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THE
EXCHANGE CLEARING SYSTEM



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THE EXCHANGE CLEARING SYSTEM

BY
PAUL EINZIG

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1935

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TO
RICHARD
AGED FOUR
WHO MAY LIVE TO WITNESS
THE ADVENT OF A MORE
RATIONAL ECONOMIC SYSTEM

P R E F A C E

IN this book the author has endeavoured to find a compromise between the extreme orthodox and the extreme radical attitude towards international trade and finance. According to the orthodox school our salvation lies in the restoration of complete freedom in the international exchange of goods and in international transfers of funds. The attitude of these thinkers is based on the fact that the system of *laissez-faire* in international trade and finance worked satisfactorily before the war. They overlook the fundamental changes in the world's economic and financial system brought about since 1914 and do not realise that the system, which before the war contributed to the world's slow but steady progress, would in the changed conditions make for instability and would gravely handicap further progress.

The other extreme is represented by the radical school of isolationists who, while realising that the commercial and financial intercourse between nations cannot be stopped altogether, advocate its reduction to a bare minimum. Realising the disadvantages and dangers of anarchy in international finance and trade, they seek a remedy in the highest possible degree of economic isolation. They fail to realise that, in addition to the degree of international intercourse which is indispensable, an increase in the volume of foreign

trade and foreign financing is desirable from the point of view of the improvement of the standard of living.

Irreconcilable as these two conflicting points of view may appear, there is nevertheless a possibility of compromise. The ideal solution would provide some means of retaining and even of increasing the volume of international commercial and financial operations, while preventing them from disturbing internal and international equilibrium and from handicapping progress. This ideal solution is provided by the system of exchange clearing.

The object of this book is to show that, through the universal adoption of exchange clearing, mankind would be in a position to enjoy all the advantages of international trade and finance without having to endure their disadvantages. The author describes the system as it has operated in the past and as it operates in the present. He indicates the shortcomings of the existing arrangements and makes a series of suggestions for their improvement. His conclusion is that it is both possible and desirable to adopt exchange clearing all over the world as a permanent integral part of a planned economic system.

In advocating the universal adoption of exchange clearing the author feels that he cannot be accused of Utopianism. Although very little is known about the system in Great Britain, it is actually in operation in a by no means inconsiderable part of the Continent and in some parts of South America. There are at the time of writing seventy-seven bilateral exchange clearing agreements in operation. Notwithstanding the

criticisms directed against it, the exchange clearing system has rendered valuable services to the countries which have adopted it. The majority even of those who condemn the system have to admit grudgingly that in the existing circumstances its application is an indispensable emergency measure.

In the author's view, the exchange clearing system is much more than a mere makeshift and should be retained permanently. His views are shared by a small but growing number of theoretical and practical experts. His book on *Exchange Control*, which devoted two chapters to the theoretical and technical aspects of exchange clearing, met with a favourable response in quarters interested in the problem, but was criticised on the ground that it did not enter adequately into the details of the proposal of international clearing. In the present volume, an attempt has been made to repair this omission; the possibilities of the adoption of international clearing, the various alternative systems, the economic and technical problems associated with it and the consequences of its adoption, are discussed in detail.

The author is well aware that he, in common with other advocates of the exchange clearing system, has committed a tactical blunder in drawing attention to its possibilities as a permanent international system suitable to replace freedom and anarchy in the sphere of international trade and finance. Before attention was drawn to these possibilities, the adoption of the system was making good progress all over the world. Those who adopted it were blissfully oblivious to the

fact that they were inaugurating a new system of fundamental importance. While exchange clearing was criticised as one of the many restrictions on the freedom of transfers and trade, it continued to make progress, and until about the end of 1934 the number of exchange clearing agreements increased steadily. In drawing attention to the possibilities of adopting exchange clearing as a permanent institution, the author and others who share his views have, however, provoked a flood of violent attacks on the system. Indeed, exchange clearing has become Public Enemy Number One in the eyes of the orthodox school.

The Governments which had concluded exchange clearing agreements suddenly became scared just as the poor fisherman of the Arabian Nights became terrified of the expanding figure of the spirit he had released from its prison. Being anxious to avoid the appearance of wanting to inaugurate a new system instead of endeavouring to go back to the so-called "good old days", the Governments have concluded a kind of informal "Saint-Alliance" against the system. The result was the institution of an enquiry by the League of Nations, and in May, 1935, the Joint Committee appointed for the purpose published a report denouncing exchange clearing as the cause of most of our troubles and urging its early abolition. This report is subjected to much criticism in this volume for its glaring one-sidedness, its grave omissions, and its amazing contradictions, which, if duly realised, should go a long way towards discrediting its conclusions. To give a characteristic example of such

contradictions, on page 46 of the report we read that "clearing agreements *tend to eliminate or restrict* any impulse or movement towards increased trade between the two parties". On the other hand, we are told on page 49 that "clearing agreements *artificially stimulate* trade between the contracting parties". And it is of this report that the Second Committee of the League Assembly of September, 1935, declared that it "constitutes an instructive example of the services which can be rendered by the technical organisations of the League of Nations in the systematic study of present-day problems in order to enlighten public opinion".

If the present volume does nothing more than draw the attention of impartial readers to the misleading character of this report, the author will feel his work in the interest of the truth about exchange clearing has not been wasted. He fully realises that it would have been wiser tactics on his part and on the part of those who have advocated international exchange clearing to abstain for the time being from drawing attention to the broader implications and possibilities of the system. In doing so he may unwittingly have assumed part of the responsibility for a setback in its progressive adoption as a practical measure to combat the depression. It is, however, no use crying over spilt milk. The challenge to the orthodox school has aroused its violent opposition, and the attacks must be met. In this book the author endeavours to answer all important charges brought against exchange clearing by the League of Nations' Report or by other critics.

It is conceivable that as a result of the strong

opposition to exchange clearing and also of the unsatisfactory results produced by its abuse in certain cases, the adoption of the system will suffer a setback in the near future. There can be no doubt that, since *laissez-faire* dies hard, an attempt will be made once the present depression is overcome to revert to the former system of anarchy in international trade and finance. The author is convinced, however, that exchange clearing is the system of the future. If the world fails to learn this lesson from the present depression, it will sooner or later have to realise it as a result of a future depression.

P. E.

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CHAPTER I

INTRODUCTORY

BEYOND doubt, the Victorian prosperity of Great Britain was based to a very large extent upon the expansion of her foreign trade during the nineteenth century. The conquest of the world's markets by British manufactures yielded a large and growing income, first to those engaged in industrial production and export trade and later to those who held the foreign loans by which rising exports were financed. Eventually there followed an all-round increase of purchasing power. Thus the high standard of living in Great Britain was largely due on the one hand to the willingness of foreign countries to absorb the surplus of British manufactures, and on the other to the willingness of the City of London and the British investor to finance the foreign purchases of British goods.

In the circumstances it was only natural that both public and scientific opinion in Great Britain during the nineteenth century should have been strongly in favour of internationalism in trade and finance. British economic thought, which incontestably held the lead in the world's economic literature, was fundamentally "free-trader" in its conception. In accordance with the materialistic conception of history, the opinion of the nation was guided by its material interests which, throughout the pre-war period, were best served by an increasing internationalisation of

trade and finance through the application of *laissez-faire* principles.

It is all the more surprising, then, that after the war a movement against this internationalisation should have developed in Great Britain. In other countries the controversy between free-traders and protectionists was proceeding more or less on pre-war lines. The conception that it is an advantage to export as much as possible and to import as little as possible remained supreme all over the world. It was only in Great Britain that the necessity of importing in order to be able to export was duly realised. There were signs, however, even before the crisis, of the development of that school of thought which favours a reduction of both imports and exports to a bare minimum. This school of thought differs from that of economic nationalism which, while aiming at reducing imports at all costs, endeavours at the same time to maintain and even to increase exports. It introduced a new conception of, and a new attitude towards, international trade. Simultaneously, the advisability of free lending abroad was also called in question. At first it was suggested that borrowers should be made to spend the proceeds of their loans in Great Britain—a suggestion which horrified the liberal school whose teachings declared that there was no need for such restrictions since the proceeds of loans would in the long run be spent on British goods in any case. The radical school, however, went even further and began to urge both a deliberate reduction of lending abroad and a reduction of foreign trade. Needless to say, before the crisis this school of thought made but little progress. Commercial and financial internationalism had its roots too deep in

British public opinion to be eradicated at short notice. Great Britain still possessed those basic industries whose prosperity depended almost exclusively upon foreign markets. She was still the largest creditor country, with huge receipts from overseas investments, necessitating a liberal attitude towards imports. She still possessed that unique organisation, the City of London, which to a very large extent lived on international trade and international finance. It is easily understandable that Great Britain should have been reluctant to adopt the teachings of a school of thought which was opposed to internationalism in trade and finance. And yet the very fact that such a school of thought did arise and that its adherents included such a clear thinker as Mr J. M. Keynes duly indicated the change in the situation of the country. Before the war the mere postulation of the idea of aiming deliberately at a reduction of international trade and international lending would have been unthinkable. Although the idea met with the utmost opposition even after the war, the fact that it succeeded in securing a foothold at all is sufficient indication of the changing conception in Great Britain.

What was the explanation of this change? Was it due simply to the fact that a thinker of critical and unconventional mind happened to have arisen, or was it due to a fundamental change in economic background? To answer this question it is necessary to examine the conditions which made possible the spectacular expansion of international trade and finance during the nineteenth century, and until 1914. As we shall see in the next chapter, that period was characterised by a high degree of political and financial stability and by a gradual evolution. There were

practically no major political upheavals between 1815 and 1914. Such minor wars and revolutions as occurred from time to time in Europe or other continents were not sufficient to affect the world's economic and financial position to any high degree. In the economic sphere, development was on the whole gradual. Although it was interrupted by periodic crises, these were not of sufficient extent to affect fundamental stability. Thanks to the gradual character of the progress, fundamental disequilibrium did not arise. Price levels in various countries were more or less at an equilibrium with one another. The gold standard functioned normally. There was, generally speaking, no difficulty in meeting the trade deficit of most countries by means of borrowing abroad. The expansion of fictitious wealth kept pace with the increase of real wealth. The expansion of the international interchange of goods was accompanied by a more or less corresponding expansion of international financial facilities. It is true that there was an accumulation of international indebtedness, but its growth was not over-rapid and it was accompanied by an expansion in the volume of foreign trade which enabled honest debtors to meet their liabilities.

This state of affairs, which in many ways approached closer to the ideal than has any period in modern economic history, came to an abrupt end as a result of the war. The world inherited from the war a state of disequilibrium which made it impossible to return to pre-war conditions after the cessation of hostilities. Political conditions themselves were not as stable as before the war. There were internal upheavals in many countries and the international political horizon remained far from clear of stormclouds. The disequili-

brium between fictitious wealth and real wealth, the discrepancies between the price-levels in various countries, the maldistribution of gold, the increase of international indebtedness unaccompanied by a corresponding expansion in international trade, the fluctuation of international lending—all these were bound to lead to serious disturbances in the economic and financial sphere.

It is true that the world made an attempt to pretend that no change had occurred. The gold standard was restored in most civilised countries. Notwithstanding the increase of economic nationalism, international trade was allowed a high degree of freedom and so was international finance. It was taken for granted that, because before the war this freedom served the best interests of mankind, it would have the same effect in the post-war period. Few people realised that what was the pre-war world's meat was to be the post-war world's poison.

Those who in the light of the experience of the last decade have come to the conclusion that an excessive degree of economic freedom is detrimental to the interests of mankind, are inclined to look down upon the pre-war generation which did not realise the advantages of planning and Government intervention. In reality, the high degree of economic freedom that existed before 1914 suited the pre-war conditions remarkably well. It was only amidst the changed conditions that economic freedom ceased to produce the desired effect. The disequilibrium inherited from the war was too profound and the disturbing factors were too strong to permit of readjustment through the automatic working of factors brought forth by the economic system of *laissez-faire*. Many of those who

have recognised the change in conditions, and the consequent necessity of changing the system, are naturally inclined to be critical towards the orthodox school which fails to realise the need for change. They themselves, however, are no less narrow-minded than their orthodox opponents if they fail to realise that the system of economic freedom was just as closely in accordance with pre-war requirements as the system of intervention and planning is in accordance with post-war requirements.

Prior to the crisis, the number of those who became aware of the change was negligible. Most economists, statesmen, and bankers believed that the world could and should resume just where it left off in August 1914. The result of this belief was that the existing disequilibrium was allowed to increase, and in various directions new disequilibria were allowed to develop. The inevitable consequence was the boom. And the consequences of that were the Wall Street crash, the slump in commodities, the financial crisis of 1931, and the deflationary depression whose end, after six years, is not yet in sight.

Although innumerable factors were responsible for the crisis, the immediate cause of the breakdown was the international disequilibrium. We shall see in Chapter III. how the disorganisation of the pre-war relationship between debtors and creditors made it impossible for the increasing international indebtedness to be settled in the form of goods, and how the tendency towards industrialisation in formerly agricultural countries added to the difficulties. We shall see how the fact that Great Britain lost her lead in the sphere of international trade and finance affected the whole world's position. We shall see that it was impossible

to expect a restoration of equilibrium through the working of free trade and free finance. According to the liberal school, the main cause of the difficulties that led to the collapse of 1929-1931 was inadequate freedom. We shall try to show that the difficulty was not too little freedom but too much of it.

The first breakdown occurred in that most sensitive section of the economic system, the machinery of international finance. Before long it spread over the sphere of international trade. The effects of the financial crisis were a further increase of economic nationalism; restrictions upon international payments in consequence of the depletion of international resources in many countries; suspension of international lending and a tendency towards economic and monetary isolation. New barriers to international trade were raised in the form of exchange restrictions, quotas, higher tariffs, etc. The volume of foreign trade inevitably declined, for to all these obstacles there was added the increased risk in selling to financially weak countries. These countries were no longer in a position either to pay their debts or to continue to import freely as previously they had done, in the hope that some other country might take their goods and thus enable them to pay for their imports. Their gold and foreign exchange reserves declined to a dangerously low level, and it seemed that the conditions prevailing in Central Europe during the early post-war years, when some countries were unable to feed their populations, might well recur.

It was at this stage, when in many directions a complete deadlock was threatening international trade, that a new system made its appearance. This system—that of exchange clearing—made it possible

for countries which had no foreign exchange available for their imports, to continue, nevertheless, to buy abroad. It enabled them to pay for their imports and to maintain at least a reduced volume of foreign trade. The new system was anything but popular. It was treated as one of the many new restrictions, and was considered merely as a necessary evil in the countries which applied it. In those which kept aloof, it was viewed with undisguised hostility, for these countries felt that most of the advantages obtained by those who applied it were gained at their expense. Nevertheless, the circumstances prevailing in 1931, which will be described in Chapter IV., were such as to make the application of the system highly desirable in a number of countries. And as we shall see in Chapter VI. and subsequent chapters, notwithstanding its unpopularity the system made rapid progress all over Europe and also in other continents.

It is the author's contention that the world in general and Europe in particular owes a great deal to the system of exchange clearing. Together with the system of compensations it has gone a long way to mitigate the evil effects of the crisis in the countries which were hardest hit. It is also the author's contention that, despite its disadvantages, the system, if adopted universally, could be made to work highly efficiently, to the benefit of all parties concerned.

A large part of this book is devoted to discussing the problem of exchange clearing and compensation. The development of the system, the manner of its operation in various countries, the difficulties which it has encountered and the way these difficulties have been met are discussed in detail. The author is not blind to the shortcomings of the system; but he believes that

they can be overcome, and that a universal application of the system would provide that solution which in the changed conditions we cannot expect to find under a régime of relatively free trade and finance. Owing to the unpopularity of the system, it is highly probable that as soon as conditions have improved sufficiently to enable the Governments to dispense with it they will do so without hesitation. At the same time, the author is convinced that exchange clearing is the system of the future and that, if it is abandoned, sooner or later another crisis of first-rate magnitude will compel the world to adopt it.

The difficulties in the sphere of international trade and finance since 1931 resulted in the increase of the number of those favouring commercial and financial isolation. Their case has been strengthened considerably by the progress of internal trade in the majority of countries since the restrictions on international trade were introduced. In Great Britain, for instance, in spite of the contraction of export trade which is considered indispensable to the prosperity of the country, the index of production actually shows an increase compared with the boom years. Several other countries with depreciated currencies have had a similar experience, and this has led to the conclusion that foreign trade is not, after all, as vital as liberal economists would like us to believe. The latter would cheerfully sacrifice £10 millions of home trade for the sake of the vague hope of gaining £1 million of foreign trade. Apparently they prefer one bird in the bush to ten in the hand.

It is a commonplace repeated to boredom that there can be no real prosperity through home trade alone, since it merely consists of taking in each other's wash-

ing; that home trade can barely provide bread and butter—anything beyond that can be obtained only through foreign trade. The author does not agree with this conception. In his opinion, £1 million of foreign trade is worth not more but in one sense less than the same amount of home trade, because it is less steady and less dependable. While those engaged in producing for home consumption are only exposed to the caprice of the market, those working for foreign consumption are exposed to the same risk plus the risks arising from a change in the policy of the Governments of foreign countries. On the other hand, a certain amount of foreign trade is indispensable, since no country is or can ever be entirely self-sufficient. It is also beyond doubt that an increase of foreign trade over and above this minimum is desirable so long as it is not achieved at the expense of home trade, so long as the welfare of the country is not made dependent upon it on too large a scale, and so long as it is regulated in such a way as to prevent it from interfering with stability. From this latter point of view, the system of exchange clearing and compensation is of particular significance.

The conflict of interests between home and foreign trade assumes a rather more than academic interest in connection with the problem of monetary stabilisation. The main argument in favour of an early stabilisation of sterling and other currencies is that it would make possible an increase in the volume of international trade. Even those who are in favour of immediate stabilisation admit that this result can be achieved only at the cost of a deflationary monetary policy which would inevitably react unfavourably upon home trade.

This leads to a more fundamental question. Simul-

taneously with the development of a school favouring home trade against foreign trade, the monetary school of expansionists has also made considerable progress. In fact, the adherents of the two schools are to a very large extent identical. Those in favour of giving preference to home trade want to expand production and purchasing power in the home market, and hope by such means to solve the problem of "poverty amidst plenty". The chief obstacle to that policy is the effect of monetary expansion on export trade and on monetary stability. If the policy of expansion leads to a rise in the internal price-level, or even if it prevents a fall which would otherwise take place in accordance with the tendency of the world level of prices, then the result is a fall in exports. Those engaged in export trade will then pay the price of the prosperity of those engaged in home trade. According to the isolationists, it is to the interest of the community as a whole that, if it is inevitable that foreign trade should suffer through the expansion of home trade, the number of those who suffer should be kept as low as possible. This they claim to be able to achieve by discouraging foreign trade. From a monetary point of view, internal expansion might lead to a falling tendency in the exchange value of the national currency. Under the gold standard this would ordinarily necessitate a contraction of credit, and this again would be followed by a decline of productive activity. Those in favour of expanding home trade are, therefore, inclined to oppose the return to the gold standard.

The experience of the last few years has proved that the absorbing capacity of the home market is larger than the orthodox school would have liked us to believe. The frequently mentioned "saturation point"

which is held up as a bogey to frighten isolationists has not yet been reached, and, indeed, there is no reason whatsoever why it should ever be reached, provided that planning prevents the development of over-production in individual commodities. It is beyond doubt that the policy of isolationism provides better opportunities for the utilisation of technical progress to improve the standard of living. Nothing the adherents of *laissez-faire* can possibly hold out is sufficient to outweigh the advantages of increased planned production independent of the caprices of the world market.

At the same time, it is a mistake to underrate the importance of international trade as a factor in the welfare of mankind. As we have already pointed out, it is necessary for every country to import certain commodities. From the point of view of the improvement of the standard of living, it is desirable that foreign trade should go far beyond this indispensable minimum. If, while developing home trade to the utmost limit of technical possibilities, it were possible at the same time to retain a large volume of foreign trade, and even to increase it, this would undoubtedly be the ideal solution. Under the orthodox system of international finance and trade this solution would evidently be unattainable. To return to the old system in the changed conditions would be to perpetuate instability and to impose a severe handicap upon the expansion of home trade. Given the prevailing temper of public opinion, this would lead in the long run to the adoption of an extreme isolationist policy in the interests of home trade.

The right solution lies in the adoption of exchange clearing and compensation as a basis for international

commercial and financial intercourse. With the aid of this system it would be possible to maintain and even to increase foreign trade and yet to devote the energies of a country to the full development of its home trade without exposing it to the disturbing influences of the repercussions of that policy upon foreign trade and currency.

CHAPTER II

THE LIBERAL SYSTEM

IN the light of post-war difficulties we are tempted to believe that the decades that preceded the war had attained the ideal. A comparison between the stability of economic and financial conditions that existed before the war and the perturbed state of things we have been experiencing during the past two decades leads easily to the conclusion that pre-war days are for us a paradise lost. Those who have a recollection of pre-war conditions—as the majority of those holding responsible positions doubtless still have—cannot help longing for their return whenever confronted with one or other of our present-day troubles. Even those classes whose standard of living has risen since pre-war days are inclined to forget that pre-war stability meant for them a perpetual barrier against their rise above subsistence level. All they can remember is that prices, wages, and employment were relatively stable. After the harassing uncertainty of the last few years, many of them would be glad to sacrifice prospects of progress for the sake of a return to pre-war stability.

It is to this desire of the public to regain the paradise of pre-war conditions that the orthodox school owes the relatively strong support it still enjoys. It has but to promise that pre-war stability will return if its advice is followed, and it is sure to retain the support of a dwindling but still considerable section of public

opinion. Even those who are capable of realising that conditions have changed too much to make it possible to apply the pre-war system of economic freedom with satisfactory results continue to feel drawn towards economic liberalism for sentimental reasons. The temptation to favour a return to pre-war conditions of stability is difficult to resist.

It may well be asked, however, whether by reverting to *laissez-faire* it would be possible to restore the conditions that existed before 1914. The answer of the liberal school is emphatically in the affirmative. According to its thesis, all that the Governments have to do is to restore the freedom of trade and finance that existed before the war, when pre-war conditions will automatically return. If this were true, the Governments could not be excused for delaying another day in taking these steps. But can we accept the predictions of the orthodox school? Most of its adherents in their dogmatism would prefer to see perpetual poverty and even a collapse of civilisation on the basis of economic freedom rather than prosperity and progress at the cost of the curtailment of that freedom. It would be an unquestionably risky experiment to follow their advice. A return to a régime of freedom would involve substantial sacrifices, painful readjustment, and the grave disturbances which inevitably accompany any sudden change. Is there any reason to believe that the result would outweigh these disadvantages? To answer this question it is necessary to examine the conditions in which freedom of trade and finance operated successfully before the war. We have to ascertain whether this freedom was the cause of the pre-war prosperity and stability, as the orthodox school would like us to believe, or whether it was itself the effect of the factors

responsible for prosperity and stability.

In the first place, let us glance at the political background. The hundred years between the end of the Napoleonic Wars and the beginning of the World War were characterised by a degree of political stability that was without precedent since *Pax Romana* came to an end through the decline of the Roman Empire. From an economic point of view the wars that were fought between 1815 and 1914 were relatively unimportant since they did not strain to the utmost the resources of the nations engaged in them, and did not materially disturb the world's economic structure. While the Napoleonic Wars produced profound economic and financial effects in Europe, the subsequent wars of the century produced only local and passing effects in the economic and financial sphere. The revolutions and civil wars that occurred were not such as to cause fundamental economic disturbances outside the countries directly concerned. In a word, the shocks administered to the economic system by the political factor were relatively unimportant. The automatic working of the system of *laissez-faire* was not disturbed by major political troubles.

