Report by Ernest Waters on the European Payments Union (1954)

Caption: In 1954, Ernest Waters, head of the Payments Division of the Organisation for European Economic Cooperation (OEEC), outlines the role and operation of the European Payments Union (EPU).

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The European Payments Union

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The European Payments Union is an institution which, within the framework of the O.E.E.C, has for three years and more provided the means for the financial settlement of all transactions, both on account of visible and of invisible trade, between all Member countries of the O.E.E.C. with one another and also with the overseas territories and the countries in monetary association with the O.E.E.C. countries — including in particular all the countries of the sterling area. The E.P.U., therefore, is the clearing house for a considerable proportion of world trade and settles probably some 50 per cent of the payments resulting therefrom.

To understand the purpose of the European Payments Union, it is necessary to recall the conditions prevailing at the end of the Second World War in the field of intra-European trade and payments. In nearly every European country the problems of reconstruction and industrial rehabilitation were accompanied by foreign payments difficulties. The value of the various European currencies was so uncertain and the need for goods of all sorts so great, that countries hesitated to grant substantial credits to one another or to accept any form of payment other than either essential commodities (of which there was a general scarcity) or of gold and dollars, although the dollar reserves of nearly all European countries were at a very low level. Most countries, therefore, resorted to bilateral agreements in an attempt to balance payments each with one another, and this meant necessarily the restriction of trade in both goods and services to the financial means of the weaker partner and allowed only for most modest credit margins.

As early as 1948 the O.E.E.C. endeavoured to give greater flexibility to this network of restrictive bilateral agreements and their accompanying quantitative restrictions on imports. In October 1948 the first Intra-European Payments and Compensations Agreement was signed covering the period up to June 1949, and in July 1949 a second Agreement was signed covering the period to the 30th June 1950. Both these Agreements provided that as a counterpart of a portion of the dollar aid received by them under the Marshall Plan, Member countries should grant credits to their European partners for amounts determined for each bilateral relationship. Thus, part of the dollars received under Marshall Aid served, so to speak, twice over; directly for the purchase of goods from the dollar area, and indirectly to finance credits between European countries and to help them to resume less restrictive financial and commercial relations. Moreover, both Agreements provided for the establishment of compensation systems between three or more Member countries, thus permitting of a partial offsetting of surpluses in one relation against deficits in another, and so reducing the bilateral balances requiring settlement and economising in the use of the credits set up under the Agreements.

However, the credits established under the first Agreement were strictly bilateral, and although the second Agreement marked a slight advance in that part of these credits were multilateralised and could thus be used to effect payments in favour of any Member country, in essence the two Agreements maintained the bilateral framework within which European trade and payments had been constricted since the end of the war.

By the end of 1949 it became possible to take the first step towards the gradual abolition of quantitative restrictions on imports between Member countries; but the freeing of trade was still hampered by balance of payments difficulties, particularly in relations between those countries with hard or relatively hard currencies and those whose currencies had remained soft. However, in 1950 a decrease in the European dollar deficit, together with a more general development of economic stability in Member countries (where, in many instances, production had regained pre-war levels) made new progress possible in the payments field through the establishment of a truly multilateral and far more flexible system, that is to say, the European Payments Union. Established on 1st July 1950 by an Agreement signed by all O.E.E.C. countries, the purpose of the Union was essentially to help its Members to proceed with the liberalisation of their trade on a non-discriminatory basis, and without regard to the relative hardness or softness of the currencies of Member countries.

The financial mechanism of the Union combines two basic principles: automatic multilateral compensation (or offsetting) and automatic credit. The first provides that the bilateral accounts of a Member country with each of the other Member countries are closed at the end of each month and the balances thus determined —

both surplus and deficit — are then added up so as to arrive at a net monthly balance of the country concerned in relation to all the other Member countries as a whole. Thus Member countries are no longer required to settle their debts and claims with each of their partners separately but merely to settle, monthly, a net debit or credit balance with the Union. They can, for example, without affecting their overall position in relation to the other Member countries, incur a continuous deficit with certain countries, provided that this deficit is offset by a continuous surplus with other countries.

