and the practical difficulties of the present attempt to organize and put into operation a regular procedure for offsetting bilateral balances.

Organizational History

The effort to establish a European clearing system grew out of the Paris Conference of the Committee of European Economic Cooperation. At that conference the Benelux delegations proposed to the Financial Committee a system for reducing payments balances by offset operations, with the suggestion that a part of eventual dollar aid should be used to pay net, irreducible balances, and so permit a substantial enlargement of European trade. The Financial Committee recommended -- "assuming that the American aid will be available" -- adoption of the Benelux proposal, and suggested that a meeting of experts be held immediately in London to work out the technical details. Accordingly, representatives or observers from each of the sixteen CEEC countries and bizonal Germany, from the United States, and from the International Monetary Fund, attended a preliminary meeting in London during September 22-27. This meeting named itself the "Committee on Payments Agreements", and issued a report which was published in Volume II of the U.S. State Department's edition of the CEEC reports.

The Committee's report stated that

> "a number of the Governments ... desire that some part of American aid should take the form of dollars which can be used, first in making payments for goods supplied by one of the participating countries (including Western Germany) to another, and subsequently by the country which receives such payments to cover supplies from the American continent. ... It is not suggested that additional American aid should be granted, but that American aid should be so arranged that it will serve both purposes instead of one purpose only."

It was further stated that the drawing up of more detailed proposals as to the method of arranging American aid should be postponed until after the views of the U.S. Government had been expressed. In the meantime, and despite failure to obtain support for the project from the United Kingdom, the Benelux countries, France, and Italy declared themselves "ready immediately to examine the possibility of concluding an interim agreement" which would involve automatic offsets without provision for settlement of the remaining balances. All the participating governments agreed to exchange information as to the status of their payments-agreement balances as of the end of June and the end of August 1947.

The second meeting, which took place in Paris during October 15-25, was notable in several respects. It was attended by all the CEEC countries, except Ireland, and the U.S. Government sent observers. The International Monetary Fund, however, failed to respond to the invitation. On the first day of the meeting, a request was received from the Bank for International Settlements asking permission to send an observer, and this request was approved. (The Governor of the National Bank of Belgium, one of the countries originally sponsoring the plan, is also Chairman of the BIS Board of Directors.) Subsequently, the BIS was chosen to act as agent for administering the offset operations. The Bank thus obtained justification for its continuing existence as an operating institution.

Two sub-committees were formed, the first to consider the possibilities for offsets on the basis of the June 30 and August 31 figures, and to study the manner in which American aid might best be applied to this purpose; the second was charged with working out details of an interim agreement providing for automatic offsets among France, Italy, and the Benelux countries. The first sub-committee immediately ran upon the stumbling block that it still had no assurance that American aid would be forthcoming, no information as to its possible form, nor even knowledge of the United States' official attitude toward the scheme. Consequently, in the final report published by the Paris meeting, it was stated that "the Committee is of the opinion that the best way to advance study of the question is to seek the cooperation of expert American opinion," and that "the Committee would keenly appreciate any opportunity which might be found for bringing together American and European ideas on the subject."

The second sub-committee made more substantial progress: an Agreement for Multilateral Monetary Compensation was drafted and published together with a general report of the meeting. The report contained a table showing the status of payments-agreement balances at the end of June and of August, and included also a number of theoretical examples of the manner in which compensations might be effected on the basis of the June figures. On November 18 in Paris, the Governments of France, Italy, the Netherlands, and Belgium (acting also on behalf of Luxembourg) signed the Agreement.

Shortly after the Paris meeting, it was made clear to the Committee on Payments Agreements that the U.S. Government was sympathetic to the adoption of a multilateral clearing system, but that dollars could probably not be made available expressly for the purpose of settling net balances. Although the draft legislation later submitted to Congress provided for the use of dollars for purchases outside the United States, the amount which might be applied for intra-European payments remained indefinite, and there has been no basis for further discussion of the scheme by the Committee.