From an economic point of view the world experienced steady progress. The pace at which trade and finance expanded was comparatively even. The exploitation of natural resources, the construction of modern ways of communication and technical progress were comparatively gradual. Professor Alfred Marshall was fully justified on the basis of pre-war experience in adopting the saying "*Natura non facit saltum*" as the motto of his *Principles of Economics*. It is true that an important part of the so-called industrial revolution occurred during the nineteenth century,

and that while it lasted it caused dislocations that are inevitably associated with progress under a system of economic freedom. By the middle of the nineteenth century, however, this industrial revolution was over, as far as Great Britain was concerned, and the spread of its achievements over the Continental countries was a gradual process which caused relatively little economic dislocation.

Even the industrial revolution itself did not cause dislocations nearly as violent as would have been caused had it taken place in a world with a more highly developed financial superstructure. It is true that it deprived large sections of the community of their livelihood, thus causing a maldistribution of purchasing power—the creation of big fortunes went on side by side with the ruin of large numbers of firms and individuals. The effect of such dislocations was, however, tempered by the fact that the financial organisation was comparatively undeveloped. It is the exaggeration of the effect of such a crisis, as a result of an involved and over-developed financial system, that increases the resultant losses nowadays. During the nineteenth century the world was largely spared the effect of such factors.

Moreover, although the progress was strikingly uneven as between various countries, this did not lead to international difficulties. The country which made the most rapid progress was Great Britain, and she knew how to handle the benefit she derived from her lead without allowing it to become a source of *embarras de richesse*. In all probability a series of export surpluses such as Great Britain secured during the greater part of the nineteenth century would have led to grave international crises had it been secured by

a country unwilling or unable to finance the trade deficits of other countries. Fortunately for the world, Great Britain possessed both the willingness and the technical ability to re-lend the surplus she gathered. At the same time, she was quite willing to accept payment from her debtors in the form of goods. When Germany was becoming industrialised towards the end of the nineteenth century, she was prepared to follow the British example in re-lending her surplus. Indeed, in her case, lending to a large extent preceded the creation of an export surplus. Among the countries which underwent a process of industrialisation during the late nineteenth century, Belgium, France and Germany were equally prepared to lend their relatively moderate surpluses abroad.

The nineteenth century—or, to be correct, the period between 1815 and 1914—was characterised by a relative equilibrium. Generally speaking, additional fictitious wealth was created only in proportion to the increase of real wealth in the form of railways, industrial plants, ships, etc. Possibly there was a slight increase in the ratio of fictitious to real wealth through unproductive expenditure on the development of modern armament. To that extent fictitious wealth increased more rapidly than real wealth. The discrepancy was not, however, too large and developed so gradually as to be imperceptible.

A high degree of equilibrium prevailed also between the price-levels of various countries. There appeared to be no indication of any marked discrepancy between prices in leading countries. Allowing for the cost of transport and customs tariffs, it may be said that the price-level was more or less the same throughout the civilised world. Changes in the value of im-

portant currencies which would have disturbed this equilibrium were few and far between after the liquidation of the legacy of the Napoleonic Wars. It is true that the depreciation and devaluation of Latin American currencies was a frequent occurrence, but these currencies were not at that time of sufficient importance in international trade for their oscillations to cause any serious disturbances.

There was relative equilibrium also between the development of international trade and that of international transfers. This was largely the result of London's functioning as the world's banker. Together with the minor lending centres, London was prepared to finance for short term or for long term the import surplus of relatively undeveloped countries. The expansion of international trade did not, therefore, lead to transfer difficulties. Nor was there any such sudden change in international indebtedness as that produced by the war of 1914-1918, which would have caused a sharp discrepancy between international trade and international transfers. The biggest disturbing influence in that respect was the French indemnity paid to Germany in 1871. Its absolute figure and its relative importance bear no comparison, however, with the reparation claims and inter-Allied debts inherited from the war of 1914-1918. From time to time, the flow of European capital into newly discovered gold-fields or towards a rapidly expanding overseas country led to some slight dislocation between international trade and international transfers, but this dislocation was always moderate in extent.

The adoption of the gold standard during the last three decades of the nineteenth century by the greater part of the civilised world was a gradual process. For

this reason, and owing also to the fact that it largely coincided with new important gold discoveries, it did not lead to a scramble for gold such as was experienced during the return to the gold standard after the war. Once adopted, the gold standard generally functioned normally in most countries. It provided the corrective for those dislocations which inevitably arose from time to time. Had these dislocations assumed the gigantic dimensions of those we have encountered since the war, the gold standard would inevitably have broken down in the nineteenth century. As it was, however, the system proved eminently suitable as a means of smoothing the only minor disturbances which arose. It helped to maintain the international price-level and the equilibrium between international transfers and international trade. The stability of exchanges it created encouraged both exports and imports. It also encouraged the conclusion of those long-term engineering contracts which played such an important part in the development of backward countries during the century. Above all, it encouraged international lending on a large scale.

While in most countries international trade was to some extent hampered by tariffs, there was little or no handicap to international lending. It is true that Paris and Berlin, the second and third largest lending centres before 1914, were largely guided by political considerations. As, however, London lent freely, and as she was by far the largest lending centre, it may be said that international financing before the war was based on the principle of freedom. It is true that this freedom led in many instances to the accumulation of excessive indebtedness, but the accumulation was moderated by occasional defaults on the part of some

debtors who had over-borrowed. Their default was due not to world causes or to any fundamental defects of the system, but almost invariably to budgetary difficulties due to causes peculiar to the borrowers. Usually, too, only one country defaulted at a time, so that the disturbances caused were not extensive.

The world has gradually become divided into two categories, into creditor nations and debtor nations. With the exception of France, which until the war was largely agricultural, creditor nations were more or less highly industrialised, while debtor nations were mainly raw material producers. The latter had no particular desire to develop suddenly into industrial nations, even though they sought gradually to increase their industrial production, and to that end granted protection to certain branches of home industries. Generally, however, they were prepared to accept the manufactures of the more advanced industrial countries in exchange for their own primary products. Moreover, such industries as developed in the primitive countries before the war, under the protection of customs duties, catered almost exclusively for local requirements. The quality of the goods they produced was usually too inferior to compete abroad with the manufactures of more experienced producers, and, as a rule, their price was not competitive, except under the protection of the tariff wall. In consequence, the countries with a low standard of living and a low level of wages did not appear as competitors of countries with a high standard of living and relatively high wages.

Although industrial technique was far from stationary during the last decades of the nineteenth century and the first decade of the twentieth century, its pro-

gress bore no comparison with that experienced during either the industrial revolution or after the war. The danger that the relative competitive capacity of a country might be upset by some important invention or by the adoption of more rational methods in some other country was not great. The progress in the industrialised countries was largely uniform.

Another reason why it was possible to maintain a system of relative freedom in international trade was that the wage-structure was comparatively elastic. Consequently, the producers of any given country were in a position to cut their costs if faced with foreign competition. In the absence of rigid trade unionism, backed up by the political influence of the working classes, it was possible to pass the greater part of the burden of foreign competition to the shoulders of the workers.

To summarise the argument, it may be said that the economic liberalism of the nineteenth century had its foundation in the political, economic, and financial stability that prevailed; in the equilibria between fictitious wealth and real wealth, between price-levels in various countries and between the volume of international trade and that of international transfers; in the absence of sudden jumps and shocks in the evolution of the economic and financial system; in the absence of an over-complicated financial superstructure; in the fact that international stability depended largely on Great Britain; in the gradual character of industrial progress; in the absence of competition from countries with a low standard of living; and in the greater elasticity of wages and costs. In such conditions it was safe for a country both to allow its trade balance to take care of itself and to

abstain from interference with free international movements of its funds.

Possibly some of the factors enumerated above were themselves to some extent the consequences, and not the causes, of the relative freedom in international trade and finance. In general, however, there can be no doubt about which set is the cause and which the effect. If, for some obscure reason, the world had introduced in the 'nineties all the restrictions on international trade and finance which were to be introduced forty years later, that in itself would not have upset international stability. Nor would it have disturbed the equilibrium, internal or international. The dislocations thus caused would not have interfered with the gradual character of progress, neither would London's successful leadership in international finance have suffered materially. Lastly, the imposition of such restrictions would not have affected the internal elasticity of wages and costs. Admittedly, the development of some of the factors which made free trade and free finance possible may to some extent have been assisted by the existence of this freedom, but to an overwhelming degree the latter was made possible by the existence of the set of factors discussed above. It was their subsequent disappearance that deprived *laissez-faire* of its *raison d'être*.

CHAPTER III

THE BREAKDOWN OF LAISSEZ-FAIRE

WITH the outbreak of the war in 1914, the period of freedom in international trade and finance came to an abrupt end. It was inevitable that, in the interests of national defence, all belligerent countries should have imposed restrictions upon the free movements of goods and the free transfer of funds. Even neutral countries were unable to maintain complete freedom. The restrictions to which the public submitted without protest were considered the inevitable result of the war. They were regarded as essentially war-time institutions, and it was taken for granted that they would be removed immediately the hostilities were over.

If the war of 1914 had not far exceeded the dimensions of any of the wars between 1815 and 1914, doubtless the termination of hostilities would have soon been followed by a return to pre-war freedom. In reality, the war brought about changes in the world's economic structure so fundamental as to rule out the possibility of restoring *laissez-faire* in international finance and trade. In its economic and financial consequences the war unsettled and changed the whole set of circumstances upon which the pre-war freedom had rested.

Throughout the four and a half years of the war, Europe was a heavy buyer of commodities from the other continents without being able to pay for more than a fraction of her purchases in the form of ex-

ports. Europe had not only to increase her purchases of raw material and food, but had also to resort to buying overseas huge quantities of war materials. The result was a revolutionary change in the state of international indebtedness. Europe ceased to lend abroad; in fact she had to liquidate a large part of her earlier claims and, in addition, had to contract an international indebtedness running into milliards of pounds. Simultaneously with this, the progress of industrialisation in the other continents increased the difficulties, to Europe, of repaying the debt contracted during the war.

While the international indebtedness contracted during the nineteenth century had been largely of a productive nature, the proceeds of the loans contracted during the war were used for the most unproductive of all purposes. The indebtedness contracted internally by the belligerent countries met with a similar fate. The result was on balance an increase in fictitious wealth which was not accompanied by a corresponding increase in the value of real wealth. A state of disequilibrium developed. It might have been remedied by allowing commodity prices to rise to a sufficiently high level, but owing to the deflationary monetary policy pursued by the leading countries this rise was not possible. The value of the leading currencies was raised to its pre-war level and the disequilibrium was perpetuated. The result was a lack of stability which in itself ruled out the possibility of operating the pre-war liberal system.

In addition to this fundamental disequilibrium, there were also discrepancies between the price-levels of various countries. These discrepancies were due to the arbitrary rates of stabilisation, chosen without

regard to the economic parities. The exchange rates were no longer adjusted to the relative difference between the price-levels. Nor was it easy to eliminate these discrepancies through cutting costs. One of the results of the war was the strengthening of the political power of trade unions and the working classes in general. The extent to which this power was strengthened varied according to the country, but in the countries where it was highest it became impossible to carry out a downward readjustment of costs and prices. Before the war if the producers of a country found that they were being under-sold the remedy was to a large extent in their own hands. After the war, in Great Britain and a few other countries, producers who attempted to cut their costs in order to face competition met with the utmost resistance. The financial superstructure, internal and international, also became immensely complicated after the war. The increase of fictitious wealth led to a corresponding increase in the importance of the financial superstructure. Consequently, the system became top-heavy. The amount of financial resources owned by the public and handled largely by banks and other financial institutions rose to a multiple of its pre-war figure. Moreover, not only did the amount advance, but innumerable new channels for the employment of financial resources had been created. They became hopelessly interwoven into a highly complicated and sensitive system. There was also a considerable increase in the number of invisible financial links between various countries. Investment and speculation abroad became more popular. The financial structure of one country became more sensitive to disturbing influences in every other country.

The tendency in this direction was not altogether a post-war development; it originated towards the end of the nineteenth century and developed gradually before the war. Its development became accentuated, however, after the war.

Another new source of disequilibrium which arose after the war was that between international trade and international transfers. As we noted in Chapter II., before the war the movements of each were more or less parallel. The war, however, created a huge political and commercial indebtedness, the sudden growth of which threw the international organisation out of gear. It was impossible for foreign trade to expand at short notice to a sufficient extent to cover the increased requirements of international transfers.

There was also a change in the international economic and financial balance of power. Before the war London's experienced leadership went a long way towards smoothing out the minor discrepancies which arose. After the war the lead in the sphere of international finance was captured by the United States. The banking centre of New York did not possess London's traditions or her experience of acting as a shock-absorber, nor had the American investing public the willingness to invest and hold the huge amount of foreign securities the issue of which was essential to keep the system going.

The pace of progress in methods of production seems to have been accelerated since the war. It has become possible to increase productive capacity almost indefinitely. At the same time, progress has ceased to be as gradual a process as it was before the war. Alfred Marshall's motto, "*Natura non facit saltum*", no longer held good; nature began to proceed in jumps.

Some countries, however, got well ahead of the others in their improvement of methods of production. General conditions began to play a leading part in hastening or retarding the process. While Europe was fighting, industries in the United States attained an unprecedented degree of efficiency. After the war, inflation stimulated a rapid, if not well planned, expansion of German industries. A few years later, the reconstruction of the devastated areas in France, together with the payment of generous indemnities to those who had suffered damage, and the stimulating effect of the depreciation of the currency, led to the industrialisation of the country on highly modern lines. Not until after the beginning of the crisis, however, did Great Britain make a serious effort to catch up her industrial competitors in their progress.

Another effect of the war was that countries with a low standard of living developed industries which in subsequent years launched out into fierce competition with the exporters of countries with a high standard of living. Industrialisation was no longer confined to Europe and the United States. It made rapid progress in Japan, China, India, etc. Simultaneously with this process, wages in the old industrial countries became more rigid; but even if they had not, it would have been impossible for these countries to enforce sufficiently drastic cuts to meet the new competition. In no circumstances would the working classes of Great Britain, for instance, have tolerated the reduction of their standard of living to the level of the Japanese coolie.

These are only a few of the innumerable factors which threatened the equilibrium in international trade and international finance. They exposed the

nations to violent fluctuations in their trade balances and to violent attacks on the stability of their currencies. Notwithstanding this, statesmen and economists pretended that no change had taken place. They preached the gospel of a return to the pre-war freedom, full of confidence that "if things were allowed to take care of themselves all would work out for the best". Although most countries were unable completely to restore the pre-war freedom in trade and finance, progress was gradually made in that direction, especially after the stabilisation of currencies. The world actually succeeded in convincing itself that the surface stability established from 1925 onwards was identical with that fundamental stability which existed until 1914.

It is a stock phrase of orthodox economists, repeated to boredom during the last few years, that the crisis was due to the failure after the war to restore completely the freedom in international trade and finance. We have heard so much about this that it is high time that the other side of the story was told. In the author's opinion, the trouble was not that there was too little freedom but that there was too much. It is true that, owing partly to industrialisation in agricultural countries and partly to the desire to defend existing industries, most countries increased their customs barriers compared with their pre-war level. This did not, however, prevent the international flow of goods from rising well above its pre-war figure. It may be objected that this increase in the volume of international trade was in keeping with the increase in international transfers caused by the changes in international indebtedness. In reality, this was not so. It was the debtor countries, and not the creditor coun-

tries, which imported more. There was reckless lending and reckless borrowing, leading to reckless spending on the part of those who could least afford it. The comparative freedom of international trade and finance led to a rapid increase in the burden of international indebtedness, instead of bringing about a tendency to readjustment. When the German authorities made half-hearted efforts to check the excessive borrowing, they made themselves thoroughly unpopular in the eyes of both potential lenders and potential borrowers. The inadequate efforts of the British authorities from time to time to place an embargo on lending abroad met with a very unfriendly reception. It is easy to imagine what would have happened if the Governments had gone further, by closing their frontiers to unwanted imports, or by insisting that the creditor should take goods in payment if he wanted to be paid at all. There would have been an outcry of indignation at such a violation of the sacred principle of freedom. The Governments who had dared to take such unpopular measures would have been swept away by popular indignation. Nearly all the economists, the Press, and the public still blindly believed in the nineteenth-century doctrine that things would work out for the best if only the Government abstained from interfering. Yet, if trade and exchange restrictions had been introduced, say, in 1927 instead of in 1932, they would have gone a long way towards preventing the crisis, or at any rate towards mitigating it considerably.

The customs barrier which was erected by the United States is often denounced as the main cause of the international disequilibrium. Doubtless it made it more difficult for debtors to pay their debts. It is,

however, doubtful whether, even in the absence of any change in the American tariff policy, Europe would have been able to export a sufficient amount of goods to the United States in face of the increased efficiency of American home industries. The fact that American export trade competed successfully with Europe in Latin America, the Far East and, to a large extent, even in Europe itself, shows that the tariff was by no means the only factor responsible for the abnormal export surplus of the United States. The chief source of trouble was not that the United States raised her tariffs but that Europe did not adequately retaliate by closing her markets to American manufactures or by making the payment of political and commercial debts to the United States dependent upon the admission by the latter of more European goods. This is only one of the many examples which show how the inadequate degree of Government intervention has been responsible for the difficulties that the world has experienced since 1929.

When after 1931 a large number of countries had to default on their foreign loans owing to transfer difficulties, creditors and debtors began to hurl bitter reproaches at one another. The creditors accused the debtors of having borrowed recklessly, without regard to their capacity to repay; of having spent the proceeds of the loans largely for unproductive purposes; of having failed to maintain a sufficient degree of liquidity to enable them to repay the foreign short-term loans when called upon and to maintain, in spite of all difficulties, the service of the long-term loans. The debtors retaliated by saying that during the period of stability loans were simply thrown at them; that it was the creditors who, by lending without discrimina-

tion and without regard to the debtors' capacity to pay, held out temptations which the debtors were unable to resist; that by suddenly ceasing to lend and suddenly attempting to withdraw short-term credits, the creditors were largely responsible for the insolvency of the debtors. Above all, the debtors reproached their creditors for demanding repayment of their loans without being prepared to accept repayment in the form of goods.

Doubtless mistakes were made on both sides. They were largely due to the absence of adequate planning and intervention. It is impossible to single out either creditors or debtors as the scapegoats. The responsibility rests with that theory of economic freedom which made it possible for creditors to lend and debtors to borrow without regard for the consequences. According to the nineteenth-century conception of *laissez-faire* it is of no consequence that a country should over-lend or over-borrow, over-export or over-import, for "the normal working of natural forces" will sooner or later restore the equilibrium. A country which lends or spends more than it can afford will, according to this conception, sooner or later balance its accounts by selling more goods abroad. Even if the recipients of the loans or the sellers of the goods are not compelled to spend the proceeds in the country concerned, the money, it is said, will go round and round and by some mysterious process will sooner or later return to its country of origin. According to the orthodox school there is no need, therefore, to worry about "temporary" discrepancies. At the time when this conception first became general the abnormal tendencies in international trade and transfers were on the whole moderate. The classical economists never

reckoned with discrepancies of such dimensions as developed during and after the war of 1914-1918. Since then not only has the absolute figure of abnormal discrepancies increased, but also the relative divergence of these discrepancies from the normal. They assumed such dimensions that it was idle to expect automatic readjustment. What was required was drastic Government intervention to regulate foreign trade and foreign loans. If it was necessary for the debtor countries to borrow so as to fill the gap left in their financial resources as a result of extreme inflation, the proceeds of their loans should have been repatriated not in the form of goods but in the form of gold. Actually, having spent abroad the money borrowed abroad, they enabled their creditors to lend the same amount over and over again. Hence that increase of international indebtedness which was the immediate cause of the crisis.

CHAPTER IV

THE TRANSFER CRISIS

It would be gross exaggeration to claim that the situation that arose in consequence of excessive freedom of trade and finance prior to 1931 was the sole cause or even the main cause of the crisis. It was, however, a very important direct cause. But for the freedom with which creditors were allowed to lend, and the freedom with which debtors were allowed to spend the proceeds of their borrowings, the transfer crisis of 1931 would never have arisen. It was because there had been excessive lending that creditors became unduly nervous in May 1931. It was because there had been excessive spending that borrowers became hopelessly illiquid. Had there been more control and less freedom in international trade and finance prior to 1931, Central Europe would have been less vulnerable. Even though the fundamental causes of the depression would have operated, they would not necessarily have resulted in the panic of 1931. Possibly, the painful but inevitable process of adjustment and liquidation would have taken place in a less disorderly manner.

In the absence of planning on an international scale, the great creditor centres lent far too much to Germany, Austria, Hungary, and other countries. In the absence of co-ordination, the first serious shock led to a panicky withdrawal of credits from these countries. And since the borrowers had taken the greater part of the proceeds of their borrowings in the shape of excess-

ive imports, they were not in a position to meet the sudden demand for repayment.

To a very large extent the Creditanstalt crisis, and all that followed it during the summer and autumn of 1931, was the result of unfettered activity in international finance and trade. This does not mean that those engaged in that activity can now be held as scapegoats for the crisis. They constituted part of an established system and were no more to blame for the consequences than the machinery of an industrial plant is to blame for the over-production of which it is the direct instrument. It was the job of the exporters to sell abroad as much as they possibly could. It was none of their concern that, by over-importing, the buyer country got into difficulties. It was the job of the bankers to lend to those foreign borrowers who were considered individually dependable. It was impossible for them to know that, by enabling a debtor country as a whole to over-borrow, they were contributing to a new crisis. Individual bankers were not in a position to ascertain the total extent of borrowing by various countries, much less were they in a position to judge whether the indebtedness of certain countries was beyond their capacity.

It is equally unjustifiable to put the blame for the crisis of 1931 on the monetary authorities, Treasuries and Central Banks which failed to foresee and forestall these developments. Admittedly, the monetary authorities should have been in a better position than individual merchants and bankers to perceive the danger signals of over-trading and over-financing on the part of certain countries. It should have been their duty to warn financial and commercial interests and, if that was insufficient, to take steps to impose control

over such international commercial and financial activity as was contrary to general interest. In some instances there was indeed such intervention. The general attitude, however, remained based on the principle of *laissez-faire*. The conception that it was the task of the authorities to guide international trade and finance and divert them from undesirable channels was in its infancy. There were doubtless some vague notions that the monetary authorities should intervene in the case of dangerous developments, but their duty in this respect was by no means clearly defined. Whenever they did intervene, as in the case of the British embargo on lending abroad or the German regulations on borrowing abroad, they exposed themselves to criticism and attacks. Moreover, the authorities themselves were not in a position to judge the situation adequately. The secrecy of banking activities was still considered sacrosanct, and in most countries the authorities had no means of ascertaining the exact nature and extent of international lending.

The Treasury officials and Central Bankers are not, therefore, any more to blame for the crisis than are bankers and merchants. The root of the trouble was the system and the general conception on which it was founded.