The offsetting of bilateral surpluses and deficits referred to above takes place each month; in addition, the Union provides another form of automatic compensation through the operation of what is called the "cumulative principle". Under this system, the settlement of a country's net deficit in any month or months is automatically reversed if that country should subsequently develop net surpluses (and vice versa for net surpluses and subsequent deficits); so that a country's position in the Union at any given date is, in fact, its cumulative position over the whole period since the Union was started.

The automatic credit principle is based on a system of "quotas" — each Member country having a quota corresponding broadly to the importance of its share (including that of its overseas territories and associated monetary areas) in the total value of intra-European trade and payments. These quotas fix the amount of credit which each country can be called on automatically to grant or receive, and the net monthly balance of each country with the Union, provided it is within its quota, is settled by the granting or receipt of credit, or partly in credit and partly by the receipt or payment of gold or dollars. The amount of credit and gold thus required is fixed by the terms of the Agreement, the proportion of credit to gold varying according to a country's position in the Union and the extent to which it has used up its quota. When a country has completely exhausted its quota, it will have received or paid an overall amount of 40 per cent in gold and the balance of its cumulative position, 60 per cent, in the Union will have been settled in credit, but the experience of the Union over the last three years has shown that by far the larger part of transactions between Member countries is settled by the operation of the Union's compensation system. Thus, at the end of the first three years of the functioning of the Union, the sum of the monthly bilateral balances brought in for settlement totalled some $ 20,000 million and, of this very large total, about 75 per cent was settled through compensation mechanism and only the balance of 25 per cent by the granting of credits and by gold payments.

The accounts of the Union — reflecting the debt due to and by the Union as a result of the monthly settlements — are maintained in a special unit of account of a fixed gold value and which is at present equivalent of one U.S. dollar.

The Union's accounts are kept and the detailed monthly operations involved in the working of the Union are carried out by the Bank for International Settlements at Basle, acting as Agent for the O.E.E.C. The Central Banks of Member countries report to Basle at the end of each month the balances of their bilateral accounts with the other Member countries of the Union; the Agent then determines the compensations to be carried out and the amounts of credit and gold to be received or granted by individual countries vis-à-vis the Union; on a certain fixed date each month the Agent then instructs the Central Bank of each Member country to carry out certain operations, the effect of which is to cancel the bilateral claims and obligations that have been developing during the month and to replace these with a debt or a claim in the Union, coupled with the receipt or payment of a certain amount of gold.

Like all organisations receiving or granting credit, the Union can function only on the basis of a certain Working Capital Fund, both to ensure that the Union would always be in a position to meet its obligations and also to provide an additional measure of security for the credits granted to it by Member countries. When the Union was created, the U.S. Government put at its disposal a contribution of $ 350 million and it was this generous and constructive act that made possible the establishment of the Union.

Thus, the European Payments Union has for the last three years enabled Member countries to consider the problem of their balance of payments with other Member countries, and with their monetary areas, from a general rather than a bilateral standpoint. Thanks to the automatic credit facilities in the Union — and the operation of the "cumulative" principle under which current deficits are reversed by subsequent surpluses —

countries have moreover been able, at least within certain limits, to meet temporary deficits without seriously decreasing their gold or convertible currency reserves. The Union has on the whole fully justified the confidence placed in it by the Governments of all the countries concerned, though the development of world events have caused it to function in very different conditions from those for which it was conceived.

When the Agreement for the Establishment of the Union was drawn up, the economy of Member countries was close to equilibrium. Events in Korea, the violent price fluctuations which followed, the re-armament undertaken in most Member countries — to mention only a few factors — caused, as is well known, serious economic disequilibria in several countries, the consequences of which are still deeply felt in certain countries. The fact that the Union resisted the interior pressures caused by these developments is a proof of its flexibility and its strength.