Progress continued, nonetheless, on the project for multilateral offsets not involving transfers of gold or dollars. Under authority of the new Agreement, the signatory governments held a clearing rehearsal at Basle during November 20-25. The meeting was attended also by Denmark, Norway, Sweden, and the United Kingdom, and these countries signified their adhesion in principle to the Agreement as occasional members. Greece, Switzerland, and the United States sent observers. Data were available showing the status of balances at the end of September and October, and experimental calculations were made of the possible compensations. The BIS was formally designated as agent for the operations, and the first actual offsets were scheduled for early January 1948. All the procedural details were worked out at this meeting. Finally, it was decided that the five permanent members to the Agreement should meet once again, this time to consider the possibilities for offsets involving, somewhere along the circuit, an increase in a balance or the appearance of a new balance.

Such a meeting was held in Brussels during December 18-22, but little progress was made in developing the technique for this type of offset, it being apparent that each case would involve individual bargaining. Instead, the meeting occupied itself chiefly with consideration of a precise, mathematical formula submitted by the Netherlands delegation, designed to secure the maximum reduction of balances. Opinions differed as to whether this approach should be used, or priority should be given to reducing "critical" balances, that is, balances which had reached or were near the credit ceilings. France, which has a number of critical debit balances, succeeded in obtaining approval of the latter technique.

With these thorough preparations made, the members were ready to make the first attempt. There assembled at Basle during January 8-14 the five permanent members to the Agreement, together with Norway, the United Kingdom, and the French zone of Germany as occasional members (the French zone and Greece having adhered to the Agreement on this basis after the November meeting at Basle). Two important occasional members--Denmark and Sweden--failed to attend, however, with the result that the initial operation had little chance of success. Practically every key circuit permitting substantial reduction of balances involved these countries; without their assent only minor amounts could be cleared.

In addition to these two, five other of the CEEC countries were not in attendance: Austria, Greece (an occasional member), Iceland, Ireland, and Turkey. Their absence or failure to join is probably explained, in all but one case, by a lack of opportunity to participate in any offsets, each country having either all credit or all debit balances in its bilateral accounts. Austria, however, has indicated that it would like to adhere to the Agreement, but "is not a free agent." Portugal, Switzerland, and bi-zonal Germany sent observers to the first operation. Switzerland's abstention from the Agreement so far is perhaps best accounted for by the fact that the Swiss franc is a convertible currency and credit balances held by other countries can be "cleared"; nonetheless, Switzerland has attended every meeting of the participants, and has cooperated by supplying information as to the status of its payments-agreement balances. It should be mentioned also that once again the U.S. Government sent observers, and that this time observers likewise were present from the International Monetary Fund and the International Bank for Reconstruction and Development. The Fund appears to have conferred its blessing on the project and to have acknowledged the new role of the BIS.

That "the first compensation was on a modest scale" appears to be a mild statement, although no figures have been, or are likely to be, published. It is too early, however, to decide whether or not the effort will be worth continuing. The time for making this decision will not come until it is known whether dollar aid can be used to broaden the scope of the clearing.

Theoretical Possibilities

It is not intended here to analyze at length the mechanics of using American financial assistance to support a European clearing system.1/ Provision is made in the draft ERP legislation for "off-shore" purchases, and the manner in which this might operate initially is described in a document submitted by the Department of State for the use of the Senate Foreign Relations Committee:2/

1/ For an early discussion of several means by which this might be done, see this Review, July 15, 1947.

2/ "Outline of European Recovery Program", December 19, 1947.

> "The Economic Cooperation Administration might ... find it feasible and desirable to buy with dollars from some of the participating countries part of the equipment and other commodities needed by some of the others. These purchases would permit the allocation of a portion of the total aid in a way which would facilitate the financing of essential trade among the participating countries. The use of ECA funds in this manner would not increase the cost to the United States since the dollars made available to one of the participating countries would be available for meeting that country's deficit with the Western Hemisphere.
>
> "At a later stage it may be possible for the ECA to integrate the off-shore purchase with a multilateral clearing mechanism for Europe."