The history of the transfer crisis in 1931 is too well known to require detailed repetition. The reckless withdrawal of credits from Central Europe depleted the gold resources of the German, Austrian, and Hungarian Central Banks on an alarming scale. Within a few weeks these Central Banks were confronted with the alternative of suspending the gold standard or suspending the repayment of external short-term indebtedness. With the disastrous effect of post-war

inflation still fresh in their minds, they preferred to choose the second alternative by introducing a partial transfer moratorium. The crisis in Central Europe produced immense repercussions all over the world. It was responsible for that run on the pound which led to the suspension of the gold standard in Great Britain.

The vulnerability of Great Britain, like that of Central Europe, was largely the result of freedom in international trade and finance. The extent to which London was over-lending abroad was not adequately realised until the figures of the Macmillan Report became available. While the authorities attempted from time to time to restrain long-term lending, they did not interfere with short-term lending or the acquisition of securities in overseas Stock Exchanges. As a result of the one-sidedness of their intervention, the reduction of long-term lending led to a simultaneous increase of short-term credits abroad. What was even worse, the British authorities did not adequately realise the extent of London's short-term foreign liabilities. The complete lack of control over international transfers led to the accumulation of huge amounts of foreign funds in this country, in the form of deposits, bill holdings, or security holdings. The Macmillan Committee made an effort to ascertain the first two items, but was not altogether successful in doing so owing to the unwillingness of the London agencies of certain foreign banks to disclose their figures. The amount of foreign holdings of British securities was, however, entirely unknown. As a result, those responsible for British monetary policy had not the faintest idea as to the extent of the pressure on sterling that could arise from this source.

Freedom of trade was also to a large extent re-

sponsible for the vulnerability of sterling. Ever since 1926 it had been evident that sterling was grossly overvalued and that it was likely to remain so for a long time to come. Consequently the trade balance was growing increasingly adverse. Notwithstanding this, the authorities were not in a position to defend sterling against the consequences of an adverse trade balance by means of introducing restrictions on imports. It was not until after the collapse of sterling that the adoption of a protective tariff became politically possible.

It is thus evident that excessive freedom in international trade and finance was largely responsible for the lack of resistance of sterling to the attack of 1931. Admittedly, fundamental factors were against its maintenance at its pre-war parity. The immediate cause of its breakdown was, however, the weakness of its technical position, and this weakness arose from lack of adequate control in international trade and finance.

It is often argued that the transfer crisis of 1931 was due to special circumstances which are not likely to repeat themselves, such as reparations, war debts, the abnormal circumstances of post-war inflation and stabilisation, etc. In reality, owing to the fundamental changes brought about by the war, there is no reason whatsoever to suppose that a similar transfer crisis would not arise again and again in future in the absence of restrictions. It is true that reparations have ceased to exist and that war debts have faded into the background. There are, however, many actual and potential disturbing factors which would be capable of leading to another transfer crisis in the absence of adequate intervention and planning.

About this more will be said in a later chapter.

The crisis of 1931 made most countries realise, what they ought to have realised long ago, that they could not afford to allow international trade and transfers to take care of themselves. The theory that a country can allow its merchants, bankers, and capitalists a free hand in buying, selling, borrowing, lending, or investing abroad, became evidently untenable. The financially weak countries realised that unless they adopted stringent measures of restriction, their gold resources would soon become depleted and they would then no longer be in a position to cover abroad even their most elementary requirements.

It was in order to avoid the starvation of their populations and a complete breakdown of their monetary systems that the weak countries imposed restrictions upon their foreign trade and foreign transfers before it was too late. This aspect of the restrictions introduced in 1931 and after is not adequately understood. Intelligent opinion all over the world is too much under the influence of *laissez-faire* economists who denounced these measures as the sheer outcome of the wickedness or ignorance of politicians. They maintained that, instead of intervening, the Governments in question ought to have allowed a natural readjustment to take place. It is true that in plain English natural readjustment would have meant wholesale bankruptcy and starvation in the countries concerned, but orthodox economists are always more concerned with their doctrines than they are with the welfare of mankind. Practical statesmen can hardly be blamed because, instead of being dogmatic, they have resorted to unpopular but inevitable exchange restrictions, quotas, customs tariffs, and other methods

of defending their dwindling reserves.

It goes without saying that these measures led to a contraction of international trade and dealt a severe blow at the structure of international finance. Let us for a moment visualise, however, what would have happened if, instead of adopting restrictions, the financially weak countries had followed the words of wisdom preached by *laissez-faire* economists. Withdrawals of foreign funds and a flight of national capital would soon have depleted their gold reserves. After having spent their last penny they would have had to introduce restrictions; alternatively, they would have had to allow their exchanges to depreciate. It is easy to imagine what a disastrous slump there would have been in the currencies which had no longer any gold backing. Was it not much wiser to impose restrictions before the gold reserve had become completely exhausted? Would the satisfaction of postponing the inevitable restrictions by another few weeks, or a few months at the most, have been worth the heavy sacrifices? All but a few doctrinaire economists would reply emphatically in the negative.

It is true that some of the countries which played for safety, in 1931 or in subsequent years, by imposing restrictions on international trade and finance were under no immediate necessity of doing so. For example, when France sought to defend the franc by the adoption of quotas, this restriction was not necessitated by any immediate danger of a collapse of the franc. Indeed, in possession of the second largest gold reserve in the world, France would have been in a position to face for years a series of adverse trade balances without being exposed to the same danger as financially weak countries. Taking a long view, however, the French

measures of defending the franc by interfering with the freedom of trade were as justifiable as those taken by financially weaker countries. In the long run, the persistent decline of the French gold reserve through chronic trade deficits would have led to an accelerated outflow of capital. From the point of view of the defence of the franc it was, therefore, justifiable to restrict imports. Whether it was wise to defend the franc at its parity is another question. But given the fact that this policy had been decided upon, trade restrictions were inevitable.

It is not without significance that while during the war it was some years before adequate restrictions on international trade and finance were adopted by the belligerent countries, during the crisis a much higher degree of restriction was adopted in the course of a few months. In 1914, the mentality of the Governments was still essentially under the influence of nineteenth-century doctrines. They imagined that even amidst the disturbed conditions created by the war they could rely upon the automatic readjustment brought about by *laissez-faire*. By 1931, this confidence in the all-curing effect of *laissez-faire* had disappeared. Although the emergency with which the Governments were confronted bore no comparison with that of the war, they realised none the less that it required swift intervention. Technically, the methods applied after 1931 were much more efficient than those applied after 1914. At the beginning of the war, restrictions were an innovation, but in 1931 the Governments had the benefit of the experience of their own countries and other countries during and after the war.

This does not mean that the methods adopted at the beginning of the crisis were necessarily suited to

their purpose. It was several years before the systems of restrictions had become really water-tight in some countries, while in other countries they are still far from being water-tight. Restrictions were applied to various branches of international trade and finance gradually; occasionally the tendency was reversed in some countries, which decided to discard some of the least popular methods. Apart from these set-backs, it may be said, speaking generally, that the world trend since 1931 has been towards stricter and stricter restrictions. In the sphere of international trade, customs tariffs have been raised in every country. On the initiative of France the system of quotas has been widely adopted. The allotment of foreign currencies for imports has been subjected to restrictions, while in some countries imports themselves have come entirely under Government control. Above all, in a large number of countries foreign trade has come to be regulated by exchange clearing and compensation agreements. In the sphere of international finance an immense variety of methods of exchange restrictions and management have been adopted. The details of these methods are described and examined in the author's book, *Exchange Control*. There is at the Governments' disposal an immense variety of means of influencing the exchanges by intervention.

Lending abroad has also come under official control, though in this respect the system adopted in most countries is far from water-tight. The international movements of funds between centres which are not subject to exchange restrictions are still free, though there is a tendency towards closer supervision of these movements, and towards the discouragement of transactions of an obviously speculative character.

The crisis of transfers has thus led to an all-round curtailment of freedom in the sphere of international trade and finance. Those who condemn the measures introduced should be reminded that the restrictions imposed by the Governments have been made necessary by the crisis, which in turn was largely the consequence of excessive economic freedom.

CHAPTER V

THE CONSEQUENCES OF RESTRICTIONS

THE result of the various forms of restrictions on international trade and finance was inevitably a sharp decline in the volume of international commercial and financial transactions. It is true that other factors besides restrictions contributed to this decline. It is also true that the contraction in the volume of foreign trade was incomparably smaller than that which occurred in its total value. In fact, according to League of Nations statistics the volume of international trade is still well up to its pre-war level, even though it is under its level of 1929. The main cause of the contraction of the value of international trade was the fall in commodity prices, for which restrictions can hardly be considered mainly or even largely responsible.

Even in the complete absence of restrictions, international business would inevitably have declined owing to the fall of prices, the decline of confidence in the solvency of overseas debtors, the fluctuation of exchanges, and the decline in the purchasing power of consumers all over the world. The importance of this latter point is not adequately realised. The fact that customs barriers, quotas, exchange restrictions, etc., have been imposed is by no means the only reason why the public in most countries nowadays buys less foreign goods than it did six years ago. In 1929, the purchasing power of the public in most countries was much higher than it is to-day and most people could

afford to spend more freely. Part of their incomes was spent on foreign goods, whether necessities or luxuries. Now that their incomes are lower they are not in a position to spend the same amount either on home products or on foreign products. Even in the absence of any restrictions, the amount of their purchases abroad would inevitably have declined.

It would of course be idle to deny the fact that restrictions were responsible for a considerable part of the decline in the volume and value of international business. Admittedly, the result of trade restrictions was to throw a large number of wage-earners out of employment. Wages, salaries, and dividends fell and purchasing power contracted. This in turn tended to accentuate the depression in general. Notwithstanding this, it would be grossly unfair to put all the blame on restrictions, and unwise to assume that once these restrictions are removed all will be plain sailing. And yet this is what we have been told over and over again by newspapers, politicians, economists, and speakers at international gatherings of every kind. Those who promise the advent of the millennium through the removal of the restrictions fail to realise that as things are most Governments are not in a position to return to a régime of freedom. To do so would be a leap in the dark by which they would run the risk of depleting their resources. It is evident that this risk would be very grave if any one particular country were to decide to abolish restrictions, and trust to luck that other countries would follow its example; but the risk would be hardly less grave even if a second international economic conference were to lead to an agreement for the simultaneous removal of restrictions in all countries.

Further, the advocates of the immediate removal of

restrictions fail to realise that the curtailment of freedom in international trade and finance was in accordance with the fundamental world trend. This does not of course mean that all the various restrictions, once adopted, should or will be maintained. It is possible and even probable that their unpopularity will lead to a reaction, and that as soon as various Governments think they can afford to do without restrictions they will restore a high degree of freedom. Taking a long view, however, the struggle between anarchy and planned restrictionism can only end in the latter's victory. This again does not mean that restrictions in the present form will be retained as part of a new system. The world learns through trial and error and it is quite conceivable that many of these measures which have been adopted since 1931 will be discarded and replaced by more suitable measures.

Nevertheless, even as it stands, with all its shortcomings and deficiencies, the existing system of restrictions is not nearly as harmful as its opponents pronounce it to be. Its disadvantages are not nearly as grave as they are alleged to be, and it has very substantial advantages which its opponents usually ignore.

Unquestionably, those directly concerned with international trade and finance have every reason to cry for the return of the old days. Apart from the actual loss of business they suffer, they must find it extremely irksome to have to put up with all these regulations. This reason alone would be sufficient to induce them to abolish all restrictions overnight if the decision rested with them. It is nowadays more difficult to do business with foreign countries. There are many more regulations which have to be borne in mind; various

kinds of formalities have to be complied with; and a great deal of red tape has to be put up with. For this reason alone many people who would be in a position to overcome the newly created difficulties prefer to leave foreign business alone and to concentrate their activities on home business. The dislike of the average business man for filling in forms, applying for permits, obtaining certificates of origin, etc., etc., is responsible for part of the contraction in foreign business which has followed restrictions. Merchants brought up in the "good old days" cannot be bothered with all that. Possibly a generation brought up under the régime of restrictions may find them much less objectionable than the older generation does.

Above all, there can be no doubt that in this case, as in so many other cases, one man's poison has become another man's meat. If imports are excluded by tariffs, quotas, or exchange control, and if the merchandise in question can be produced at all at home, then home producers stand to benefit by the restrictions to the same extent as foreign producers stand to lose by them. This is what has actually happened, especially in countries where home trade was not strangled by deflation. The countries of the Sterling Bloc have been able on the whole to maintain their home trade at, or even to increase it above, its pre-crisis level. While industries catering for export trade have remained depressed, those industries which depend mainly upon home trade for their prosperity have been able to register satisfactory progress. In Great Britain the index of production has actually risen above its figure for 1929, notwithstanding the decline in the volume of exports. This has been due, in part at any rate, to the protective customs tariffs

introduced after 1931. In France the system of quotas has saved home producers from having to carry the full burden of the depression and has enabled them to retain at least the home market despite increased foreign competition. Under the protection of restrictive measures, new industries have sprung up all over the world, while in industrial countries such as Great Britain, Germany, and Italy the development of agriculture has made some progress. Most countries have become much more self-sufficient as a result of the restrictions.

Most economists will doubtless denounce as an unforgivable heresy the view that the increased self-sufficiency of the various countries is an advantage. Undoubtedly it is a violation of those sacred nineteenth-century doctrines which advocated the highest possible degree of international division of labour. That system had unquestionably the advantage that under it goods are produced where they can be produced under the most favourable circumstances and at the least cost. Against this, however, the nineteenth-century system has two grave disadvantages. One is that it makes various countries more interdependent and therefore more vulnerable, and the other is that it prevents an adequate expansion of home production within the various countries. In fact, a higher degree of independence for a country means not only a higher degree of security against international crises but also an increase in its standard of living.

The effect of restrictions on international finance is somewhat similar to their effect on international trade. Those engaged in international financial operations have found their sphere of activity curtailed con-

siderably as a result of the shrinkage of foreign trade, exchange restrictions, embargoes on foreign loans, etc. There is no longer enough international financial business to go round. Consequently those hitherto engaged in that specialised branch of activity had to look round for new spheres of activity. As the scope for international transactions has been reduced, bankers have had to focus their attention to a larger extent upon financing home trade. This is what is taking place to a particularly high degree in Great Britain. While before the crisis the City was essentially international, during the last few years its international character has declined to no slight extent. Issuing houses which in the past confined their activities to foreign Government loans have had to take an interest in home industries in order to keep themselves occupied. Acceptance houses and discount houses have had to make an effort to popularise the inland acceptance because they have been unable to get sufficient foreign acceptance business to cover their overhead charges. The instalment selling bills, with the aid of which payments on easy terms are financed, have become popular in the discount market which before the crisis would not have dreamt of touching them. The theory that foreign acceptances are self-liquidating while home bills are not has been disproved by the experience of the crisis which dispelled the myth of the liquidity of foreign acceptance credits. It has been found that less than one per cent of instalment bills has been defaulted upon by the debtors, and the signature of a good instalment financing company is sufficient to guarantee the market against that small percentage of losses. In the sphere of finance, as in the sphere of trade, the tend-

ency towards a higher degree of national independence has been decidedly an advantage. From the point of view of the general public, restrictions imposed upon international finance prevent investors and speculators in many countries from shifting their funds abroad. Those very anxious to shift funds have to resort to illegal channels and take the risk which that involves. It goes without saying that such Government interference with the freedom of citizens to dispose of their possessions is strongly resented not only by those directly concerned but also by liberal economists. They do not appear to realise that the freedom of investors and speculators to transfer their capital wherever they expect to obtain a higher yield or a speculative profit is against the public interest. Their freedom thus to transfer was largely responsible for much trouble even before the crisis, but its disadvantages have been greatly aggravated since the crisis. Doubtless it has certain advantages; these, however, are heavily outweighed by its disadvantages. Countries which have made their restrictions upon such international capital movements practically watertight, such as Soviet Russia, Germany, or Italy, are exposed to disturbing influences to a much less degree than the countries where the transfer of capital is free or where restrictions are not applied efficiently enough.

It cannot be sufficiently emphasised that the disadvantages of restrictions have been increased and their advantages have been minimised by the lack of adequate experience and the haphazard way in which the measures have been adopted. Restrictions were introduced as emergency measures under the pressure of momentary requirements and to a very large extent

without regard to the fundamental and permanent interests of the nations. As in spite of that they have served a useful purpose, it is easy to imagine how much more advantageous they would be if adopted systematically after careful study of their ultimate object.

The above defence of exchange and trade restrictions must not be taken to imply that the author is in favour of reducing international commercial and financial intercourse to the indispensable minimum. He is fully aware that an expansion of home trade necessitates larger imports of raw materials and is accompanied by larger imports of other articles of production and consumption. It is essential, however, to discriminate between necessary and superfluous foreign trade. Very often foreign manufactures are bought in preference to the corresponding home-made goods, not because they are better or cheaper, but simply because they are different or just because they are foreign. It is difficult to provide any economic justification for foreign trade of such a character. If restrictions result in the disappearance of such superfluous foreign trade, there is no legitimate ground for complaint. It is only if they go beyond that degree and cut into useful and necessary foreign trade that restrictions become harmful.

The ideal solution would be to devise a system of restrictions which, while eliminating superfluous foreign trade and superfluous foreign finance, enables the countries to maintain and even increase those international commercial and financial operations which are of a useful character. In the absence of restrictions, such an increase is bound to render the countries concerned more vulnerable and tends to handicap internal expansion. The system of Govern-

ment intervention which can claim to have the advantages of restrictions without their most important disadvantages is that of exchange clearing. The remaining chapters of this book will be devoted to the description of that system as it is and as it ought to be.

CHAPTER VI

THE ORIGIN OF EXCHANGE CLEARING

As a result of the circumstances described in earlier chapters, it appeared at the end of 1931 and for some time in 1932 that the financially weak countries would soon be unable to maintain even that indispensable minimum amount of imports which was required to satisfy the most important primary necessities of their population. Their gold reserves were dwindling rapidly, despite the exchange restrictions, for these were far from water-tight. They checked superfluous imports, it is true; but as practically every other country had imposed similar restrictions, as fast as each sought to strengthen its technical position by reducing imports or by not paying for them, so it suffered a disadvantage because its exports in turn were excluded from other countries or were not paid for.

The absurdity of this deadlock was only too obvious. Every one of the Danubian and Balkan States closed its frontiers to the exports of the others and blocked payments to them. As a result, none of them appeared to be better off than it would have been if no such precautions had been taken. And yet the imposition of restrictions by these countries was inevitable. Given the weakness of their gold resources, they could not possibly trust to luck that under a régime of freedom they would not become the victims of an adverse trade balance and an outflow of funds which would eventually reduce them to starvation and chaos.

Country *A* introduced restrictions because countries *B*, *C*, and *D* introduced restrictions. Country *B* introduced restrictions because countries *A*, *C*, and *D* had done so, and so on and so forth. But even if country *A* had full assurance that countries *B*, *C*, and *D* would not introduce restrictions, it would have hesitated to take the risk of remaining on a basis of freedom in trade and finance. In the absence of assurance on the part of the other countries that they would continue to buy *A*'s goods and pay for them in due course, it would have been suicidal for any one of them to try to retain the régime of *laissez-faire*.

The result was a deadlock which threatened to strangle completely international commercial intercourse with the weak countries. The only obvious way to break this deadlock in the absence of means of overcoming its fundamental causes was to achieve an agreement for the interchange of goods in such a way as to preclude the possibility that the interchange would deplete their currency reserves. Country *A* was willing to take the goods of country *B* so long as it had the assurance that it could make payment not in cash but in the form of goods. This solution was arrived at through the conclusion of exchange clearing and compensation agreements.

The necessity for such a solution—the obvious one—was not confined to relations between weak countries. There was an equal necessity for its application also in the relations between strong countries and weak countries. The latter were unable to pay cash for their imports from the strong countries. The arrears of overdue commercial debts as a result of transfer moratoria were accumulating, and exporters of the financially strong countries were faced with the alternative of

taking the risk of having to wait indefinitely for payment, or losing their market. Evidently, the solution was to use the proceeds of the exports of weak countries to strong countries to meet the payments for the imports of weak countries from strong countries. This is what actually happened in many instances. In fact, the first exchange clearing agreement was concluded, not between two weak countries, but between a strong and a weak country.

On November 14, 1931, the Swiss and Hungarian Governments concluded the first exchange clearing agreement. By virtue of this agreement, payment for trade between the two countries was to be made through the intermediary of the two Central Banks. There was no longer any need for Swiss and Hungarian importers and exporters to buy and sell exchanges in connection with their dealings between each other. The substance of the agreement was that Swiss importers of Hungarian goods would pay the purchase price in Swiss francs into a special account kept by the Swiss National Bank, and that Hungarian importers of Swiss goods would pay the purchase price in pengoes into a special account kept by the Hungarian National Bank. Swiss exporters to Hungary were to be paid out of the amounts paid in by Swiss importers from Hungary, while Hungarian exporters to Switzerland were to be paid out of the amounts paid in by Hungarian importers from Switzerland.

At the time of its conclusion, the agreement attracted barely any attention even in the countries directly concerned, much less in other countries. Most people regarded it as "just another form of irksome exchange restriction". Even the originators of the scheme themselves appear to have failed to realise the true

significance of their innovation. They thought they had adopted a new palliative, when in reality they had created a new system which may become the forerunner of a new era.

The idea of an international clearing is not altogether new. In 1912, the International Economic Union held a congress in Brussels which was attended by delegates of a number of Central Banks, and which passed, among others, resolutions favouring the establishment of a system of international transfers for holders of current accounts in Central Banks, and the creation of an international clearing-house which would offset one against the other the debits and credits of the member banks. This proposal aimed of course at a purely voluntary international clearing; indeed, before the war or even before the crisis, it would have been utterly impossible to find supporters for the idea of a compulsory clearing. An institution which was in fact practising voluntary international clearing was the Universal Postal Union, whose central office at Berne was in reality, within its limited scope, an international clearing-house.

After the war the Reichsbank attempted to put into practice the recommendations of the Brussels Conference of 1912 by opening clearing accounts with a large number of Central Banks. Through these clearing accounts it was possible to transfer funds to and from Germany without having to buy or sell exchanges. This again was a purely voluntary arrangement and its scope was rather limited, for few other Central Banks were inclined to follow the Reichsbank's example. The advent of the crisis with transfer restrictions in Germany and elsewhere brought the operation of the system to a standstill.

The Brussels International Financial Conference of 1920 also passed resolutions in favour of international clearing, though what it had in mind was the passing of international balances, and not individual transactions, through such a clearing. In other words, the idea was to substitute a settlement through book entries for the settlement of net international debit or credit balances by gold movements. The same idea reappeared in a more concrete form after the establishment of the Bank for International Settlements. In many quarters, the utmost importance was attached to the functions of the bank as an international clearing-house. And yet its prospective scope in this sphere was very narrow indeed. There was never any question before the crisis of substituting an international clearing for the free transfer of international payments. All the proposed arrangement sought was economy in costs by reducing as far as possible the actual physical shipment of gold, replacing shipments by earmarking operations. Those who attached exaggerated importance to this very insignificant economy in transport costs were guilty of the error of mistaking the shadow for the substance. Instead of concentrating on the necessity for reducing the fundamental causes of superfluous and disturbing gold shipments, they aimed at reducing merely the physical displacement of gold, which in itself would not obviate the harmful effects of fluctuating gold reserves of Central Banks.