The special efforts for co-operation and comprehension which were required from the interested parties, that is to say, the Governments of Member countries and of the United States, are perhaps the most far-reaching if not the most spectacular results achieved by the O.E.E.C. This co-operation found original expression in the Managing Board of the European Payments Union.

The Managing Board was created under the E.P.U. Agreement as a body which, under the authority of the Council of the O.E.E.C., is entrusted with the task of supervising the application of the Agreement and the management of the Union's Working Capital Fund. It is composed of seven members, nominated by the Council and chosen in their personal capacity as financial experts rather than as official representatives of their countries. A representative of the United States Government and the Chairman of the Intra-European Payments Committee of the O.E.E.C. attend meetings of the Board and participate in its discussions but not in its decisions. The Managing Board meets, as a general rule, once a month and its sessions last for about a week; between sessions a Committee of Alternates prepares the work of the regular members.

The Board is responsible not only for decisions concerning the execution of the operations of the Union and for the management of the Working Capital Fund; in addition, the Board is charged with studying the development of the financial position of Member countries, and where it considers the position of a Member is in danger of becoming critical or of impeding the normal functioning of the Union, the Board has the duty of making recommendations to the Council of the O.E.E.C.

Moreover, the mechanism of the Union provides, as stated above, for the automatic granting of credit only within the limits of each country's quota. When a country exceeds this limit or shows a tendency to "do so, that is to say, if it becomes temporarily or for a prolonged period an extreme creditor or debtor of the Union, it is the function of the Board to make proposals for the settlement of surpluses, in the Union in excess of creditor quotas, and also to submit recommendations for the granting of special credit facilities to a debtor country which is in temporary difficulties.

The Board's studies and proposals in this field are based on reports and on detailed examinations which take place, if necessary, with the help of experts from the countries concerned. This procedure constitutes a big step forward in the development of European co-operation; on the one hand Member Governments submit to an extremely detailed examination and furnish full information as to the economic and financial positions and policies of their country; on the other hand, such examinations often serve to bring to light repercussions which the policy being pursued in one country may be having on the position of one or several other Member countries. In the result, Member Governments may be called upon to accept recommendations of an international organisation concerning their internal financial and economic policies, and on concerted action to meet difficulties which may be common to all Member countries.

The European Payments Union has thus constituted an important stage on the road towards European co-operation and recovery. It was not, however, designed as a permanent institution; on the contrary, it was designed as, and remains essentially a transitional system intended, as is stressed in the E.P.U. Agreement itself, to facilitate a return to complete multilateralism in trade and to the general convertibility of currencies. When this goal has been achieved there will, in all probability, be no further need for a European Payments Union existing independently of such world-wide institutions as the International Monetary Fund.

In the meantime, the operation of the Union has in itself helped to bring about some degree of convertibility for the currencies of its Member countries. But this progress, substantial though it has been, is not enough. The Union was organised — inevitably — on a regional basis, and although the area served by the Union is indeed a very wide one, it does not include the vital dollar area. Thus in the long run the system can only work completely efficiently if all Member countries remain approximately in balance with each other over a reasonable period of time, and as soon as one or more countries tend towards a persistent creditor position within the region, whilst having a corresponding debtor position outside the area, difficulties must arise. This problem is inherent in any regional system, and indeed this is a position which is now showing clear signs of developing in the Union, where countries with large surpluses in the Union find themselves unable to use these surpluses to meet their deficits with countries that are not Members of the Union. The Rules of the Union are kept under constant study with a view to adapting them to the development of the world situation and the possibility of making progress towards its ultimate objectives; but in the long run, the only solution to this problem must lie in the general multilateralisation of trade and the convertibility of currencies, and the true measure of the ultimate success of the Union will be the speed with which it can render its further continuance unnecessary.