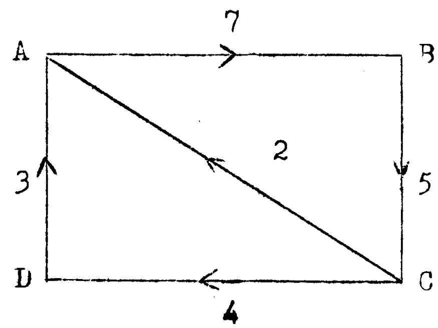
It is evident that off-shore purchases could be used to expand intra-European trade, and the objective should be to obtain the maximum expansion at minimum cost. This could be done if the use of dollars were preceded by a thorough clearing of bilateral balances. Failing this, a greater amount of dollars would be required to finance intra-European trade than would otherwise be the case. Application of dollar aid <u>in a particular manner</u> probably would serve as sufficient inducement to obtain the establishment of an effective multilateral clearing system. As will be seen, the ERP countries so far have been reluctant to commit themselves to a fully effective clearing mechanism.

The simplest system, and the one which would result in the maximum reduction of balances, would be a central clearing pool in which each country would have, after clearing, either a net debit or a net credit balance vis-a-vis the remainder of the group as a whole. The amount of gold or dollars which the net debtor countries would be obligated to transfer to the rest of the group might then be reduced by the amount of the credit margins which the net creditor countries had extended in their various bilateral payments agreements to all countries in the system. There are many possible modifications of this basic system. For example, in the technical note presented by the Benelux delegation to the CEEC, it was suggested that each net creditor country should be allocated a share in the claim against each net debtor country, and that the credit margin established in the payments agreement between each debtor and each creditor should govern the amount of the gold or dollar transfer obligation. Such modifications have certain relative advantages in one respect or another, but substantively the result remains very much the same.

The central pooling system was discussed at the Paris meeting in October, but rejected. There were strong resistances to abandoning bargaining positions made possible by the maintenance of direct debtor-creditor relationships. Instead of a central clearing pool, the delegates turned their attention to a system of clearing via circuits selected from the given pattern of bilateral balances.

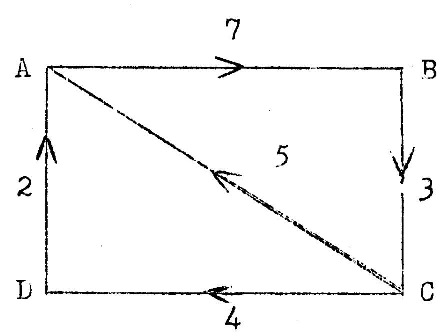
The maximum amount which can be cleared via a circuit system is very likely to be less than the amount which could be cleared via a central pooling of balances. One can construct a case in which the amount cleared would be the same under either system; this is illustrated in Figure A.

Figure A.



(Arrows indicate the direction of the debit balances, i.e., A has a debit balance of 7 with B.) If one calculates the net position of each country, as would be done by a central clearing system, the result is as follows: A has a net debit balance of 2; B, net credit of 2; C, net debit of 1; and D, net credit of 1. Before clearing, total balances in each direction amounted to 21; the amount cleared has been 18. The same result in this instance would be achieved via circuit clearing, if one proceeded first to clear the longer circuit (ABCD) by 3 on each side (amount cleared = 12), and then to clear the shorter circuit (ABC) by 2 (additional amount cleared = 6). Frequently, however, one will encounter cases in which the amount that can be cleared via the circuit system is smaller. This is illustrated in Figure B.

Figure B.



In this diagram, the amount cleared via a central pool would be 15 (total balances in either direction before clearing = 21; net balances in either direction after clearing = 6). But a maximum of only 11 could be cleared via the circuit system. The general rule governing these cases is that the amount cleared via a circuit system will always be less than the amount cleared via central pooling of balances if the initial clearing reduces the common denominator of another circuit subsequently to be cleared. This was not the case in Figure A, because the common denominator of the subsequent circuit, 2, was not affected by the initial clearing; in Figure B, however, the common denominator of the subsequent circuit was reduced by the initial clearing from 3 to 1. In addition, even when the initial clearing does not affect subsequent circuits, the result sometimes will be that circuit clearing does not by itself achieve the maximum reduction of balances, but ends in an "open" circuit which necessitates a series of direct bilateral transfers.