The idea of the Bank for International Settlements was not international exchange clearing but international gold clearing. To that end, the bank would have welcomed a decision by all Central Banks to keep gold deposits with it, for with the aid of these deposits the clearing could have operated. Until the

crisis, however, this idea met with but little response on the part of the Central Banks associated with the Bank for International Settlements. It was not until after 1931 that an item of gold deposit appeared on the returns of the bank, and up to now the amount deposited has remained very moderate.

During the early period of the bank's existence it was suggested that the bank should endeavour to act as a clearing-house for international payments by Central Banks. This suggestion was, however, opposed by the directors of the bank on the ground that this would deprive the foreign exchange market of part of its legitimate turnover. As the bank was anxious to allay the fears and jealousy its establishment aroused in banking circles, it was not prepared to undertake even this very limited exchange clearing. The only clearing which operated to some extent during the early period of the bank's existence was that for reparations and war debts payments. The Treasuries concerned had accounts with the bank, which, having received payments on account of reparations and inter-Allied debts, credited the amounts obtained to the recipients of reparations and war debts. As some of the Treasuries were both creditors and debtors, the credit and debit items largely offset each other and it was only the net balances that had to be bought or sold through the foreign exchange market. This limited clearing arrangement died a natural death with the cessation of reparations and war debt payments during 1931-1932.

Evidently, such clearing arrangements as existed prior to November 14, 1931, were of a limited scope. They were confined either to payments between Governments or to purely voluntary payments by

private individuals. These arrangements contained the rudiments of international transfers without the intermediary of the foreign exchange market, but owing to their voluntary and limited character they did not in any way affect the international interchange of goods. The idea of a universal and compulsory exchange clearing did not exist before 1931. All the proposals made for the establishment of international clearing envisaged something totally different, something more limited in scope and incomparably less significant in its effects.

When the first exchange clearing agreement was concluded it had no theoretical background. As is so often the case, practical statesmen and administrators stole a march on economists. The inauguration of the new system was not preceded by any theoretical discussions between experts. Indeed, for long after its establishment, economists failed to take any particular notice of it. They simply considered it an additional variety of restriction, an additional manifestation of economic nationalism. It is to the credit of the London Chamber of Commerce that it was the first to recognise the broader implications of the exchange clearing system. In 1933 this organisation elaborated a scheme by which the whole international monetary system was to be based on exchange clearing. We propose to discuss this scheme in later chapters. For the present it is sufficient to point out that it was the London Chamber of Commerce, an organisation consisting not of theoretical economists but of practical business men, that first realised the long-term possibilities of the new system.

In the countries where the system was actually in

operation, its broader implications were not recognised. The Press duly reported every new exchange clearing agreement and every change in the existing agreements, and gave publicity to the complaints arising from their working. The Universities condemned exchange clearing as they condemned blocked accounts, transfer restrictions, and other similar interferences with freedom. The statesmen responsible for the conclusion of exchange clearing agreements never missed an opportunity to apologise for them as measures dictated by inevitable necessity, and never failed to pledge their word that they would be removed, together with other restrictions, as soon as conditions made it possible.

When the author of this book published his book on *Exchange Control*, in which he presented exchange clearing as a permanent and rational solution in keeping with the general tendency towards planning, his attitude was subjected to sharp criticism by many reviewers of the book. M. Lamoureux, the then French Minister of Commerce, recognised, however, the significance of the new trend of thought, which began to receive support also in Continental economic literature. On his initiative the League of Nations appointed in September 1934 a special committee to enquire into the clearing and compensation systems. It was not until three years after the conclusion of the first exchange clearing agreement that most of its supporters and opponents began to realise the true significance of the new system, and the necessity for closer investigation of its nature and possibilities. Although, as we shall see in a later chapter, the League Committee performed its task most inadequately, its enquiry certainly has the merit of having drawn atten-

tion to the problem, and of providing material concerning the various clearing agreements.

The answers given to the questionnaire sent out by the League of Nations Secretariat to all countries with exchange clearing agreements throw some light on the origin of the agreements. The League of Nations' Report does not take the trouble to analyse properly the material thus received and is content to say that "the establishment of exchange clearing arose out of conditions created by the institution of exchange control" (page 10). We propose to make good this omission and, on the basis of the material which the League Committee failed to use adequately, we shall summarise the reasons given by the various Governments for their decision to conclude exchange clearing agreements:

(1) Difficulty of obtaining payment for current exports to countries with exchange restrictions.

(2) Difficulty of obtaining payment of accumulated arrears of commercial claims from countries with exchange restrictions.

(3) Difficulty of obtaining payment of financial claims from countries with exchange restrictions.

(4) Desire to export to financially weak countries whose authorities were unable to allot sufficient exchange to their importers.

(5) Desire to maintain exports to countries, weak or strong, which introduced quotas or other forms of prohibitive barriers to imports.

(6) Need to safeguard the currency reserves from depletion.

(7) Settlement of debts in order to be able to continue to obtain goods on a credit basis.

(8) Endeavour to reduce the disturbing effect of cash transfers on exchanges.

(9) Desire on the part of weak countries to continue to import.

(10) Effort to replenish the currency reserve.

(11) Endeavour to increase the efficiency of exchange restrictions.

(12) Endeavour to balance trade with particular countries.

(13) Desire to retaliate for being victimised by exchange or trade restrictions.

(14) Effort to induce creditors to accept payment in goods.

A remarkably large percentage of the answers declare as the object, or at any rate one of the objects, of the establishment of exchange clearing the desire to maintain and increase foreign trade. Even though this in itself does not prove that exchange clearing tends to maintain or increase foreign trade, it clearly shows that those who concluded the agreements expected them to produce such an effect. This is an essential point in which exchange clearing differs from other methods of interfering with the freedom of trade and exchange. No Government would think of claiming that it established exchange restrictions or quotas or high tariffs with the object of maintaining or increasing foreign trade. They are bound to be aware that these restrictions must inevitably cause a contraction in the international commercial and financial turnover. On the other hand, those responsible for exchange clearing hoped at any rate, rightly or wrongly, that their action would be beneficial to international trade. This is a point which should not

have been missed by the League Committee had it carried out its task with due thoroughness and impartiality. While the report lays much stress upon the intention of some countries to use the clearing system in the same way as quotas or customs duties (page 21), it ignores the desire, expressed by the majority of the Governments concerned, to preserve by means of exchange clearing what was left of foreign trade. In only one instance was the declared object of exchange clearing the balancing of bilateral trade, and in only two instances was its object retaliation to restrictions introduced by other countries.

CHAPTER VII

WHAT IS EXCHANGE CLEARING?

FROM the time of the conclusion of the first clearing agreement until the time of writing, the number of such agreements has increased almost without interruption. It is true that in some instances agreements which failed to produce satisfactory results have been discontinued. Such temporary set-backs have not, however, affected the expansion of the system. Countries such as Austria, which for a time reversed their policy and endeavoured to liquidate their exchange clearing agreements, have had to conclude new clearing agreements with the same countries or with other countries. Towards the middle of 1935, the accumulation of unclearable credit balances of clearings with Germany induced several countries to take steps to discontinue the arrangement, but this appears to be a mere passing phase and the chances are that most countries will realise sooner or later that their interests concerning trade with Germany are better safeguarded with clearing than without it.

It was especially among the Danubian and Balkan States that exchange clearing was adopted rapidly. Practically every Danubian and Balkan State has or had at one time an exchange clearing agreement with practically every other State of the same groups. This is only natural, since without exception all these States are financially weak. This, together with the vital necessity for them to trade with one another, induced

them to adopt the only practicable solution for maintaining such trade. The much-desired Danubian Economic Union has in fact become a reality in consequence of the adoption of exchange clearing between the Danubian countries. We propose to return later to this aspect of exchange clearing.

While establishing clearing agreements between one another, the Danubian and Balkan States have also concluded clearing agreements with a number of financially strong countries in Western Europe. Switzerland was the first among the creditor countries to realise the advantages of exchange clearing. Her example was followed by Italy, France, Belgium, Holland, Sweden, Norway, and Denmark. The system found its way also to the Baltic States, Poland, and Spain. Outside Europe, Chile, and Brazil have resorted to it. At the time of the publication of the League of Nations' Report, 77 clearing agreements were in operation. Since the report was compiled, some of the existing clearing agreements have been discontinued but others have taken their place, so that the number of agreements is probably still about the same.

Thus, the establishment of exchange clearing in the majority of civilised countries, especially in Europe, is an accomplished fact. If, four years ago, it had been suggested that this would happen, most economists would have ridiculed the very idea, and statesmen would have dismissed the possibility as a Utopian dream. As it is, economists confine themselves to criticising, attacking, and abusing exchange clearing. They can no longer ignore its existence, but they have not yet settled down to the stage when they can analyse it scientifically, even though critically. Most of the opponents of the system are unable to control their

temper when discussing it, and consequently they invariably weaken their arguments by grossly overstating their case. This is what the League of Nations' Report has done.

We look in vain in the League Report for a classification and definition of the various types of exchange clearing agreements. The Committee was too busy denouncing it and advising its speedy removal to find time to analyse it properly. Yet a definition of the system is badly needed, for it has become customary to include under the heading of exchange clearing various kinds of exchange agreements, semi-clearing agreements, and payment agreements which should not be classed as exchange clearing agreements. Much confusion arises from the fact that in many cases the arrangement concluded is exchange clearing from the point of view of one of the contracting parties, but it is some other form of agreement from the point of view of the other party. To complicate matters further, the use of the terms "private clearing" and "compensation" is a rich source of confusion. It is important, therefore, in order to avoid misunderstanding, to define clearly the exact meaning of exchange clearing.

First of all let us define the meaning of clearing. It is a process whereby two or more parties offset claims against each other with the object of eliminating or reducing cash transfers. In internal relations the clearing takes place as between individual debtors and creditors or between banks. If we substitute countries for individuals or banks as the parties involved in clearing, we arrive at international clearing. Under a régime of freedom, international clearing goes mostly through the channels formed by the banks and the foreign exchange market. To some extent, every bank

engaged in international business carries out a certain amount of international clearing by "marrying" the buying and selling orders for foreign exchange that it receives from its customers. If a London bank receives a buying order for 100,000 dollars and at the same time it receives a selling order for 150,000 dollars, in the ordinary course it will sell in the foreign exchange market only 50,000 dollars. The next stage in the process of international clearing is the local foreign exchange market. To a very large extent, it is possible in a good foreign exchange market to offset buying and selling orders in the same currency without having to buy and sell abroad more than the balance of the transactions. In reality, thanks to the existence of excellent telegraph and telephone facilities with other countries, the foreign exchange markets are in close contact with one another and as often as not the counterpart of buying or selling orders is found abroad even though it would be possible to "marry" the transaction in the local market. In the final result, however, it is correct to say that the net result of a large number of transactions during a day is that the local market has offset buying and selling orders of its nationals against each other, and has found a counterpart abroad only for the balance—the difference between the buying and selling orders in particular currencies.

The foreign exchange market goes a step further in carrying out international clearing. It clears not only the credits and debits of the same country but also the surplus balances of various countries in various currencies. If on balance London is a buyer of dollars and a seller of French francs, and Paris on balance is a seller of dollars and a buyer of sterling, then the two markets offset their operations against each other.

More often than not, it is impossible to attain this end between two markets alone, but triangular and multi-lateral operations will achieve it.

It is hardly ever possible to offset all legitimate commercial and financial transactions even on the international market. The net balances are carried by speculators who are willing to buy or sell the currencies concerned provided that the price bid or offered suits them. Thus, speculation forms an integral and indispensable part of the system of international clearing through the foreign exchange market. It is well to bear this fact in mind at this stage for it reduces to its true value the claim that the system of a free foreign exchange market provides an ideal channel for international transfers.

In addition to "automatic" clearing through the foreign exchange market, there existed before the war a system of artificial voluntary clearing through the intermediary of post-offices. There was also a certain limited degree of artificial clearing through Central Banks during the years prior to the crisis. All these arrangements were essentially voluntary.

The main characteristic of exchange clearing, in the sense the term should be used, is its compulsory nature. Exchange clearing is a system by which importers (and other debtors) are compelled to pay the amounts they owe to foreign claimants into a special account the proceeds of which are used wholly or partly for the settlement of claims of nationals against the foreign country concerned. As in domestic clearing, the process is carried out through the intermediary of an institution which offsets debits and credits of a country against nationals of another country. While in the foreign exchange market the process of clearing

just happens without any conscious effort to that end, in exchange clearing as in domestic clearing the process is carried out by deliberate action.

Exchange clearing in the real sense of the term has to be compulsory. A voluntary arrangement differs but little from the limited voluntary clearing that the Reichsbank and some other Central Banks operated before the crisis.

According to the extension of the scope of the system, exchange clearing can be:

- (1) Unilateral.
- (2) Bilateral.
- (3) Triangular or multilateral.
- (4) International.

There are, at present, unilateral,• bilateral, and triangular exchange clearing agreements in operation, but international clearing is still far from advancing from the stage of its conception in theory to that of realisation.

Exchange clearing is unilateral when applied to debits and credits arising from a country's relations with another country without reciprocity on the part of the latter. It is the widespread belief that unilateral clearing is always an unfriendly act, an act of aggression or retaliation on the part of the country which introduces it. Doubtless in some cases unilateral clearing has been introduced as a retaliatory measure against a country which has defaulted on its obligations or has imposed restrictions upon trade and finance with the other country. In such cases, the adoption of unilateral clearing by one country is usually followed by the establishment of bilateral clearing between the two countries either through

retaliation on the part of the country concerned or through agreements between the two countries. This is what actually happened in the case of France and Estonia. Owing to the difficulties of obtaining payment for French exports to Estonia, the French Government imposed unilateral clearing upon French payments to that country. Thereupon, the Estonian Government negotiated a bilateral exchange clearing agreement with France.

It is possible, however, to introduce unilateral exchange clearing by mutual understanding between the two countries, in which case the clearing will remain unilateral until the agreement is changed. There is at present a unilateral exchange clearing agreement in relation to trade between Great Britain and Italy. Italian importers of British goods are compelled to pay the purchase price in lire into the Italian National Institute of Exchange and out of the proceeds Italian exporters to Great Britain receive payment in lire for their goods. On the British side there is no compulsory exchange clearing. British importers of Italian goods are at liberty to pay the purchase price into the special account of the Bank of Italy with the Bank of England, and in fact are urged to do so. They are, however, at liberty to make payments in any other way they please. The proceeds of this voluntary clearing arrangement are used for the settlement of the claims of British exporters to Italy; but, notwithstanding this, the arrangement cannot be regarded as exchange clearing from the British point of view.

The instances of unilateral clearing are very few; in the predominant majority of cases exchange clearing has assumed the form of bilateral agreements. This is at present by far the most important form of

exchange clearing and will be dealt with in detail in subsequent chapters. Bilateral clearing can be the result of the adoption of separate unilateral clearing arrangements by two countries against each other, but in practice it has always been the result of an agreement negotiated between the two countries. The details of the bilateral clearing agreements vary considerably. According to their scope they may relate exclusively to visible imports and exports; or they may include invisible import and export items; or they may include also capital items. According to their object, they may aim merely at the facilitation of payment for current exports; or they may provide for repayment of trade debt arrears; or they may provide for interest and capital payment on financial debts. They may differ from one another in various other respects from a financial, legal, or technical point of view.

Although the clearing established through bilateral agreement is compulsory for the nationals of the two countries in their trade with each other, in most instances it is possible with or without special permit to avoid clearing by resorting to direct compensation, or in other words, to barter. Such barter transactions are exempt from the otherwise compulsory settlement through the intermediary of clearing accounts. This point will be discussed in detail in Chapter XIX., which deals with Compensation Agreements. It is mentioned here as an example, to show that the application of the principles of the clearing system is by no means guided by a spirit of rigid doctrinairism.

Triangular clearing is the system by which debits and credits of three countries are offset against one another. This can take place in two different ways. It

is conceivable that three countries may come to an agreement for the establishment of joint clearing accounts. So far there has been no agreement of this type, and the chances of one being concluded are none too favourable. As the League Report points out (page 52), "every clearing agreement is an agreement *sui generis* which is closely bound up with the special economic, financial, and monetary situation of each of the contracting parties considered separately and in its bearing on the situation of the other party. Hence it is difficult to include third countries in the arrangement." A much more practicable form of triangular clearing, which is in fact already in operation to a limited degree, is that in which the triangular character of the arrangement is confined to the balances arising from the working of three separate bilateral agreements. In this case the clearing is not as a rule automatic, but by special agreement the surplus of country *A* against country *B* may be used for the settlement of the deficit of country *C* against country *B*, and in return the surplus of country *C* against country *A* will be used for the settlement of the deficit of country *B* against country *A*. Although up to now the extent to which such clearing has been adopted is limited, it has immense possibilities. One of the unpardonable shortcomings of the League of Nations' Report on exchange clearing is that it did not take the trouble to investigate these possibilities.

For the sake of simplicity we have discussed multilateral clearing in its simplest form, namely, in the form of triangular clearing. Needless to say, clearing can be quadrangular, quinquangular, etc. From such multilateral clearing, international clearing is only one step. The mere fact that a number of countries

agree that their clearing balances should offset one another does not establish international clearing. To attain that end it is necessary to have some sort of central organisation which acts as a clearing-house between the national clearing offices. In the author's opinion this highly developed clearing would be the ideal permanent solution of the problems of international transfers.

CHAPTER VIII

SCOPE OF BILATERAL CLEARING

WE pointed out in the last chapter that exchange clearing agreements vary widely according to their scope. While the settlement of payments for imports and exports is by far the most important task of clearing arrangements, the majority of agreements contain provisions also for other kinds of payments. In fact, it is hardly possible to find two agreements the scope of which is identical. It is nevertheless possible to classify them into the following broad categories:

(1) Agreements to cover trade in certain specified commodities.

(2) Agreements to cover trade in all commodities produced in the countries concerned.

(3) Agreements to cover trade in all commodities produced in the countries concerned and their colonies.

(4) Agreements to cover trade in all commodities produced in the countries concerned (and their colonies) and some or all commodities finished in the countries concerned (and their colonies).

(5) Agreements to cover, in addition to the above, transit trade of the countries concerned.

(6) Agreements to cover, in addition to the above, various items of invisible trade.

(7) Agreements to cover also the repayment of commercial arrears.

(8) Agreements to cover also the payment of interest on financial indebtedness.

(9) Agreements to cover capital repayments.

(10) Agreements to cover other kinds of capital transfers.

The most primitive form of bilateral clearing is the arrangement limited to certain commodities. Such an agreement has been in force between Italy and Bulgaria since January 1, 1933. It is confined to the amount due for the purchase of Bulgarian tobacco by the Italian tobacco monopoly and the amounts due by Bulgarian debtors to certain ~~foreign~~ industrial undertakings. Within its limited scope this agreement operates in the same way as the unlimited commodity clearing agreements. If, as in this case, the number of the commodities concerned is very small, the arrangement bears some similarity to compensation agreements. The difference is that the goods are not exchanged for goods but are *bought and sold by payments in the ordinary course into the respective clearing accounts*. The number of such limited commodity clearing agreements is *very small*. They were usually concluded with countries whose export trade consists mainly of one, or at any rate very few, commodities. Most of these agreements have been replaced by exchange clearing agreements covering all commodities. The limited clearing between Italy and Bulgaria, however, remains in force in spite of the conclusion of a general clearing agreement in June 1934. Payment to the Italian industrial undertakings concerned continues to be made out of the proceeds of official tobacco purchases, while Bulgarian tobacco exporters receive payment out of the purchase price of the Italian manufactures in question.

A number of the general clearing agreements are

confined to goods produced in the two countries concerned. In some cases, colonies and mandated territories are included in the agreement. The countries which so far have included colonies in all or some of their exchange clearing agreements are France, Holland, Belgium, Italy, and Spain. This fact shows that technically it is possible to include in the same agreement countries with different currencies and even different customs territories. In all cases, however, the colonies concerned have no autonomy, their interests being safeguarded by the mother country. It would be more difficult to include self-governing Dominions whose interests are not necessarily identical with those of the mother country and which are accustomed to negotiate their own commercial treaties. It would be even more difficult to include in the same agreement foreign countries with conflicting interests.

In a number of agreements provisions are made for goods produced originally outside the countries concerned but finished within those countries. The percentage represented by national labour of the countries concerned in the value of the goods exported by finishing trades plays a part in determining whether or not the commodities in question can be included in the clearing.

In the majority of exchange clearing agreements, transit trade is excluded from the clearing. This is because the inclusion of transit trade would facilitate the circumvention of the clearing agreement. It would enable the exporters of third countries to use the clearing arrangement to obtain payment for their goods to the prejudice of exporters of the contracting parties. Some countries whose transit trade is of importance have endeavoured to include it in the clearing, but the

result of the experiment has been for the most part unsatisfactory. For instance, Switzerland originally included transit trade in her bilateral agreement with Germany, with the result that goods of foreign origin increased the credit balance of her clearing account with Germany to an inconvenient degree. It was decided at the end of 1934, therefore, to exclude transit trade. There are, however, several agreements in force in which transit of goods is allowed to be included, usually to a limited extent.

Interest on financial indebtedness is provided for in many exchange clearing agreements. Indeed, a considerable percentage of the agreements have been concluded mainly for that particular purpose. The only occasion on which the British Government was seriously considering the adoption of exchange clearing was when Germany announced her decision to default on the interest service of the Dawes and Young Loans. Most clearing agreements between Germany and her creditor countries were the result of this default, even though the interests of current export trade of the creditor countries have since overshadowed the original purpose for which the agreements were concluded.

A large number of exchange clearing agreements cover a variety of invisible export items. Apart from the service of external debt, invisible exports covered by some exchange clearing agreements include payments arising out of the settlement of accounts between the railways, post-offices, and telegraph administrations of the countries concerned; transfers for the requirements of tourists; payment of shipping freights; payment of insurance premiums; payments representing the expenditure of diplomatic missions abroad, students with scholarships and the expenditure on the

support or repatriation of nationals of the countries concerned who get into financial difficulties in the other country; cost of manufacturing licences, patent fees, royalties, newspaper subscriptions, advertisements, and similar minor items. Among all these, only the shipping freight, insurance premiums, postal, telegraph, telephone and railway accounts and tourist expenditure are of importance. The other items are in themselves insignificant and are mentioned only to indicate the wide range over which exchange clearing can be extended.

Hitherto we have been dealing with the current items, visible and invisible, of the trade balance. The scope of exchange clearing extends, however, also to transfers on capital account. In fact, a large number of exchange clearing agreements have come into existence in order to provide a way for capital transfers. The very first exchange clearing agreement, between Switzerland and Hungary, was arrived at because Switzerland wanted to collect her frozen commercial claims from Hungary. It may of course be a matter of opinion whether the transfer of frozen commercial claims of recent origin constitutes a current item or a capital item. A number of exchange clearing agreements have, however, been concluded definitely with the object of facilitating payments on account of the long-term debt. In so far as the payments represent interest, they constitute current invisible trade items, but in so far as they represent sinking fund they constitute capital items. Other capital items which are subject to exchange clearing include the proceeds of sale of property, inheritances, dowries, etc.

In many quarters great importance is attached to the possibility of collecting debts and transferring

capital by means of the exchange clearing system. Doubtless the rapid progress of exchange clearing has been largely due to the desire of creditors to overcome the transfer moratoria through which their claims became frozen. But for this consideration, exchange clearing would in all probability have been confined to the Danubian States and the Balkans. It is in their capacity of creditors, anxious to collect their claims, that the financially strong countries of Western Europe have adopted exchange clearing. If the British Government should ever decide upon adopting exchange clearing, it will probably be in order to make a defaulting debtor pay. Indeed, the Debts Clearing Offices Act of 1934 was actually passed with that object in view.

Between them the various exchange clearing agreements cover practically every current and capital item of the international balance of payments. It is true that no single agreement is sufficiently comprehensive to replace completely by bilateral clearing the foreign exchange market between two countries. The tendency is, however, decidedly towards a widening of the scope of exchange clearing agreements. The early agreements covered only a relatively small range of items; most of them were confined to visible trade and commercial arrears. It is only comparatively recently that invisible trade has been included in the arrangements. The inclusion of the service of financial indebtedness and capital transfers is also a recent development.

The experience of various clearing agreements shows that technically it is possible to include within the scope of exchange clearing everything that has been transacted in the foreign exchange market under the régime of free exchanges. Universal clearing is not a

Utopian dream but is well within the realm of practical politics. It is true that for the convenience of tourist traffic it is necessary and desirable to enable prospective visitors to countries with which there is exchange clearing to buy at least a sufficient amount of the bank-notes of these countries to cover their requirements until they are able to collect the amounts transferred through exchange clearing. Even these bank-notes can, however, be put through exchange clearing; payment for them by the purchasing banks could be arranged through the clearing system.

The scope of exchange clearing could also be made universal for capital transfers. At present even the most comprehensive exchange clearing agreements provide for the transfer through clearing accounts only of payments by debtors to their creditors. No arrangement has been made so far for the inclusion of new credits and loans granted to the debtor. Possibly this is because in the existing conditions nobody would think of granting new credits to countries with exchange restrictions. There is, therefore, no reason for covering these transactions by the clearing system. If and when, however, lending to such countries is resumed and if the exchange clearing system is retained, the creditor country will doubtless realise the advantages of including the new loan and credit transactions in the clearing arrangement. The clearing system could be made to cover even the export of capital for approved investment purposes. It is unthinkable that under any rational system investors should ever be allowed a free hand to transfer their capital abroad whenever and wherever they like to do so. Strict control of such international capital movements will sooner or later become a permanent institu-

tion. The replacement of a free foreign exchange market by the clearing system would go a long way towards facilitating the task of enforcing such control. As, however, there can be no question of stopping the export of capital altogether, exchange clearing should be made to serve the purpose of facilitating the transfer of capital for approved purposes.

This chapter has been confined to a description of the scope of existing bilateral clearing arrangements and to an indication of the possibility of its further expansion. It has not been concerned with the details of the working of the system, with the difficulties encountered, or with the effects produced. All these will be dealt with in later chapters. Here we must confine ourselves to concluding that bilateral clearing can be developed, and is in fact already on its way towards being developed, into a water-tight system covering completely the commercial and financial relations between the contracting parties.

CHAPTER IX

HOW BILATERAL CLEARING OPERATES

EXCHANGE clearing is a highly involved system the smooth working of which depends upon the solution of a large number of problems relating both to principles and to technical details. In dealing with its practical aspects, it ought to be borne in mind that exchange clearing is an entirely new system. It would be too much to expect that in less than four years the methods of its technical execution should have attained perfection. Indeed, the rules of exchange clearing are still in the stage of evolution, although it is impossible not to recognise the progress made during the last two years towards their crystallisation into a definite system. What is astonishing is not that this process of evolution has not yet reached a conclusive stage but that it has reached its present advanced stage. The system can be improved only through trial and error. Its imperfections are gradually discovered and remedies are applied.

One of the reasons why the improvement of the system has not been more rapid is the lack of adequate information about its working. There has been no systematic interchange of information between the various countries concerned with the system, so that each one of them has had to learn wholly at its own expense instead of learning partly at the expense of others. From this point of view the publication of the material collected by the League of Nations has been

very helpful. It enables the Government officials and technical experts of various countries to compare the details of various clearing agreements and to adopt any which they consider an improvement upon their existing arrangements. It is a pity the League Committee did not consider it necessary to make adequate use of this valuable material. The main text of its report ignores questions of detail completely and confines its criticism to points of principle. Annex I devotes some seven pages to questions of technical detail, but gives little more than a rather inadequate summary of the answers received from various Governments. There is no attempt even at analysis and critical examination of the technique of exchange clearing, let alone constructive suggestions for its improvement.

The first practical question that arises concerns the organisation which is in charge of the operation of the clearing system. In the majority of the countries with clearing agreements it is the duty of the Central Banks to operate them. In a number of countries, however, separate institutions have been created for that purpose. Such institutions exist in France (under the auspices of the Paris Chamber of Commerce), Belgium, Holland, Switzerland, Italy, etc. In some countries, such as Czechoslovakia, the Central Bank sometimes delegates its functions to big commercial banks for specific purposes. In Poland a private company is in charge of exchange clearing. In every case, the banker of the clearing office is the Central Bank, with which the former keeps its accounts. Thus, in final result the clearing takes place in every case through the intermediary of Central Banks. Needless to say, exchange clearing involves a large amount of office work, and

where the Central Banks are in charge of it they have to increase their staffs considerably. It also necessitates frequent decisions of principle which keep the executive reasonably busy. For these reasons, many Central Banks have not been keen to undertake a task which would thus divert their energies and attention from their normal functions. In several countries where exchange clearing was originally entrusted to Central Banks, clearing offices have been subsequently established.

A much more important question of a technical character is that of the exchange rate at which the payments are converted from the national currency of the debtor to that of the creditor. In every case payments by debtors into the clearing account are made in their own respective national currencies. Indeed, it is one of the main advantages of exchange clearing that it relieves debtors of the necessity of buying foreign exchange and enables them to settle their debts by payment in national currency. Even if the goods are invoiced in terms of the currency of the other contracting party or in terms of a third currency, the debtors actually pay only in national currency. The question is at what exchange rate are these payments converted into the currency of the creditor country? Various solutions are possible:

- (1) The gold parity.
- (2) The official rate of exchange.
- (3) The market rate of exchange.
- (4) A conventional rate of exchange.
- (5) Rates of exchange to be fixed from time to time by agreement between the two clearing offices.

In most of the early exchange clearing agreements

the rate of exchange was fixed at the legal gold parity. This system, however, was found to produce highly unsatisfactory results in countries where the internal value of the currency was considerably depreciated. It resulted in the breakdown of the agreements concluded by Austria during the first two years of the application of the system. Since the real value of the schilling was depreciated well below its legal value, the payment for imports and exports on the basis of the legal gold parity tended to encourage the former and handicap the latter. The trade balance of Austria deteriorated in consequence. Much of the criticism raised against exchange clearing in general was due to this and other similar experiences, although the inadequate results were not due to any fault inherent in the system but merely to the mistaken solution of a question of technical detail. This example shows how important technical details can be for the results of the system.

The fixing of official exchange rates usually serves the purpose of allowing for the depreciation of a currency without actually changing its legal parities. So far as the rates fixed represent the real exchange value of the currencies, the arrangement may be said to be on the whole satisfactory. Compared with the solution of applying the market rates of exchange for the conversion of the currencies, the application of such official exchange rates presents several advantages as well as disadvantages. On the whole it is considered preferable to base the conversion on the market rates.

In many cases, arbitrary rates are fixed by the exchange clearing agreements and these rates remain in force until the agreements are terminated, unless

changed by mutual consent. In order to obviate the necessity for lengthy negotiations between Governments for changing the exchange rate, the agreements sometimes confer authority upon the clearing offices of the contracting parties to agree between themselves upon the exchange rate.

Whichever method is chosen, it is of importance that the rate of conversion should follow real exchange rates as closely as possible. Apart altogether from the effects of an artificial rate upon the trade balance, it has the disadvantage of encouraging the circumvention of the clearing system. It is important to realise that by regulating the exchange rate at which conversion is made, the Governments concerned are in a position to influence their trade balances without having to change the actual exchange value of their currencies to that end. If, however, a country has exchange clearing agreements with every important country, the regulation of the rate of conversion amounts in practice to modifying the exchange value of the currency concerned.

An important question of detail is whether losses through exchange differences should be borne by the debtors or by the creditors. If the payment is converted on the basis of the market rate of exchange, then the question does not arise, for in that case the creditor is entitled to a fixed sum expressed in his own currency. Whenever arrangements are such as to give rise to exchange differences, the usual practice is that they should be met by the debtor. In early agreements the debtor was discharged from all further liabilities towards his creditor by the payment into the clearing account of the amount due. In more recent agreements, however, he is usually considered liable for the amount

due until the creditor actually receives it from his own clearing office. The difference is of importance, for, apart from considerations as to the exchange rate, there is also the possibility of a breakdown of the agreements between the two countries. Although most agreements contain provisions that in such cases the clearing office of the country with a favourable balance is entitled to collect funds from its importers until all claims of its exporters have been met, the latter naturally prefer to have the additional safeguard provided by the continued liability of their debtors.

The compulsory character of clearing raises another set of technical questions. The control is exercised by the authorities in charge of the operation of the exchange clearing agreements, but it is usually reinforced by the collaboration of customs authorities. The normal procedure is as follows: The exporters of the contracting parties notify their Central Banks about the claims arising through the sale of goods to the other country. Their declaration is checked with the aid of the customs authorities who supervise export trade. In the importing countries, the customs authorities usually refuse to clear the goods unless and until permit is produced from the exchange clearing authorities. This does not necessarily mean that the purchase price has to be paid into the clearing account before the goods can be cleared from the customs authorities. The British Debts Clearing Offices Act of 1934 seems to be based on that principle, but in practice its execution may prove difficult owing to the custom of selling goods on a credit basis. From the point of view of the satisfactory working of the exchange clearing, it is sufficient if the importers declare their debt to the clearing office, and their undertaking to pay when the liability

becomes due should be sufficient for the release of the goods. Needless to say, the clearing office would not assume responsibility to the creditors or to their authorities for the actual receipt of the payment until it materialised.

On receipt of the payment in national currency, the clearing office of the importing country immediately notifies the clearing office of the exporting country, while the latter notifies the exporters. As a general rule, the exporters are paid only if funds are available on the clearing account. If the funds available are not sufficient, the exporters are paid in chronological order as and when the funds come in. In some agreements, preferential treatment is secured to certain classes of exporters who enjoy priority either over all receipts of the clearing account or over receipts from a certain source. Usually if a Government is anxious to encourage the export of certain commodities or invisible exports, such as tourist traffic, it arranges for such preferential treatment. For instance, currency for German tourists in Switzerland is provided out of the proceeds of German coal exports to Switzerland which are reserved for that purpose. Currency required by Roumanian tourists in Czechoslovakia is provided out of the proceeds of Czechoslovakia's exports of machinery for the Roumanian oil industry. The number of such exceptions is, however, relatively small; the general rule is strict chronological order.

Occasionally Governments and Central Banks desirous of encouraging export trade are prepared to make advances to exporters pending the clearance of their claims. For instance, the first German-Hungarian agreement provided for advances to German exporters up to 50 per cent of their claims. A subsequent agree-

ment went further by providing for the immediate payment to exporters by both German and Hungarian authorities. In France the Government decided in August 1935 to grant advances on the frozen claims of French exporters under clearing agreements. Such arrangements are, however, exceptional, though it would improve the working of the system considerably if they were to become the general rule.

In some cases the authorities are doing their best to assist trade under the exchange clearing system. In other cases, however, the policy adopted by the authorities in charge of the execution of exchange clearing is responsible for a contracting tendency of trade. In many countries the clearing offices formerly adopted the practice of refusing to accept payments by importers if the adverse balance on the clearing account assumed inconveniently large proportions. The result was that exports to that country under the clearing agreement became discouraged. The accumulated adverse balance was in fact reduced by discouraging imports by such means. This provided an opportunity for the critics of the exchange clearing system to point out triumphantly that, where bilateral trade was not already balanced, the working of the clearing system tended to balance it at a lower level. In reality, exchange clearing was in such cases used improperly as a means of enforcing import restrictions. Subsequently in most countries which pursued such practices proper import control was adopted, thus obviating the necessity for refusing payments into the clearing accounts in order to check imports. Whatever imports were authorised, payment for them was henceforth accepted. This was the experience of clearing with Germany. Indeed since the middle of 1934 the German author-

ities, far from being anxious to prevent running up debit balances on clearing account, have done their utmost to encourage the practice, for it has secured for them the import of much needed raw materials on a credit basis. Moreover, the authorities of the exporting countries, confronted with a large and apparently unclearable credit balance on their clearing accounts with Germany, have had to make efforts to liquidate the balances, partly by adopting a more liberal attitude towards the import of German goods.

The allocation of the amounts collected on clearing accounts raises another set of technical problems. We have seen above that in some instances arrangements are made for the preferential treatment of certain classes of exporters. Usually exporters in general receive preferential treatment compared with financial creditors. Amounts due for current exports receive preferential treatment compared with commercial arrears. All this is not left to the discretion of the authorities concerned but is fixed by the bilateral agreements. In several instances, separate percentages of the receipts are earmarked for current exports, for commercial arrears and for financial claims. If the balance of payments is strongly in favour of the debtor country there is a chance of realising a surplus over and above all these claims and this surplus is usually placed at the free disposal of the Central Bank of the debtor country. In some instances, the Central Bank of the debtor country is anxious to retain a certain fixed percentage of the proceeds of the clearing, irrespective of whether all commercial and financial claims of the creditor country are satisfied.

Most clearing agreements contain clauses relating to the possibility of compensation transactions with or

without special permission. This point will be discussed in detail in Chapter XIX., which deals with compensation agreements. We shall see that exchange clearing and compensation, far from being rival systems, are very largely complementary.

There are innumerable other technical details arising from the working of clearing agreements. To cover adequately all of them would require volumes. The details which have been given in this chapter are, however, sufficient to indicate the nature of the questions arising from the application of the new system and the solutions that have so far been found. Indeed, it may be said that exchange clearing with all its theoretical and practical problems constitutes a new branch of economics on an equal footing with banking or currency or public finance.

CHAPTER X

EFFECT OF EXCHANGE CLEARING

IN Chapter VI. we enumerated the reasons which induced various Governments to adopt exchange clearing. We now propose to examine how far their anticipations have been justified by the results obtained through the application of the system. It is of course always difficult to establish definite relation between cause and effect in the economic and financial sphere. In physics and chemistry it is possible so to arrange experiments as to "isolate" a given cause, and thus to ascertain its exact effects, with the elimination of all other causes that would otherwise modify the result. In economics, however, such a process is impossible. Innumerable factors are always at work and the effect of the factor in which we are interested may be stimulated or cancelled out by other factors. For this reason none of the Governments to which the League Secretariat's questionnaire on exchange clearing was addressed was able to meet the request to indicate in exact figures the change in its foreign trade produced by exchange clearing. In many respects, however, the effects of exchange clearing are distinctly visible even if they do not lend themselves to expression in concrete figures.

In examining the effects of exchange clearing agreements we have to discriminate between financially weak and strong countries. For obvious reasons it was more important that the former should obtain satis-

factory results. For them the application of exchange clearing was not a luxury but an indispensable necessity. As we pointed out in Chapter VI., but for the application of exchange clearing the condition of these countries might have become desperate. Their import and export trade would have declined below the minimum that is indispensable for maintaining the standard of living at subsistence level. Owing to the import restrictions and exchange restrictions introduced by other countries, they would have been unable to export or receive payment for their exports, and owing to the unwillingness of other countries to export without receiving payment they would have been unable to import their primary necessities. The opponents of the system of exchange clearing may well marshal an intimidating array of figures showing that after the adoption of exchange clearing foreign trade in general continued to decline even in the financially weak countries in Central and South-eastern Europe. It is impossible to estimate how much greater the decline would have been in the absence of clearing agreements. Yet, even in the absence of concrete figures, it is a matter of common sense that, but for the facilities created by the exchange clearing agreements, these countries would not have been able to maintain their purchases from one another or from financially strong countries to anything like the extent to which they actually did.

Let us take an example. Hungary was in desperate need of Roumanian timber, but her National Bank was unable to allot exchange for it. Roumania in turn badly needed some of the manufactures produced by Hungarian industries, but again the Roumanian Central Bank was not in a position to allot exchange

for that purpose. A system which made it unnecessary for either of the two Central Banks to part with any of its foreign exchange resources evidently helped to enable each country to continue to buy goods from the other. Thanks to the adoption of exchange clearing, they were able to avoid having to allow their shortage of foreign exchange to interfere with the normal interchange of goods. In the absence of an exchange clearing agreement, both Hungarian and Roumanian exporters would have had to cease selling goods to the other country, for financially they were not in a position to wait indefinitely for the payment, even if they had been prepared to take the risk involved. Obviously the alternative to exporting with the aid of exchange clearing was not exporting at all.

In a number of cases, the conclusion of exchange clearing agreements was followed by an increase in the volume of trade between the contracting parties. In the majority of cases, however, the adoption of exchange clearing was unable to prevent a further decline in 1932 and 1933. This was due to the world-wide contraction of purchasing power which continued until 1933 in some countries and which still continues in others, and to the increasing tendency towards national self-sufficiency, through which many countries have been able to reduce their indispensable imports.

It may be stated safely that the results of exchange clearing in the Danubian and Balkan States, where the system has been adopted almost universally, have far surpassed those which a Danubian Customs Union could possibly have produced. For all practical purposes these States have actually created a kind of economic federation through the conclusion of exchange clearing agreements between one another. The

adoption of the system has done more to prevent a further shrinkage of inter-Danubian trade than would have been possible by an all-round reduction of customs duties by 10 or even 20 per cent, which is about the maximum that could reasonably have been expected of an economic union on the lines proposed by M. Tardieu in 1932. What is more, this Danubian and Balkan economic union is by no means a closed bloc. Those countries which have close trade relations with the Danubian and Balkan countries, such as Germany, France, and Italy, have taken good care not to be left out. They have concluded exchange clearing agreements with most of these countries, thereby securing for themselves what is practically equivalent to most-favoured-nation treatment. The result which could not be attained by diplomatic discussions and conferences has thus been achieved through the adoption of exchange clearing.

The answers given by the financially weak countries to the questionnaire sent out by the League Secretariat as to the effect of exchange clearing on the volume of trade vary widely. Some replies are definitely favourable, others are less so. Austria, for instance, states that "the unfavourable effects which might have resulted from exchange restrictions were neutralised by the provisions of the clearing agreements". The Chilean reply remarks "an increase in Chilean exports under the stimulus of the stipulation that the proceeds are to be applied to payments in the other contracting country have been neutralised by the unexpected maintenance by the European countries of import licences, quotas, etc., in spite of the agreements". Hungary states that in three cases out of eleven there was an increase in trade during the year following

the introduction of the clearing system, while in eight cases a decrease was reported. Roumania states that while the conclusion of exchange clearing agreements was followed by a decline in trade, subsequently there was a recovery owing to the endeavour of creditor countries to stimulate imports from the debtor countries in order to bring about a more rapid settlement of debts. Yugoslavia supplies some figures to show that at a time when foreign trade was on the decline all over the world, the operation of exchange clearing agreements with Czechoslovakia, France, Germany, Italy, Switzerland, Austria, Greece, Hungary, and Poland resulted in an increase of Yugoslav exports to those countries from 2071 million dinars in 1932, to 2888 million dinars in 1933, while Yugoslav exports to the rest of the world declined from 2747 million dinars to 2070 million dinars. These figures are sufficient to cast doubt upon the frequently repeated statement that exchange clearing tends to reduce trade between the contracting parties.

Among the financially weak countries, only Bulgaria and Czechoslovakia reported unfavourably on the effect of exchange clearing on their foreign trade. Bulgaria complains that her export surpluses to the countries with exchange clearing have declined. Czechoslovakia states that she had to reduce exports to Germany in order to liquidate her surplus.

On the question of the extent to which exchange clearing enabled exporters to obtain payment, the answers of financially weak countries are more unanimously favourable. In Austria, Chile, Estonia, Greece, Hungary, Latvia, and Yugoslavia, exporters were able to obtain payment either immediately or with relatively little delay. The answers of financially strong countries

show a different picture, but then these countries are generally in a better position to wait for payment. In financially weak countries the necessity of waiting even for six months would in all probability have compelled many firms to cease to export.

In taking into consideration the answers of various countries to the League questionnaire, it is necessary to bear in mind the general tendency to exaggerate the disadvantages of an existing system and to minimise its advantages. Judging by the tone and contents of some of the answers, one is inclined to ask why the Governments did not abolish the system if they disliked it so much. Evidently even those who regarded exchange clearing as an evil considered it a necessary evil. From the point of view of weak countries, the exchange clearing system has the immense advantage of releasing them from the blame for being unable to pay for imports. The financially strong countries realise that unless they buy a sufficient amount of goods from the financially weak countries the latter cannot be expected to pay. For this reason, where exchange clearing operates, delay in payment for exports does not as a rule create a bitter feeling against the debtor. The creditor countries realise that the delay is due not to any unwillingness to pay but to inability. In any case, the debit balances on clearing accounts which weak countries are unable to clear are usually a mere fraction of the total transactions carried out, and for which payment to exporters has been made, through the exchange clearing. There is far too much heard about these balances and far too little about the amounts of transactions which have been settled satisfactorily. Exchange clearing enables importers of financially weak countries to continue to obtain goods

on a credit basis. Financially strong countries without clearing usually insist upon cash payment for goods exported to countries with exchange restrictions. Financially strong countries with clearing agreements are, however, prepared to trade on the basis of the usual credit terms. This in itself provides the financially weak countries with highly valuable help during a difficult period. Unquestionably, the adoption of exchange clearing by weak countries has gone a long way towards preventing their currency reserves from being depleted. In the absence of exchange clearing agreements, they would inevitably have had to spend a large part of their reserves on indispensable imports. As it is, they have been able to secure a large part of those imports with the aid of clearing, without having to part with any foreign exchange. In some cases, exchange clearing has enabled the weak countries even to increase their gold reserves. For instance, Germany has been able gradually to increase her gold stock since the middle of 1934, thanks to the adoption of a large number of exchange clearing agreements. It may be said, therefore, that exchange clearing has saved more than one currency from collapse. While it is undoubtedly desirable to adjust weak currencies to their economic parities, it is essential that the readjustment should take place according to plan and that the authorities should maintain control over the depreciation. Otherwise it would degenerate into a disastrous slump and would lead to extreme inflation.

Exchange clearing has undoubtedly increased the efficiency of exchange restrictions. Whatever theoretical objections there may be against these restrictions, it is obviously desirable that when applied they should be enforced efficiently. One of the most dangerous

loopholes is wholesale evasion on the part of exporters. Although exchange clearing does not completely eliminate the possibilities of evasion, it reduces them considerably. In the absence of exchange clearing the proceeds of exports from the country with exchange restrictions are supervised only by that country itself. On the basis of exchange clearing they are supervised by both the countries concerned. While the exporter of the country with exchange restrictions may consider it worth his while to run the risk of evading the law, under exchange clearing he is unable to do so without the connivance of the foreign importer, who may be reluctant to break the law of his own country merely in order to oblige the exporter.