Abandonment of the central pool system, therefore, represented a step away from complete multilateralism. It also meant a loss of simplicity in the clearing operation. Use of the circuit system involves a choice among many alternative circuits, and one must determine the proper criterion for this choice. On the assumption that the greatest degree of multilateralism was to be sought, a Dutch mathematician (Dr. Ekker), as mentioned previously, devised a formula which would result in the maximum reduction of balances which might be obtained via the circuit system. Without attempting to duplicate his achievement, one may set forth the conditions which would need to be fulfilled in order that the maximum total offset be accomplished:

1. One should begin by constructing the longest possible circuit, i.e., the circuit including the largest number of balances.

2. If two or more circuits of equal length can be constructed, one should select that circuit which has the largest common denominator. This circuit should be cleared first.

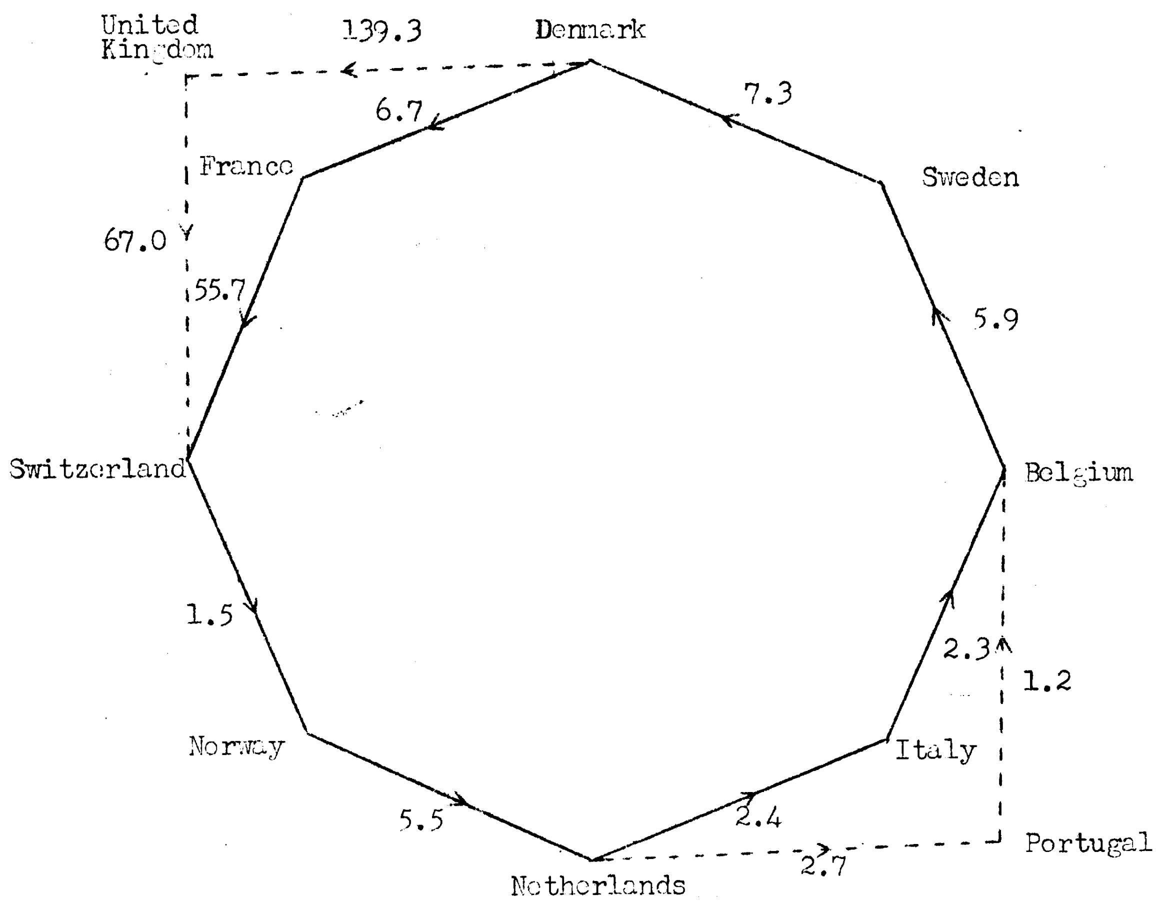
3. Each successive clearing should be carried out according to the same principle, i.e., utilizing the longest remaining circuit with the largest common denominator for circuits of that length.

These principles may be illustrated by referring again to Figure B. If, instead of beginning with the longer of the two possible circuits, one had first cleared the circuit ABC, the longer circuit would thereby have been broken; the total amount cleared would have been 9, instead of 11.

The problem of constructing the longest possible circuit when one is dealing with a large number of countries is fairly difficult. As an example one may use the figures for balances as of August 31, 1947. Five of the countries submitting data had all credit or all debit balances, and therefore could not be included in a closed circuit. Of the remaining ten countries, eight was the maximum number which could be included in a single circuit, but the other two could each be substituted for certain other countries within the circuit. Figure C depicts graphically four circuits of maximum length which could be constructed on the basis of the August 31 balances. Amounts are in millions of dollars.

The circuit including Portugal would permit a cancellation of only $1.2 million from each balance, whereas by omitting Portugal a common denominator of 1.5 million (Switzerland-Norway) could be applied. The choice is therefore simply between using France or the United Kingdom in the first clearing, and this choice is not affected by our principle.

Figure C.



After clearing one of these two alternative circuits, the next step would be selection of the longest remaining circuit, and so on. To illustrate in a single small diagram the complete procedure would be confusing, but such a diagram on a larger scale can be constructed and utilized.

So much for the methodology of achieving the maximum total reduction of balances via circuit clearing. It will be immediately obvious, however, that application of this procedure would encounter many resistances. There is particularly the objection, raised by France at the Brussels meeting, that critical balances might be left quite untouched by this method. It may therefore be necessary to modify our objective by adding another principle, viz., that priority should be given to clearing the longest circuits which can be constructed so as to include the most critical balances. But this is not a precise formulation of the principle, because it may be found preferable to achieve a greater reduction in a critical balance by confining the operation to a shorter circuit. It should be apparent, therefore, that the purely technical difficulties of selecting the appropriate method of circuit clearing are great.

Practical Difficulties

Quite apart from theoretical problems, there are important practical obstacles to establishment of a workable clearing system. Unless a large circle of countries can be persuaded to adhere to an automatic system, i.e., to permit a central agency to effect clearings on the basis of its own selections, then each operation will be handicapped by the hesitancy of members to approve offsets to which there are many, possibly more favorable, alternatives. Where balances have exceeded or neared the credit margins, the creditor country may be reluctant to surrender the possibility of receiving gold or dollars. Countries with debit balances may hope to secure an increase of the credit margins, and so be reluctant to have their own claims against other countries reduced. Seasonal or more fundamental swings in the direction of trade balances may be anticipated, so that a creditor country may wish to hedge against future requirements.

It is this type of consideration, presumably, which has led the United Kingdom, the Scandinavian countries, Greece, and the French zone of Germany to refrain from committing themselves except as occasional, i.e., wholly voluntary, participants. As a result of their abstention, the five permanent participants have declared that during the first six months of the Agreement they will accept automatic compensations only among themselves. In effect this has meant that no compensations will be automatic, because no possibilities have existed for offsets involving the permanent members except via circuits including occasional members.

A commitment to full automaticity on the part of all members would be the best means of ensuring that the system would work on a significant scale. It is probably true that clearing "on a modest scale" is better than none. Likewise it is true that opportunities for clearing which were not available at the time of the January offset may arise later. But a great advantage could be exploited if the principle of off-shore purchases were applied in a manner that would offer a strong inducement to participation in a fully automatic multilateral clearing system.