Let us now consider the results of exchange clearing from the point of view of financially strong countries. Admittedly, their replies to the League of Nations' questionnaire are on the whole less favourable than those of the weak countries. The principal complaint of most of the strong countries was that the weak countries with which they concluded exchange clearing agreements increased their purchases from them to such an extent as to convert an export surplus into an import surplus, or at any rate to reduce the export surplus considerably. As a result, the amounts collected on clearing account were not sufficient for the payment of the amounts due to the "strong" exporters for current exports. There was no adequate surplus for the payment on account of old debts, commercial and financial, to facilitate the liquidation of which was one of the main objects of the creditor countries in concluding the exchange clearing agreements. If the agreements fixed the percentage to be applied for old commercial and financial debts, then

the amount left over for exporters was not sufficient, and while old arrears were being paid off new arrears were created. Notwithstanding this, creditor countries managed to collect quite substantial amounts on account of commercial arrears which, but for the exchange clearing agreements, would have become hopelessly frozen. It was also through exchange clearing that Germany and other debtors were able to maintain a limited service on their financial indebtedness to countries with which clearing arrangements existed. It is true that the other side of the picture presents large credit balances on the clearing accounts with Germany and some other financially weak countries. These balances are, however, fundamentally different from claims which are simply defaulted upon. The creditor countries have always the means of reducing the balances either by increasing their purchases from, or reducing their exports to, the debtors. In the absence of an exchange clearing agreement such measures would not necessarily benefit the creditor countries. Any resultant improvement in the trade balance of the debtor countries may benefit some other creditor, and it is hardly worth any particular creditor country's while to put up with the disadvantages of having to buy more from the debtor country or to sell less to it, unless there is an assurance that, in its capacity of creditor, it will derive full benefit from its action. Obviously the desirable solution of the problem of liquidating a big clearing balance is an increase of purchases from the debtor country, and in a number of instances this solution has actually been adopted. But even if the less desirable solution, that of reducing sales to the debtor country, is adopted, the loss of the exporters will be the profit of the

creditors. The two classes, moreover, are to a large extent identical, especially as far as commercial arrears are concerned; in any case they belong to the same country.

Even though in some instances exports to the financially weak country have had to be reduced in order to liquidate the credit balances on the clearing account, this does not mean that exchange clearing tends to reduce the volume of foreign trade. After all, those credit balances were the result of large exports to the financially weak country, and these exports would not have been taken but for the existence of exchange clearing. Thus, in reducing exports in order to clear a balance, the creditor country merely deprives its own exporters and the importers of the debtor country of part of the benefit conferred upon them earlier by the exchange clearing agreement. It may be said, therefore, that both from the point of view of collecting their debts and from the point of view of maintaining their export trade the financially strong countries have on the whole benefited by the exchange clearing system.

Indeed, the final conclusions of the Governments of both strong and weak countries are incomparably more favourable than their answers upon questions of detail. On the question whether the Governments achieved the purposes at which they aimed in concluding clearing agreements, the following answers have been received:

Austria.—"As regards clearing agreements still in force, the results so far observed in the matter of the settlement of accounts are not unfavourable."

Belgium.—"Clearing agreements have to some extent

enabled trade to be re-started and frozen commercial debts to be recovered."

Bulgaria.—"Clearing agreements have achieved their purpose of averting a still greater evil—that is to say, embargoes and quotas on Bulgarian exports, the blocking of Bulgarian assets, etc."

Czechoslovakia.—"Clearing agreements . . . afford traders in the States concerned an assurance of obtaining payment, though possibly not until a long interval and only with difficulty."

Denmark.—"The Danish-German clearing agreement has yielded satisfactory results."

Estonia.—"The agreement with France has resulted in an improvement in the method of settling accounts."

France.—"France can also claim to have been satisfied with the results in the case of certain countries, in particular Austria, where the clearing has proved highly effective." Dealing with the agreements the operation of which was less successful, the French reply remarks that "it is essential carefully to distinguish the reasons for failure which are inherent in their institution and the general causes such as trade restrictions, quotas, etc., on the other hand, which would in any case have reduced the volume of French trade without any question of clearing agreements."

Greece.—"The agreements have considerably eased the foreign exchange position and to that extent have contributed to the stability of the national currency. They have facilitated the reduction of the adverse trade balance even though this result has been achieved in the majority of cases by reducing trade with the countries concerned to the level of a lower figure in the balance."

Hungary.—"The clearing agreements have made possible the payment of current imports and to a certain extent the liquidation of trade debt arrears in addition. The clearing agreements have in general helped to make the foreign exchange control more effective."

Latvia.—"The question whether the objects at which Latvia aimed in concluding her clearing agreements have been achieved must be answered in the affirmative."

Jugoslavia.—"Jugoslavia has achieved the purposes at which she aimed in concluding the agreements."

Some of the answers are inconclusive owing to the shortness of the period in which clearing agreements had operated. Out of fourteen answers, only one, that of Chile, is definitely unfavourable. Even in the case of Chile the disappointment of hopes attached to the clearing system is attributed to import restrictions on the part of European countries.

It is thus evident that however much the contracting parties may grumble about the unsatisfactory results produced by this or that clearing agreement, when it comes to expressing a definite opinion about the operation of the system as a whole they have to admit, generally speaking, that the results have been up to expectation. The report of the League Committee, while faithfully reproducing in the annexes the answers to its questionnaire, failed entirely to register in its report the fact that those responsible for the conclusion and maintenance of the clearing agreements hold the view that the results are up to expectation. If one reads the League Report, one gains the impression that the system has absolutely no redeeming features, and

one wonders why it is that those responsible for its initiation and maintenance do not abolish it forthwith. The answer is that it is not so much they, as the members of the Committee, who are so emphatically opposed to the system, and that even the Committee's opposition is based less upon practical results than upon doctrinaire considerations. About this more will be said in the next chapter.

CHAPTER XI

CRITICISM OF EXCHANGE CLEARING

As we have already pointed out, exchange clearing is a developing system, which has yet to get over the stage of initial difficulties. Its rules are being gradually established through trial and error. For this reason it provides ample material for criticism. Indeed, hardly any of the innovations brought about by the crisis has been subjected to as much criticism as has exchange clearing, whether in its underlying principles or in its details. In the present chapter we propose to examine the criticisms of a general nature, while the criticisms of detail will be dealt with in the next chapter.

For nearly two years theoretical economists took practically no notice of exchange clearing as an independent system. Most of them abused it in the same way as they abused exchange restrictions, without being able to discover any difference between them. It was not until the publication of the League of Nations report on exchange clearing that the system became the focus of uncomplimentary attention on the part of orthodox economists. Indeed the League report supplies them with ample ammunition for their attack. Every section of the report disclosed a feeling of uncompromising hostility towards the exchange clearing system. Evidently, the Committee was inspired by a strong dislike of the idea of interference with the free movement of trade and exchange. It is solely from this point of view that the system was examined.

There is no trace in the report of any investigation of the possibilities of improving world conditions by means of exchange clearing, or of any effort to remedy the technical defects of the system, so as to reduce the inconveniences caused by its application. The report viewed exchange clearing purely from the point of view of *laissez-faire* doctrinaires, who condemn Government intervention as a matter of principle even when it has practical advantages. From beginning to end the system is treated by the report as a "Public Enemy Number One" against which the Committee was determined to fight by fair means or by foul.

Human nature being what it is, it is clear that a Committee inspired by the orthodox spirit could hardly be expected to take an impartial view of exchange clearing. What is astonishing is the choice of the methods employed by the Committee in pursuing its object of discrediting the system. It would have been easy to make out a strong case against exchange clearing simply by concentrating upon its obvious defects and ignoring its advantages. The Committee, however, does much more than this. The report goes out of its way to blame exchange clearing for various disadvantages which were due to causes entirely independent of the system. For instance, exchange clearing is debited with all the adverse consequences of an overvalued currency. Doubtless the currencies of some, though not all, of the countries which have extensively adopted exchange clearing are or were overvalued, and doubtless, too, the countries concerned suffered disadvantages in consequence. They would be suffering the same disadvantages, however, if they had used, not exchange clearing, but some other means, to bolster up their currencies at an un-

economic level. It is the fact of the overvaluation of the currencies, and not the application of exchange clearing, which tends to reduce the exports and increase the imports of these countries. Obviously the remedy for the situation thus created is not the elimination of exchange clearing, as the Committee suggests, but the adjustment of the currencies to their economic parities.

The example of Austria is in itself sufficient to draw attention to the misleading character of the arguments of the report. The early agreements concluded by Austria failed invariably because they were based on the mint parity, at which the schilling was grossly overvalued. Subsequent agreements, however, according to the admission of the Austrian Government, produced satisfactory results because they were based on the actual depreciated value of the schilling. This example, which should not have escaped the attention of the Committee, is sufficient to prove that once the disadvantages of the overvaluation of a currency are removed exchange clearing no longer produces the unfavourable effects for which the League report blames the system.

Another device applied by the report to discredit exchange clearing is to blame that system for the difficulties arising from the fact that it has not yet been adopted by all countries. Every now and then we come across criticisms in the report about the adverse effect of the system upon the countries which have kept aloof from it. Of course it is a matter of opinion whether or not it is desirable that exchange clearing should be adopted universally; but, as things are, the system can hardly be blamed for the inconvenience it causes to those who do not want to adopt it. It is

characteristic of the Committee's attitude that it did not even consider the question of what would happen if all countries were to adopt exchange clearing. The report contents itself with putting the blame on the system for all the disadvantages suffered by non-clearing countries, without even attempting to indicate what would happen if these countries were to fall into line with the rest. In this respect, the deficiency of the work of the Committee is even more glaring than its omission to give adequate consideration to multilateral clearing. It is conceivable that, being aware of the fact that the universal adoption of the clearing system would eliminate many of its disadvantages, the Committee preferred to ignore the subject altogether.

There is indeed good reason to believe that, if all countries, or at any rate all countries of importance, were to be linked with one another by bilateral exchange clearing agreements, some of the disadvantages produced by the system amidst existing conditions would disappear. For instance, one of the main grievances of those financially strong countries which sought by clearing agreements to secure payment from financially weak countries is that after the conclusion of the clearing the weak countries tend to increase their purchases to such an extent as to convert their favourable balance into an adverse balance. Consequently, the creditors are unable to collect their frozen claims, which in fact increase to the extent of the surplus on their clearing account with their debtors. Thus while countries without clearing agreements complain that the financially weak countries divert their purchases to the financially strong countries within the clearing, the latter complain that financially weak countries buy too much from them. If all coun-

tries were on a clearing basis, there would no longer be any reason for diverting trade from one country to another merely in order to obviate the necessity of paying cash for the goods, since it would be possible to buy goods through clearing from every country.

Universal adoption of exchange clearing would put a stop to a favourite method of abuse. Some financially weak countries have adopted the policy of diverting their purchases to countries with which they have exchange clearing, while at the same time concentrating their exports to countries with which they have no exchange clearing. As a result they do not pay cash for the greater part of their imports, while they receive cash for a substantial portion of their exports. This was the policy which was successfully adopted by Germany. It enabled her to finance an adverse trade balance at a time when most countries would have been reluctant to grant her credit deliberately. What is more, there is good reason to believe that this abuse of the clearing system enabled Germany to accumulate a secret gold reserve. If every country were on a clearing basis, such abuses would be more difficult.

Naturally enough, the League report deplores that as a result of exchange clearing international trade tends to assume a bilateral character; that trade is being diverted from "its normal and natural channels", that countries buy goods in dearer instead of cheaper markets. The report is content to convey the impression that but for the adoption of exchange clearing there would have been a larger volume of international trade moving through normal and natural channels. The Committee refused to understand the circumstances in which exchange clearing has come about, refused to see that it was a last desperate remedy for

certain countries against an almost complete cessation of purchases abroad or an almost complete default on foreign commercial liabilities. It failed to understand that bilateral trade is better than no trade at all; that the alternative to buying in dearer markets was not buying at all; that trade through artificial channels is to be preferred to a complete cessation of trade. And yet the Committee had before it all the material showing the circumstances in which exchange clearing was adopted.

Ignoring the facts of the situation in 1931-1932, the report appears to be based on the false assumption that, if there had been no exchange clearing, strong countries would have continued to export freely to weak countries, irrespective of whether they stood a chance of ever being paid for their exports; or else it assumes that the monetary authorities of the weak countries would have continued to supply their importers freely with exchange, even though exchange reserves were dwindling rapidly. It is only on the basis of such obviously false assumptions that it was possible for the committee to arrive at the equally false conclusion that exchange clearing tends necessarily to reduce the volume of international trade. In reality, if exchange clearing fails completely, the worst that can happen is to arrive at a state of affairs which would have arisen if the system had never been adopted at all.

The argument in favour of triangular trade and against its substitution by bilateral trade is based on a gross exaggeration of the importance of the former. According to the figures published in the annex of the report, triangular trade of sixteen European countries amounted to 16 per cent of their total foreign trade in 1929, while it declined to 12 per cent in 1933.

Exchange clearing is of course blamed for this decline. In reality, in 1931, before exchange clearing began to operate, the percentage was already down to 14, so that during the two years that preceded the adoption of exchange clearing this decline was quite as pronounced as during the two years that followed it. The whole decline in the percentage of triangular trade to total trade between 1931 and 1933 was barely 2 per cent. By the extensive use which it makes of the argument that clearing adversely affects triangular trade, the report conveys the impression that at least 25 per cent, if not 50 per cent, of the world's trade was at stake, when in reality the percentage involved was negligible.

In its zeal to make out the strongest possible case against exchange clearing the Committee overlooked some rather glaring contradictions in the text of the report. On page 16, for instance, it complains that exchange clearing tends to raise commodity prices by diverting purchases from cheaper to dearer countries, and by the employment of transit trade instead of direct trade, where transit trade can be included in the clearing. On the very same page, however, the report declares that "clearing agreements tend to lower the world level of prices". The truth of the matter is that since exchange clearing enables the contracting parties to sell raw materials and manufactures which would otherwise become unsaleable, it tends to prevent a further deflationary slump of commodity prices. Possibly if it were adopted on a sufficiently large scale, the system would lead to the liquidation of surplus commodity stocks and this would result in a recovery of prices. Nobody but fanatical deflationists would regard this as a major disaster.

Another piece of inconsistency:—The report declares that under the system the collection of accumulated commercial claims entails the reduction of exports from the creditor to the debtor country, and that in general it can operate only if the balance of trade between the two parties is definitely in favour of the debtor country. In other parts of the report, however, the Committee expressed its pious hope that creditor countries would accept an unfavourable trade balance in relation to their debtor countries.

Again, on page 36, it is stated that weak countries tend to increase their purchases in countries with which they have clearing agreements in order not to have to spend their foreign exchange reserves. In the very same paragraph the report states that exchange clearing agreements have accentuated the shortage of foreign currency of the debtor countries.

Most amazing of all, the Committee expressed two diametrically opposing opinions on the effects of exchange clearing on the volume of trade between the contracting parties. On page 46 we read that, “clearing agreements *tend to eliminate or restrict* any impulse or movement towards increased trade between the two parties”. On the other hand, on page 49, it is stated that “clearing agreements *artificially stimulate* trade between the contracting parties”. The reader of the report, having paid his four shillings, is at liberty to take his choice.

Another inadmissible method employed by the Committee was that of using the term “fact” when referring to its own views. Those who have some respect for the term “fact” have every right to object to its improper use. With regard to the effect of exchange clearing on the volume of trade between the

contracting parties, the report on page 46 refers to "facts" which prove that clearing tends to reduce trade, while on page 49 it refers to "The fact [*sic*] that clearing agreements artificially stimulate trade. . . ." This example is sufficient to indicate the extent to which the "facts" of the report can be relied upon.

It is indeed unfortunate that the first effort at an investigation of the possibilities of the new system should thus be miscarried by the zeal of the Committee to make out the strongest possible case against it. Fortunately, the report so obviously overstated its case that it cannot possibly mislead anyone who reads it with an open mind. The only danger is that the opponents of exchange clearing will make use of the material thus provided and endorsed with the authority of the League of Nations. For every reader of the report itself there will be hundreds of readers of skillfully selected extracts from it.

To understand the attitude of the Committee it is necessary to bear in mind two things. One is that, of the seven members of the Committee, two were British. It is an open secret that the British Government is determined to avoid exchange clearing at all costs. In this respect its attitude is similar to that of the British Governments towards protection prior to 1931. For nearly a century Great Britain remained free-trader in the hope that other countries would follow her example. Even when it was becoming obvious that protection abroad, far from declining, tended to increase, the British Governments hoped against hope that by some miracle it might be possible to avoid having to introduce a protective tariff. Similarly, the National Government prefers to "wait and see" in the hope that the abolition of exchange clearing abroad may obviate

the necessity of its adoption by Great Britain. The country has to put up with all the disadvantages of being outside the clearing, which explains perhaps why the evil effect of the system upon non-clearing countries is given such prominence in the report. It also explains why the British Government instructed its delegates—one of whom at any rate does not harbour irreconcilable hostility to exchange clearing—to do their utmost to make out a strong case against the system and to urge its abolition. A third member of the Committee was American, and the attitude of the United States Administration towards clearing is exactly the same as that of the British Government.

The other consideration that has to be borne in mind is that the Committee drafted its conclusions at a time when the creditor countries were strongly influenced by the unsatisfactory results of their clearing agreements with Germany. This, it is true, was solely due to the fact that the system had not been adopted by all countries, so that Germany was in a position to run up big debit balances on her clearing accounts through transferring her purchases from non-clearing to clearing countries. In spite of this, the countries victimised by Germany's cunning device were bitter against the system as such, instead of blaming the cause that led to its abuse.

The above remarks by no means exhaust the criticisms the League report calls for. We propose to return to the subject in Chapter XV., when dealing with the possibilities of international clearing. Meanwhile, we propose to turn our attention to more serious matters by examining the criticisms of a practical nature directed against exchange clearing.

CHAPTER XII

TECHNICAL PROBLEMS

It goes without saying that trading under the clearing system is in many ways a more cumbersome process than trading under a régime of freedom. The merchants have to fill in various forms; they have to obtain various certificates and, in some cases, permits. There is much correspondence between the clearing and customs authorities and between the two clearing authorities. In one word, it would be idle to deny that a great deal of red tape is inevitably connected with the system as with every other kind of Government intervention. This, doubtless, constitutes a disadvantage. In itself, however, it would not offset the advantages of a rational system of international exchange. The question is whether in practice the system does not exhibit many defects which reduce its theoretical advantages. Exchange clearing has been subjected to much criticism from a practical point of view, and although the League report barely touched this aspect of the problem, it certainly should not be ignored.

In the first place, it must be asked whether in practice it is possible to enforce exchange clearing. Those who are in charge of its application have to struggle against a tendency to evasion that inevitably accompanies every official regulation of trade and finance. In the case of exchange clearing there is unquestionably an inducement to circumvent the law. Its degree varies according to circumstances. If the

exchange rate at which the two currencies are converted for the purpose of clearing does not correspond with the actual exchange rate, then there is a strong inducement to evasion. The margin between the actual rate and the rate of the clearing opens possibilities for making a profit by circumventing the clearing arrangement. The same may be said to be true, though to a less extent, if the rate fixed for the purpose of the clearing, while corresponding with the actual official exchange rate, differs materially from the "black" exchange rate. In that case, also, many export transactions from the financially weak country, which would not be profitable if the proceeds were collected through the clearing, become profitable if, by circumventing the clearing, the exporter is able to dispose of the proceeds on the "black" market.

Even if the rate fixed for the purpose of the clearing corresponds to the actual exchange rate and there is no material difference between official and unofficial rates, there may still be a strong inducement to circumvent the clearing. It is necessary to discriminate in this respect between evasion by individuals and evasion by the Governments concerned. Individuals may be tempted to evade clearing, even though no specific profit attaches to evasion, if they thereby find a convenient way for transferring their capital abroad from countries with exchange restrictions. In addition, the Governments which are parties to the clearing agreements may themselves act in bad faith by inducing their nationals to evade the clearing. There is strong circumstantial evidence to indicate that this is what the German Government has done regarding its clearing with a number of countries. For instance, towards the end of 1934 it came to the notice of the

Italian authorities that the same commodities which in the past had been sold to Italian firms as German goods were being sold by the same commercial travellers and agencies as Swiss goods. The explanation was that while Italy had a clearing agreement with Germany, she had none with Switzerland, so that Italian importers had to pay cash for goods which they were supposed to have bought from Switzerland. For the German Government this was a convenient way of accumulating free exchange. It may be objected that conceivably the clearing agreement was evaded on the initiative, and for the profit, of the German exporters themselves, in order to enable them to transfer their capital abroad. The standing of some of the German firms concerned was, however, such as to make it extremely unlikely that they would have exposed themselves to the very severe penalties attached to the violation of the law against the flight of capital. It is incomparably more probable that the German firms acted on instructions received from the German authorities and surrendered loyally to the latter the proceeds of their exports to Italy. We saw in the last chapter that Germany has made improper use of the clearing system by diverting her purchases to countries with which she had clearing agreements, while diverting her exports to non-clearing countries. In doing so she violated the spirit of the agreements though not their letter. In obtaining free exchange for her exports to clearing countries by having the goods sent under the disguise of exports from a non-clearing country, she violated both the letter and the spirit of the agreements.

There are various other means of circumventing clearing agreements besides the one described above.

It is possible to have the goods invoiced for the purposes of the clearing at a price well under their value, provided that the importers agree to pay the difference in free exchange. The scope for this type of evasion is, however, narrow, not only because it necessitates a conspiracy between importers and exporters to break the law of their respective countries, but also because the customs authorities have some idea of market prices, so that the discrepancies cannot be very large. Where compensation transactions are combined with clearing, the possibility of this kind of evasion is greater, for market prices need not necessarily be the basis of barter transactions.

The unauthorised inclusion of re-exports with exports, by a country with a credit balance on its clearing account, is yet another way of making improper use of exchange clearing agreements. Exporters all over the world follow with keen interest the announcements as to the position of various clearing accounts, and whenever there is a chance they try to pass their transactions through that clearing account which has a balance available for distribution to exporters.

Experience has led to the adoption of various devices for the prevention of such abuses. The more recent agreements contain clauses which greatly reduce the possibility of evasion. In some cases certificates of origin have to be obtained from the consulates or chambers of commerce. Needless to say, this provision increases the amount of red tape to no slight extent. Transit trade is excluded from most clearing agreements, so as to prevent abuses, but some countries, such as Switzerland or Holland, for whom transit trade is very important, have insisted upon its inclusion,

usually up to a definite percentage of either the total trade or of the proved genuine transit trade of past periods. The intelligent interpretation of the agreements by the customs authorities, however, goes further to prevent evasion than any specific provision, which may become a dead letter, can do. The customs authorities are in a position to notice if goods arrive from an unusual country of origin. Without rigidly preventing normal changes in the trend of trade, they can spot and check obvious abuses.

Needless to say, if both contracting parties are equally anxious to carry out the agreement in its letter and spirit, their loyal co-operation will go a long way towards making the system watertight. If the customs authorities and clearing offices of both countries collaborate, they can check most attempts at evasion. It is only if one of the Governments is guilty of bad faith that supervision becomes really difficult. The possible profit arising from abuses of the clearing arrangement would of course be considerably reduced if the system were adopted universally. The temptation to evade the clearing for the sake of obtaining free exchange would no longer exist. Inducement to evasion would arise only where the passing of exports through a foreign clearing account offered a better chance of early payment. Such an abuse would, however, actually facilitate the smooth working of the system. In its effect it would in a way amount to unofficial multi-lateral clearing.

Given a certain degree of goodwill and good faith, evasion does not present insurmountable difficulties. The longer the system remains in force, the better the chances are of closing the loopholes. In the long run the proportion of leakage will not be any larger than

that of smuggling is in normal foreign trade. Criticism of exchange clearing on the ground that the system is not watertight is grossly exaggerated even in existing conditions, for the total proportion of evasion is in most cases relatively small.

The exchange clearing agreements are subjected to much criticism on the part of business men on the ground that in many cases there is considerable delay in the receipt of payment for goods delivered. This is doubtless a justifiable criticism of some, but by no means all, exchange clearing agreements. Where there is a big discrepancy between imports and exports between the two parties, and where the balance is not offset by invisible items or debt payments, the exporters of one of the countries have to wait a long time for their money. This, however, is not the fault of the system. In the majority of cases, the exporters of strong countries would in any event have to wait indefinitely for the transfer of their proceeds, whether there were a clearing agreement in operation or not. From their point of view the position is much more satisfactory when there is a clearing agreement with the debtor country, for then they at least know that they will be paid eventually. Moreover, they have the reassuring feeling that they will be paid in chronological order, as and when funds become available on the clearing account, which is certainly not the case with the commercial arrears in the absence of a clearing agreement. In such a case, many creditors accelerate collection of their claims by taking a loss in disposing of their blocked currencies in the "black" market. The result is that those who wait their turn have to wait longer. The same result arises from the corrupt practices in countries where the authorities give preferential

treatment to those creditors who are prepared to pay the price for it. Such abuses are ruled out by the clearing system. Exporters of the financially strong countries can rely upon the integrity of their authorities in making payment in strict chronological order.

The system is sometimes criticised on the ground that it gives exporters a false feeling of security and encourages them to sell goods to weak countries even though there is no hope of early payment. But this, surely, ought to be considered one of the great advantages of the clearing system. If a country has no gold, and is unable to obtain credit abroad, it need not starve so long as there are foreign merchants willing to sell goods to its importers on the basis of exchange clearing. Nor have exporters on the whole reason to regret their confidence in the system. It is true that sometimes they have had to wait rather longer than they expected, and on some occasions they have had to cut a loss in order to expedite collection of their claims. This was the case with Swiss commercial claims against Hungary. The Swiss-Hungarian clearing agreement, as already stated, was established primarily for the purpose of enabling Swiss exporters to collect their arrears in Hungary out of the surplus of Swiss imports from Hungary over Hungarian imports from Switzerland. As a result of the clearing, however, Hungarian purchases had been diverted to Switzerland, and the Hungarian credit balance in bilateral trade with Switzerland had become converted into a debit balance. Thus the arrears, instead of declining, actually increased. To remedy this evil, it was arranged that Switzerland should purchase large consignments of Hungarian wheat. As Hungarian wheat was above the world market price, the transaction resulted in a loss which had to be borne

by the Swiss creditors who obtained payment as a result of the deal. The loss was, however, relatively moderate, and was amply covered, generally speaking, out of the margin of profit on the Swiss manufactures sold to Hungary. Thus the Swiss exporters found it worth while to shoulder the loss, and they had no reason to regret having exported to Hungary on the basis of the clearing agreement. In the absence of a clearing agreement, they certainly would not have exported on the off-chance of being paid sooner or later, so that the agreement was a source of profit to them.

In any case, the existence of a clearing account enables exporters to form a rough idea of the delay to which they are likely to be exposed. In the absence of exchange clearing they have no idea of the extent of arrears, and to export in such circumstances would be a leap in the dark. They are in fact exposed to the danger that their claims may become entirely frozen. This is certainly not the case with claims under exchange clearing, payment of which is mostly a mere question of time. If the credit balance becomes too large, then the Government endeavours to reduce it by encouraging imports from, or reducing exports to, the debtor country. It may go so far as to arrange for purchases of goods from the debtor country, so as to liquidate the balance. Indeed, it may be said that the Government of the creditor country is morally responsible for the liquidation of arrears created through the working of the clearing agreement, even though legal responsibility is always disclaimed. In many cases the authorities of the creditor country undertake the financing of these arrears. They may even go further by extending to them the export credit insurance schemes

which are in operation in various countries. This is exactly the kind of risk against which all Governments should insure their nationals, instead of encouraging the reckless granting of credits to unreliable debtors by insuring creditors against ordinary credit risk.

The interests of creditors are usually safeguarded even if the exchange clearing agreement breaks down. Provisions for the liquidation of the credit balance are usually included in the agreement, and in the absence of such clauses the claims are collected by maintaining unilateral clearing against imports from the country concerned. Whatever its shortcomings, the system obviously reduces considerably the risks of exporters to financially weak countries.

The insurance of exports against risks arising from abnormal delay in the working of clearing agreements, or from a breakdown of the agreements, is indeed the minimum that exporters are entitled to expect of their respective Governments. The ideal state of affairs would be that the clearing offices should possess capital of their own, which would enable them to make payments to exporters as soon as they received notice that the importers had paid the purchase price into the clearing. If there is a credit balance accumulated on a clearing account, the authorities should assume full responsibility for carrying it, and exporters should not be kept waiting until the liquidation is completed. In a small number of agreements this principle is admitted, but the authorities concerned have not done more than advance the funds pending the receipt of payments.

Unfortunately, many Governments have adopted a much more timid attitude. While some countries have done their best to make use of clearing to obtain credit

abroad, other countries have been over-anxious to avoid this. To discourage excessive imports from the countries with which they had clearing agreements, they resorted to the device of refusing payment into their own clearing account unless and until the counterpart had been provided by payments into the clearing account of the other contracting party. For example, the Hungarian National Bank refused at one time to accept payment into the Italian clearing account by Hungarian importers of Italian goods until an equivalent amount had been paid into the Hungarian clearing account in Italy by Italian importers of Hungarian goods. The result was that Italian exporters to Hungary were deprived of the reassurance that their claims would be paid into clearing accounts on maturity. This naturally tended to discourage Italian exports to Hungary. It is to such timid interpretation of the principles of clearing that its reputation for discouraging foreign trade is due.

Imposition of restrictions, however, has by no means been confined to importing countries. Where importing countries, far from discouraging exports from clearing countries, have done their utmost to encourage them, it has been the exporting countries that have considered it expedient to resort to restrictions. In several countries export to the other contracting party has been made subject to "clearing visa". An alternative solution for the exporting country would be to stimulate imports from the other party. A number of countries have, indeed, resorted to that solution. To that end, in many cases import duties have been reduced or abolished, prohibitions removed and import quotas increased. Other countries, however, were afraid of encouraging foreign trade at the expense of home trade,

and preferred to sacrifice exports rather than increase imports.

There are innumerable other technical points which are worth discussing, but the author prefers to abstain from going into too many minute technical details for fear of over-complicating the problems for the general reader. None of these problems is of such a kind as to render the system impracticable. All of them can be solved in the course of experience, and many of them have in fact already been satisfactorily solved.

CHAPTER XIII

BILATERAL CLEARING AND TRIANGULAR TRADE

TRIANGULAR trade has a strange fascination for the *laissez-faire* school. If it is true that the adherents to this school would gladly sacrifice £10 millions of home trade for the sake of £1 million of foreign trade, it is equally true that they would cheerfully sacrifice £10 millions of bilateral foreign trade for the sake of £1 million of triangular or multilateral trade. Indeed, in their eyes the virtue of foreign trade increases in proportion to the number of its "angles". The more indirect the route which payment for imports by exports follows, the more they appreciate it. The explanation of this attitude lies largely in the desire of the *laissez-faire* school to preserve the illusion that the world is one large trading community without barriers between the independent political units. The favourite form of self-deception practised by orthodox economists has always been that of convincing themselves that trading between various districts of the same country and trading between various countries is in reality the same thing. The wish being father to the thought, they actually succeeded in convincing themselves—and, what is worse, others also—that political barriers need not divide the world, which, they declare, is one large economic unit. The larger the volume of foreign trade compared with that of home trade, the more this practice of make-believe is encouraged. Hence the keenness of the *laissez-faire* school on foreign trade.

It is for the same reason that they prefer triangular to bilateral trade, and multilateral to triangular trade. The more indirect is the payment for imports by exports, the nearer their favourite dogma appears to come to reality, and the more surely they can argue that a country need not worry if it over-imports, any more than Yorkshire need worry if one year she buys more from Lancashire than she sells to her.

The cult of triangular and multilateral trade has been fostered not only by this doctrinaire attitude, but also by considerations of a more practical character. If we have to balance our sales and our purchases with individual countries we often have to buy in a more expensive market, or alternatively sell at lower prices, than would have been necessary with triangular or multi-angular trade. It is only through multilateral trade that every country is enabled to buy from the cheapest market and to sell to the highest bidder. In multilateral trade there is thus a concrete financial advantage, which can be expressed in pounds, shillings and pence.

Last but not least, triangular trade, rightly, has been considered necessary owing to the diversity of the requirements and of the systems of production of various countries. Country *A* may require the goods of country *B*, but the latter may not require the goods of country *A*, not because they are too expensive but simply because there is no demand for them in country *B*.

Triangular trade has unquestionably certain advantages, and to a limited degree it is even indispensable. As we shall attempt to show later, however, the extent of its utility has declined considerably during the last few years. In any case, recent experience has

amply proved that the advantages of a highly developed multilateral trade are heavily outweighed by its disadvantages. The system built up before the crisis had become over-complicated and consequently over-sensitive. To illustrate this, let us reduce multilateral trade to its simplest triangular formula. Country *A* exports goods to country *B*; the latter exports goods, not to country *A*, but to country *C*; the latter, in turn, exports goods, not to country *B*, but to country *A*. The circle is thus complete. The exports of *A* to *B* are paid for by the exports of *C* to *A*; the exports of *B* to *C* are paid for by the exports of *A* to *B*; and the exports of *C* to *A* are paid for by the exports of *B* to *C*. In normal conditions, all goes well. If, however, the process is checked by the action of one of the three countries, the breakdown at this point is bound to affect the other two. If *B*, for instance, introduces import restrictions, or is for some reason unable to export, the circle in which trade flows is broken. Both *A* and *C* suffer through no fault of their own. The larger the number of the countries participating in the process of multilateral trade, the more sensitive the system becomes. It is sufficient for one link in the chain to break to lead to the breakdown of the whole chain. Therefore, the vulnerability of the chain increases in direct ratio to the number of its links. The introduction of the financial factor in itself complicates the system. If a country introduces exchange restrictions or defaults on its debt, that alone is sufficient to disorganise the whole process.

Under the system of free multilateral trade country *A* never knows whether its exports will ever be paid for by corresponding imports, or conversely whether it will ever be able to pay for its imports by correspond-

ing exports. If one country out of a dozen with which the bulk of country *A*'s foreign trade is transacted in a multilateral way refuses to buy or to pay for the goods bought, or if it defaults on its debts, that is enough to put the whole system out of gear, and to prevent *A* from importing or from paying for its imports. Since 1931, we have had ample opportunity to observe the disastrous consequences of over-involved international trade and international financial relations. It is not surprising that the experience of the last few years has led to a strong reaction in favour of bilateral trade. Many Governments came to the conclusion that they would rather forgo the obscure and uncertain advantages of triangular trade and base their policy on the principle of balancing their trade separately with each country. This is the declared policy of Turkey and of several other countries.

In a large number of instances, however, it is doubtful whether the exact, or even the approximate, balancing of imports and exports between two countries is practicable. As already noted, doctrinaire considerations apart, there are practical considerations which make the maintenance of a certain amount of triangular trade desirable and even indispensable. The importance of the price factor has, however, declined during the last few years. Before the crisis, country *A*, though it exported its goods to country *B*, preferred to make its purchases from country *C*, because the latter's prices were 5 per cent or 10 per cent cheaper than those of country *B*. To-day, however, country *B* is prepared to buy from country *A* only if country *A* buys from country *B*. Thus, the choice for *A* is not whether to buy the goods 5 per cent cheaper from *C* or 5 per cent dearer from *B*, but whether to buy them

5 per cent dearer from *B* or not to buy them at all.

Doubtless the balancing of trade bilaterally between *A* and *B* (allowing of course for all invisible items and capital items) is bound to increase stability and security, for the sake of which it may appear well worth while in troubled times to pay a somewhat higher price for imports, or to receive a somewhat lower price for exports. The additional 5 per cent or 10 per cent may be regarded as an insurance premium, and as such it may be deemed well spent. Needless to say, if the difference is not 5 or 10 per cent, but 20 or 30 per cent, then the premium becomes decidedly excessive, and a stage may be reached when no trade at all will be preferred to bilateral trade.

This "price factor" obstacle to bilateral trade can be reduced considerably with the aid of subsidies to exports. This is what is being done in Germany. The obstacle presented by the absence of adequate demand on the part of the populations of two countries for each other's products is, however, more difficult to overcome. In some cases it is insurmountable, though it can be mitigated to a much larger degree than orthodox economists would like us to believe. Take, for instance, the case of Great Britain and Brazil. Although Brazil has to transfer to Great Britain large amounts for the interest on British capital lent to her, Great Britain sells much more to her than she buys from her. In order to make the trade between the two countries balance without reducing British exports to Brazil, it would be necessary for Great Britain to increase her imports from Brazil to a figure which would cover both her exports and the requirements of the debt service. The difficulty is that Brazil's chief exportable product is coffee, and that the British demand for

coffee in general and for Brazilian coffee in particular is very small. To believe the gospel of orthodox economists, it would be a sin to interfere with nature by trying to induce consumers to change their taste. And yet the historic example of the encouragement of port-drinking in Great Britain proves that it is possible to bring about lasting and substantial changes in the tastes of consumers. It was in order to encourage the export of wool and textiles to Portugal that, in the sixteenth century, Englishmen took to port-drinking. It is by no means inconceivable therefore, that they would take to coffee-drinking in order to help to maintain British exports to Brazil. It is true that the result would be a decline in the consumption of tea. But, since the Japanese penetration into China tends to reduce the Chinese purchases of British goods, such a change would also be in keeping with the trend towards stability through bilateralism in trade.

There is, however, no need to increase the British consumption of Brazilian coffee in order to achieve a bilateral equilibrium between the two countries. Brazil is quite capable of producing goods which can be sold in Great Britain without having to provoke to that end a revolutionary change in the taste of consumers. In fact, Brazil has already gone a long way towards the desired end by taking up the production of cotton. Even if Brazilian cotton is more expensive than United States cotton—which need not necessarily be so—it may be worth while for Great Britain to transfer her purchases to Brazil for the sake of balancing her bilateral trade both with that country and with the U.S. British trade with the United States shows a huge import surplus, the elimination or reduction of which would go a long way towards creating more stable

conditions in international trade and finance. Thus, by buying more cotton from Brazil, Great Britain would kill two birds with one stone.

What is needed is to drop the attitude of economic dogmatism by which triangular and multilateral trade, to the extent to which it existed in 1929, is declared indispensable, and by which any attempt to replace triangular trade by bilateral trade is treated as sacrilege. To a very large extent triangular trade can and should be replaced by bilateral trade. Admittedly, in arriving at this conclusion we lay ourselves open to the charge of trying to make a virtue out of a necessity: whether we like it or not, the existing deadlock in international trade and finance tends to divert trade into bilateral channels. But we maintain that, apart altogether from its immediate practical aspects, this tendency is a move in the right direction in that it reduces the vulnerability of our international commercial and financial system.

Having said all this, we must nevertheless admit that there remains a certain degree of triangular trade which is indispensable; and that a decline below this minimum would inevitably lead to a fall in the standard of living in the countries concerned. This irreducible minimum tends itself to decline, however, as a result of the diversification of production which is occurring in most countries in consequence of their policy of economic self-sufficiency. It is very difficult to balance trade between two countries where each has only two or three exportable products. If each has twenty to thirty products which it can offer in exchange for the imports from the other country, then the chances are that the balance of bilateral trade can be reduced. At the same time, economic self-sufficiency

does tend to reduce import requirements for certain products while tending to increase import requirements for the raw materials which are needed for the production of new kinds of manufactures. In the majority of cases, however, it is reasonable to assume that on balance the tendency to isolationism does not conflict with the tendency towards bilateral trade.

On the other hand there can be no doubt that bilateral trade tends to moderate economic isolationism. It will be remembered that in 1934 there was much talk in Germany about replacing cotton and wool by synthetic substitutes manufactured internally. These substitutes were admittedly inferior to natural wool and cotton, but since the Reichsbank's foreign exchange reserve was becoming depleted, there appeared to be no choice but to put up with the inferior substitutes. In the meantime, however, Germany has succeeded in procuring wool and cotton with the aid of compensation agreements—the most direct method of bilateral trade—and consequently the campaign for synthetic substitutes has subsided considerably. Artificial wool and cotton are still being manufactured in Germany as cheap substitutes, but not nearly to the extent which would be necessary in the absence of the bilateral agreements.

What is the effect of the exchange clearing system upon the bilateral trend of international trade? Without doubt some Governments have concluded clearing agreements with the declared object of diverting their trade into bilateral channels. In other countries, the tendency has been to produce this result even in the absence of any conscious policy to that end. Since balances on clearing account are hardly ever settled by cash transfers, they have to be settled by imports and

exports, visible or invisible. In the long run, therefore, the result is a balanced trade between countries with clearing agreements. In some instances, it is true, the balancing is difficult, and has to be achieved by artificial intervention. This intervention often assumes the form of removal or relaxation of import restrictions by the country with a favourable balance, a device to which even orthodox economists can hardly object. Occasionally, the balancing is brought about by means of special transactions arranged between the authorities of the two countries. This practice is strongly condemned by *laissez-faire* economists, especially as such transactions usually involve a moderate loss to the creditors through the diversion of trade from its normal channels. As, however, the balancing of bilateral trade by such artificial means prepares the way for further trading on a safe bilateral basis, the result is well worth the sacrifices. These, in any case, are relatively small.

Given a policy favouring the bilateral balancing of trade, it is through clearing that such an end can be achieved with the least degree of diversion of trade from its natural channels. In the absence of clearing it is necessary to limit purchases by quotas or other restrictions, or to resort to compensation agreements. Compared with these methods, exchange clearing is by far the most elastic method. It does not necessitate the curtailment of individual purchases: buyers of both countries are at liberty to buy what they want. Although it is more convenient to buy from a clearing country instead of from a non-clearing country, if the difference in the price is too big buyers will automatically resort to the non-clearing country. Through the working of clearing, foreign trade remains free; it is

only the payment for imports and exports that is regulated by the clearing agreement. It is only if and when the mitigation of restrictions has failed to achieve a balance of bilateral trade between the two contracting parties that the Governments resort to exceptional and artificial transactions.

It is sometimes stated that under the clearing system the financially weak countries tend to develop an adverse trade balance in relation to the financially strong countries. The truth is that to a large extent the remedy lies in the hands of the financially strong countries. They can assist towards the restoration of the balance either by encouraging imports from, or by discouraging exports to, the financially weak countries. This question has been dealt with in earlier chapters; the only point that need be reiterated at this juncture is that the tendency to increased purchases by weak countries need not disturb the tendency towards bilateral balancing of trade.

CHAPTER XIV

TRIANGULAR CLEARING

As we saw in the last chapter, bilateral clearing agreements tend to reduce the amount of triangular (and multiangular) trade. In the author's opinion, although triangular trade has obvious advantages, under the régime of freedom these advantages are at times more than outweighed by the disadvantages. For this reason, the reduction of triangular trade during an abnormal period should be put to the credit of exchange clearing, and not to its debit. What is more, the exchange clearing system provides the means of retaining the advantages of triangular trade while eliminating its disadvantages. To achieve this end exchange clearing must develop from its bilateral stage into a triangular stage. This end, in fact, has already been achieved in many instances; what is now wanted is that the exception should become the rule.

The reason why triangular trade is harmful and risky under a régime of freedom is that those relying upon it are exposed to a breakdown caused solely by defects in some remote link in the chain of international trade. In the case of bilateral trade, the parties concerned can more surely count upon being paid by imports for their exports, and can be more certain that they will be able to pay by exports for their own imports. In the case of triangular trade under a régime of freedom, all they can do is to trust to luck and hope for the best. If, however, triangular trade is placed

under a régime of exchange clearing, the contracting parties have the same security as they have with bilateral trade, and can in addition enjoy the advantages of triangular trade. Indeed, it may be said that just as bilateral exchange clearing is the safe method of bilateral foreign trade, triangular exchange clearing is the safe form of triangular foreign trade.

The advantages of developing triangular exchange clearing are obvious. Apart from its immediate advantages, triangular exchange clearing carries the possibility of the development of international clearing. For this reason alone, it is well worth studying.

The main purpose of the appointment of the League committee, to study the "causes, scope, methods and results" of exchange clearing, was to examine the possibilities of triangular clearing. This was, at any rate, in the mind of M. Lamoureux, the initiator of the League enquiry. Unfortunately, the terms of reference of the Committee were left too vague, and no special stress was laid upon this aspect of its task. The Committee did not fail to take advantage of this omission. Being anxious to make out the strongest possible case against exchange clearing, it ignored almost completely the possibilities of improving the system by developing triangular agreements. Out of the 23 pages of the main text of the report, only $5\frac{1}{2}$ lines were devoted to this all-important aspect of the question. Considering that $5\frac{1}{2}$ pages were devoted to restating platitudes about the desirability of removing exchange restrictions in general and exchange clearing in particular—this subject, incidentally, was entirely outside the Committee's terms of reference—it might have found something more to say about triangular clearing. All it actually said was this: "It has been suggested that

the prejudice caused to third countries [by exchange clearing] might be avoided by making it possible to transfer balances between different clearings and thus making them multilateral. But there would be material difficulties in arranging such a system and developments in this field have not been encouraging." That is all. The experts of the Committee, who were at such pains to enter into details where arguments against the system were concerned, do not on this occasion take the trouble even to tell us what the "material difficulties" to triangular clearing would be, and why developments in that direction "have not been encouraging". They simply stated it was so, and left it at that. In Annex I they are somewhat more communicative. While quoting at length some unfavourable replies by various Governments, they have to admit grudgingly that ". . . by means of this system which would no longer be confined to exchanges between two countries but would be applicable to a large number of countries, credit and debit balances would be reabsorbed more quickly". Even in the Annex the question is dealt with quite superficially, though the answers given by various Governments to the League questionnaire should have enabled the Committee to go into the problem more thoroughly.

Let us quote some of the encouraging answers:

Austria.—"The extension of the clearing system to several countries would certainly be a possibility."

Chile.—"In theory, such an extension would be valuable. . . . The only case in which such a system would appear practically possible is the case of trilateral agreements between countries whose geographical situation, etc., makes them economically complementary."

Czechoslovakia.—"Multilateral clearing agreements are suited to certain circumstances and are desirable. Czechoslovakia herself has on occasion handed over her active clearing balance *vis-à-vis* a particular country to a third State whose clearing balance *vis-à-vis* the second country was adverse. The case shows the practical possibility of tripartite clearing where circumstances are favourable. The institutions entrusted with the operation of clearing agreements between States can and should develop their functions and reduce to a minimum the unfavourable effects which are otherwise the inevitable accompaniments of clearing agreements, by recourse to multilateral agreements particularly between States which are economically and financially interdependent, so as to enable favourable balances to be used for payment to other States. In other words, any bilateral clearing agreement which leads, directly or at the end of a considerable period, to a balance in favour of one of the parties ought to be transformed into a multilateral agreement. The ideal would be the conclusion of multilateral agreements between a group of countries whose balances of payments were so well arranged that each one of the countries in the group had an equilibrium of payments in relation to the whole of the rest of the group. . . . A commission of properly chosen experts might study the concrete possibilities of agreements of this kind and examine such proposals as may be made in this connection."

France.—" . . . Multilateral clearing would appear to be a normal extension of bilateral clearings, and experiments have been attempted in this connection with certain countries which are worth watching."

Greece.—"The lack of elasticity which the present

system of compensation evinces is . . . an argument in favour of the expansion of bilateral into plurilateral agreements. . . . The Greek Government has already taken certain steps in this direction by successfully insisting on its recent agreements with Yugoslavia, Roumania, and Turkey being concluded on a tripartite basis."

Italy.—" . . . It might be possible as an experiment to adopt eventually a super-compensation system for clearing balances. The debits and credits resulting from the clearing balances concluded between the various countries might periodically be compensated when occasion offered."

Switzerland.—"It would . . . be desirable that this question of multilateral clearings should be thoroughly studied."

Yugoslavia.—"The theoretical possibility is there, and would seem to have a good chance of being translated from theory into practice."

Admittedly, some of the answers are less favourable than these, and even the favourable ones contain various "ifs" and "buts". The above quotations merely serve the purpose of showing that a majority of the Governments concerned was, on the whole, favourable to the extension of bilateral clearing into multilateral clearing. Or at any rate, these Governments held the view that the problem should be studied carefully. This is exactly what the League Committee omitted to do. Having quoted some unfavourable references (divorced from their context) from some replies, it simply concluded that the scheme would meet with material difficulties and that experience so far had not been encouraging. There is no trace of any serious effort even to define the difficulties and describe the

disappointing experience, let alone to investigate impartially the possibilities of triangular clearing.

Indeed, the attitude of the Committee towards the whole problem can best be summed up by quoting the Finnish reply to the questionnaire. After denouncing in the usual stock-phrases the evil effects of clearing agreements on foreign trade, this reply remarks on page 148 that, since clearing agreements are detrimental to foreign trade, "it would therefore be inappropriate to adopt international measures to develop the mechanism of such agreements, and still more inappropriate to endeavour to secure their general application". This reply has, at any rate, the merit of candour. The Committee itself ought to have admitted frankly that it would be inappropriate to improve the clearing system by making it multi-lateral for fear that in its improved form it would work satisfactorily and that consequently it might be retained permanently. Here we have the whole attitude of the Committee towards exchange clearing in a nutshell.

Let us try to make good the omission of the League Committee and within the limited means at our disposal make the examination which ought to have been made by the Committee. In the first place, let us define what triangular clearing is.

Triangular exchange clearing is an arrangement between three countries by which the debit balance in the clearing account of one country against another can be offset against its credit balance on its clearing account with the third country. This can be achieved in four different ways:

(1) By agreement, relating to one particular tripartite transaction, for offsetting an accumulated

credit balance against a debit balance with a third country.

(2) By agreement earmarking out of a credit balance on the clearing account a definite amount or percentage which is transferable in favour of a third country.

(3) By agreement providing for the periodical automatic clearing of debit and credit balances in the clearing relations between three countries.

(4) By the establishment of joint clearing accounts between three countries providing for automatic clearing in the same way as between two countries linked with a bilateral agreement.

So far there has been experience of only the first two methods; it is conceivable that agreements may be reached for the application of the third method. On the other hand, it seems utterly unlikely that the fourth method, that of joint clearing accounts between three countries, would ever be adopted, except perhaps for a group of countries which are in very close political or economic relationships with one another.

The simplest form of triangular clearing occurs where the liquidation of an inconvenient debit or credit balance on a bilateral clearing account is achieved by transferring it to another clearing account. In the absence of any specific provision in the clearing agreement authorising the parties to transfer their balances to a third party, it is necessary to obtain the consent of the country concerned. There have been several instances of this kind. Among others, such an arrangement referring to one single transaction was reached between Czechoslovakia, Greece, and Germany. The Czechoslovak-Greek exchange clearing agreement resulted in an unexpectedly large surplus in favour of Czechoslovakia. On the other hand,

Greece had a surplus as a result of the working of her clearing agreement with Germany. It was arranged with the consent of the German Government that the uncleared balances should be settled through a transfer on account of the Bank of Greece from the Reichsbank to the Czechoslovak National Bank. There have been other similar instances. In one case, the surplus on a clearing account was transferred to a non-clearing country, Japan. Other border-line cases are the triangular compensation arrangements which have been concluded by Hungary and other countries for the liquidation of inconvenient clearing balances. In order to avoid over-complicating the main issue, we propose to abstain from enlarging upon these cases, or from considering at this stage multilateral agreements in which the number of participants is more than three.

From the point of view of the owner of a credit balance on clearing account, the transfer of this balance to a third country cannot be a matter of indifference. As the Italian answer states, "it is obviously impossible to compel a creditor country to replace one claim by another that is more difficult to settle". A creditor country will consent to such transactions only if in doing so it can offset a debit balance which it is anxious to liquidate with a third country. The question is whether any country is ever desirous of liquidating a debit balance by means of a triangular transaction. Every debtor country under a clearing agreement would naturally prefer to liquidate its debit balance by increasing its exports to the creditor country. To some extent, and in given circumstances, this is as it should be. It is only when the creditor country is unable to admit more goods (or services) of the debtor

country without grave inconvenience to its own nationals that there is a strong case in favour of settling the balance by means of a triangular agreement. The debtor country will not consent to the transfer of its debit balance to a third party unless in doing so it is able to liquidate a frozen credit balance of its own against the third country concerned. When the choice lies between importing more from its debtor, exporting less to its debtor, or letting off its creditor from the necessity of importing more or exporting less, the last alternative may appear to be the most preferable. From a moral point of view, it is the duty of a debtor country under a clearing agreement to do its best to settle its debit balance. If this end can be achieved by the transfer of the debit balance to a third party, the debtor country should not raise undue objection to the deal. From this point of view the attitude of the German Government, which stipulated in several clearing agreements that its debit balances arising from those agreements were non-transferable to a third party, is open to criticism. It is yet another instance of the bad faith in which Germany is trying to use the clearing system to enable her to run up a large debit balance with clearing countries while maintaining a surplus with non-clearing countries.

The second method of arriving at triangular clearing is to include in the bilateral clearing agreement a clause whereby the country with a favourable balance is entitled to transfer a certain portion of this balance to a third country. Such agreements have been concluded by Greece with Yugoslavia and Roumania. Since her trade balance with both countries is favourable, Greece reserved the right to transfer a certain percentage of her credit balance to a third country. The

choice of the country is left to Greece, and it need not necessarily be a country with a clearing agreement with the debtor country. On the other hand, the balance in question remains blocked after its transfer, and the third party acquiring it can use it only for certain definite purposes.

In comparison with the single transaction discussed above, this form of triangular arrangement has the advantage that it obviates the necessity for separate negotiations with the debtor clearing country every time a balance is thus transferred. The application of the clause for triangular settlement is automatic so long as the exchange clearing agreement remains in force. The creditor country can thus rely upon being able to cede at will at least part of its clearing balance. The disadvantage lies in the fact that the operation does not necessarily work in a triangular way. The creditor may dispose of the balance to another creditor of the debtor country, in which case the transaction does not lead to the cancellation of the indebtedness as it would do in triangular transactions proper. Another disadvantage of the arrangement is its rigidity; the percentage that can be disposed of by the creditor is fixed for a relatively long period, during which circumstances may change. In any case, however, the system constitutes an improvement over the original bilateral agreements.

The third method of achieving triangular clearing is by including a clause in the bilateral agreements by which balances accumulating in favour of the contracting parties can from time to time be transferred in favour of a third country. No such agreements have so far been concluded, but it is conceivable that certain economic groups—such as a “Danube Economic

Union" or the Scandinavian countries—may sooner or later come to such an understanding. In that case triangular clearing would be entirely automatic while the clearing agreements are in force. The agreements need not be tripartite; three or more separate bilateral agreements with clauses providing for the transferability of the credit and debit balances would cover the requirements.

The question is whether or not automatic triangular arrangements are advantageous. The answer of several Governments is a decided negative. Exchange clearing is regarded by them as a means of balancing bilateral trade with particular countries. They are in consequence opposed to any standing arrangement which is detrimental to the bilateral tendency of trade. They prefer to retain control over their balances, and while they may be prepared to transfer them in individual instances, they will not do so as a matter of routine. This attitude is cited by the opponents of clearing as a proof that the general adoption of triangular clearing is impracticable, and as an indication that the organisation of clearing on an international scale is a Utopian dream. In reality, the dislike of several Governments for automatic triangular clearing is not an insurmountable obstacle. Frequent agreements for the transfer of clearing balances would go a long way towards inducing the Governments to adopt a more liberal attitude. In any case, the difference between that system and automatic triangular clearing is merely one of degree. The clearing agreements which provided for automatic triangular clearing would in any case be subject to termination at short notice, or would be concluded for short periods. The same considerations which induce a Government to refuse to agree to the transfer of its

balance would in all probability induce it to discontinue existing standing arrangements to that end.

Much depends upon the frequency of the intervals at which the accumulated balances are offset against one another. If the compensation were to take place at long intervals—such as at the expiration of the agreement or, say, every six months—then the system would differ relatively slightly from the negotiation of individual triangular clearing transactions. If, on the other hand, the balances were to be offset against one another every day, then the system would in substance be identical with the fourth method of triangular clearing, by which debit and credit items of three countries arising from trade in relation to one another are cleared in the same way as in bilateral clearing agreements. The difference is one of form. Instead of three interlocking bilateral agreements, there would be a tripartite agreement; instead of having separate accounts, the three countries would have joint accounts. In that case the proceeds of the exports of *A* to *B* would be used, as and when they arise, to offset *A*'s imports not only from *B* but also from *C*, and *vice versa*. Under such a system triangular clearing would be even more automatic than under the daily clearing of balances. Many of those who favour international clearing have this kind of clearing in mind. It will be dealt with in detail in the next chapter, on international clearing. Here we may simply note that for the purpose of triangular clearing such elaborate arrangements are not essential.

It is impossible to deny that the popularisation of triangular clearing in its simpler forms is well within the realm of practical politics. Where opinions differ is upon the degree to which the tendency can proceed

in spite of its conflict with the tendency towards bilateralism in international trade. There can be no two opinions, however, upon the fact that triangular arrangements increase the efficiency of exchange clearing and reduce its inconveniences. That is why the opponents of exchange clearing are afraid of the widespread adoption of triangular clearing.

Hitherto we have been dealing with triangular exchange clearing. Let us now go a step further and consider the possibilities of multilateral clearing. The difference between triangular and multilateral clearing is largely one of degree. So far there has been no practical experience of clearing arrangements between more than three countries, but there is no reason why arrangements similar to those affecting three countries should not be extended over four or more countries. In fact, the agreements between Greece and Roumania and between Greece and Jugoslavia can be applied in such a way as to result in quadrangular or multilateral clearing. Let us suppose, for the sake of argument, that Greece has a credit balance with Roumania which, in virtue of the clearing agreement, she is entitled to cede to a third party. Bulgaria, in turn, has a credit balance against Greece, which the latter would be prepared to offset against its Roumanian balance. Although Bulgaria has no use for a Roumanian credit balance, she can use it to settle her debit balance against Italy, while the latter may find this a convenient way for settling her debit balance against Roumania. Four birds would thus be killed with one stone. The instance given is purely imaginary, but it is quite feasible. It is reasonable to hope that transactions of this kind will be arranged in the not too-distant future.

CHAPTER XV

INTERNATIONAL CLEARING

INTERNATIONAL Exchange Clearing would be virtually identical with multilateral exchange clearing applied by a large number of countries. The main difference, apart from that of degree, is that multilateral clearing may be confined to isolated transactions; while international clearing, in its very essence, implies systematic operations, through the intermediary of some permanent organisation. While exchange clearing in its bilateral and triangular form developed almost entirely without any theoretical background, the idea of some form of international clearing has attracted progressive theoretical economists ever since Luzatti. In the form of international exchange clearing in the true sense of the term it was first put forward by the London Chamber of Commerce. In its memorandum published in 1933 that institution elaborates an entirely new monetary, financial, and economic system based on exchange clearing. The Chamber's scheme is one of the boldest reform schemes ever proposed, and, coming as it does from highly conservative quarters, it deserves more attention than it has received. While the author disagrees with the proposal from more than one point of view, he is only too willing to acknowledge its merits as a pioneer work.

Just as triangular clearing may be achieved by various methods, so international clearing may assume several different forms. It may provide for—

(1) Systematic liquidation of clearing balances through bargaining with the intermediary of an international organisation.

(2) The placing of a definite percentage of credit balances at the disposal of the international clearing institute.

(3) The placing of the whole of the balances that may accumulate during a given period at the disposal of the clearing institute.

(4) The payment of every single item arising through the international transactions of the participating countries into one international clearing account.

It will be noted that the four alternatives are identical with those of triangular clearing, dealt with in Chapter XIV. The difference is that in the case of international clearing the number of participants would be larger, and that there would be an international organisation in charge of the clearing.

The first alternative is the most primitive, and, therefore, the most practicable. The participating countries would not give the international clearing institute *carte blanche* to pool the proceeds of their international dealings and use their credit items automatically to offset someone else's debit items. Nor would the institute have to be given *carte blanche* to dispose of the whole or part of the balances outstanding at given dates. The function of the institute would be largely that of the broker who brings the parties together and provides technical facilities for them to come to terms with one another. The decision would rest with the Governments. The international clearing institute would collect the data and would communicate them to the Governments. It would obtain daily information about the status of all bilateral

clearing accounts. Every day the Governments would receive information that their clearing debtors and clearing creditors had credit or debit balances with such-and-such countries. The clearing institute would tentatively suggest to the parties concerned various ways in which the compensation of various credit and debit items could be effected. The Governments concerned would be at liberty to accept or refuse. To facilitate negotiations, it would be desirable that the participating Governments should appoint permanent representatives to the international institute, and that these representatives should have full power—within the limits determined by the policy of their Government—to agree to clearing proposals. Day after day these plenipotentiaries would meet and arrange multilateral clearings through the international institution.

This scheme can hardly be accused of being Utopian, or even over-ambitious. It does not necessitate the unselfish collaboration of nations or the universal return of confidence. The Governments may continue to distrust and dislike one another and yet come to agreement on points of mutual interest. Technically, there is nothing in the above scheme to render it impracticable. It can hardly be accused of being too radical. Indeed, if it is open to criticism it is probably on the ground that it does not go far enough. Most supporters of the idea of international clearing would insist that any arrangement which does not secure the automatic clearing of debit and credit balances, without the need for specific agreements, would be worthless. They would mention that the proposed scheme would be barely an improvement on the existing state of affairs when Governments are at liberty

to conclude triangular and multilateral clearing agreements. In reality, the proposed scheme would constitute a very important step in the desired direction from more than one point of view. Its advantages may be summarised as follows:

(1) It would create an international organisation for the purpose of clearing.

(2) It would collect and disseminate information on clearing accounts which at present is either unobtainable or obtainable only with considerable delay.

(3) It would simplify the conclusion of otherwise highly complicated multilateral agreements.

(4) It would introduce perpetual contact between Governments with clearing balances, instead of occasional negotiations.

(5) It would induce the Governments to elaborate a policy as to their clearing balances, and would assist in the development of rules embodying such a policy.

(6) It would enable international opinion to supervise the status of clearing accounts and the policy pursued by various Governments.

The establishment of an international clearing institute would in itself constitute an important advance. It is a matter of detail whether the organisation should be an independent body or whether it should be a section of the Bank for International Settlements or of the League of Nations' Secretariat. Considering the hostile attitude of both the Bank for International Settlements and the League of Nations towards clearing, it would perhaps be safer to have an institution which, in substance if not in form, would be independent of the central bankers who govern the destinies of the "super-bank" of Basle and of politicians or civil servants who run the "super-State" of Geneva.

What would be the principal functions of the international clearing institute?

(1) To establish close relations with the national clearing offices of all countries.

(2) To obtain from all of them daily figures of the state of their various clearing accounts. At present some, but by no means all, clearing offices publish such figures once or twice a week.

(3) To communicate these figures to all Governments, thereby enabling them to follow closely the development of the international clearing situation.

(4) To make tentative proposals for multilateral clearing agreements and to act as impartial intermediary in the negotiations between the countries concerned.

(5) To collect and disseminate information about the working of bilateral clearing agreements, and to investigate methods of their improvement.

Clearly, the systematic publication of clearing figures would in itself be a great achievement. It would constitute a most important step from economic anarchy towards scientific management of the world's monetary system. Under the existing conditions neither the public nor the bankers nor even the authorities of any country have the remotest idea how their international balance, or that of other countries, stands at any given moment. Their position is similar to that of the individual who never consults his pass-book. While he may have a rough idea of the amount of his more important income and expense items, he is perpetually in the dark as to whether his account is in credit or is overdrawn. No business undertaking of any size could be run successfully on such lines for any length of time. And yet this is how the world's

economic system is run. It is true that during the last few years various attempts have been made to dispel the darkness of ignorance. Estimates of the balance of payments of most countries are published every year. With a delay of between six and ten months, we are informed what the balance of payments of a country was during the previous year. Even if the figures were dependable—which is not always the case—they would not make us any wiser as to the present state of the international balance of the country concerned. In Great Britain, the Bank of England has made some attempts to ascertain foreign balances in London, but apart from the incomplete data it possesses relating to foreign current and deposit accounts, Treasury bills, and Government securities, it is in the dark about the international movements of funds.

If all international payments were made through bilateral clearing agreements, and if the figures of these payments were compiled at frequent intervals by an international institute, then everybody would know at any given moment how the international accounts stood at the close of the day. How much easier it would be for economic experts to form an opinion about conditions, and to advise Governments what to do! How much easier it would be for the Governments to formulate and execute their economic, commercial, financial, and monetary policies! How much easier it would be for bankers and merchants to make up their minds whether to grant or to refuse loans and credits! Surely, if the proposed system had no other advantages, this in itself would be sufficient to justify its adoption.

It may be argued that to ascertain the position of

international accounts is a statistical problem, and that the improvement of the art of financial statistics may sooner or later lead to the desired end. In reality, anyone who has ever made an honest effort to compile these figures must admit that his efforts were mere gropings in the dark. No conscientious statistician would care to vouch for the approximate accuracy of such computations. Even if it were possible to obtain and classify the data of all foreign exchange transactions—which is by no means the case—there would still be an immense scope for errors and omissions. The only safe way of ascertaining the figure of international payments is to force them to pass through the official channels of exchange clearing.

Another advantage of the proposed system would be that it would make possible the conclusion of multilateral transactions between more than three countries. The reason why multilateral clearing has not yet passed beyond the triangular stage is that in existing circumstances the negotiations for the conclusion of an agreement involving more than three countries would be too difficult, lengthy, and complicated. The existing apparatus for the negotiation of clearing arrangements is slow and cumbersome. To negotiate an agreement takes weeks and months, and it would be too much to expect that the clearing situation of a number of countries would remain the same for so long a time. It is not easy in existing conditions even to ascertain favourable opportunities for multilateral clearing, still less to make use of them. By the time five or six countries had settled down to negotiate, the clearing situation of at least one of the countries would have changed sufficiently to make it impossible to offset the debit and credit balances in the form

originally proposed. The proposed international office would as a matter of routine calculate every day the methods by which a multilateral arrangement could be arrived at with the maximum of benefit to the largest number of participants. With the aid of such an organisation it would be simpler for the Governments to conclude multilateral arrangements involving six or ten parties than it is to-day to conclude a triangular arrangement.

As we have noted, delay may be fatal to the success of negotiations for multilateral arrangements. From this point of view, the advantages of the appointment of permanent representatives who would be in constant touch with one another cannot be over-emphasised. There would be no need to arrange special conferences at dates suitable to all parties, for the representatives could meet every day as a matter of routine. Within the limits of the policy laid down by their Governments they would be in a position to take immediate decisions.

The advantages of giving the widest possible powers to their representatives would induce the Governments to arrive at a definite policy as to the disposal of clearing balances. As things are, most Governments have not worked out any definite rules and have to decide upon their attitude as and when a concrete case arises. There are one or two noteworthy exceptions. As we pointed out in the last chapter, the German Government is on principle opposed to agreements for the cession of its debit balances to a third party. The Greek Government on the other hand is very keen to secure the right to cede its credit balances. As for the rest, most of them have no clear conception of the significance of multilateral clearing.

The establishment of an international organisation

through which multilateral clearing would be practised systematically would help to crystalise the rules of the system in the course of experience. An evident rule is that credit or debit balances must not be disposed of when it is reasonable to assume that they are purely temporary in character. The trade balance of every country is subject to fluctuations, seasonal and others, and extraneous items that come into the clearing sometimes accentuate the temporary discrepancies between the debit and credit sides of the balance of payments. It is hardly worth while to dispose of a balance which in the normal course would be offset in any case, in the course of a few weeks, by the normal working of the bilateral clearing arrangement. On the other hand, if the balance is likely to remain in existence for several months, it is a matter of opinion whether the Governments concerned should allow it to stand over or whether they should endeavour to liquidate it through international clearing. If the balance is definitely of a more lasting nature and especially if it becomes frozen, then the weight of argument is overwhelmingly in favour of its speedy liquidation through international clearing. There is, needless to say, no rigid borderline between temporary, semi-permanent and permanent balances, and the Governments would have to give their representatives a reasonably free hand to use their judgment in this respect. Needless to say, every Government with a debit balance would prefer to liquidate this balance by inducing the creditor Government to increase its imports from the debtor country. In the course of experience it will become evident how far this is possible. As we pointed out before, in many cases the balancing of bilateral trade between two countries is

prevented by fundamental obstacles which cannot be overcome. Instead of insisting stubbornly upon attempting the impossible, the Governments concerned will have to face realities and admit that in relation to certain countries their trade balance will always have to show a surplus or a deficit. Their task will be to find other countries with which they could conclude multilateral agreements in order to dispose of this balance. The rules as to the cases in which the necessity for a surplus or a deficit is admitted will have to be evolved in the course of experience.

Yet another advantage of the proposed system would be that it would facilitate supervision of the trend of the clearing accounts of various Governments. The evidence of certain changes in various accounts would in itself indicate the trend of economic developments in the country concerned. The attitude of the Governments in question towards clearing balances would go a long way towards making evident the policy it was pursuing. If the price-level of a country were out of equilibrium and the Government wanted to make improper use of the clearing for running up debit balances, the evidence of this would provide a timely warning to exporters, bankers, and Governments.

These are the main advantages that would be attainable through international exchange clearing in its most primitive form. Those who maintain that such results would be inadequate should bear in mind that Rome was not built in a day. There is not the least chance of the adoption of universal automatic international clearing to begin with, and very little chance of its eventual adoption. The systems proposed by the London Chamber of Commerce and others sound so

Utopian that most statesmen would be unwilling to indulge in such bold experiments. On the other hand, international clearing in its simplest form can easily be realised without the risk that those who advocate it will be accused of indulging in Utopianist experimenting. International clearing already exists in practice, even though only to a very limited degree and in a very crude form; with a little goodwill the organisation of triangular clearing on an international scale would be well within the realm of practical politics.

Unfortunately the opponents of the clearing system are numerous and influential. They present it as the arch-enemy of trade and the main obstacle to prosperity. For this reason even the Governments which have concluded exchange clearing agreements are at pains to make it plain, lest they antagonise public opinion, that the clearing arrangements they have concluded are purely temporary makeshifts which will be abolished at the first opportunity. They are therefore anxious to avoid taking any steps which might be interpreted as an endeavour to perpetuate exchange clearing. It is by reason of such considerations that the establishment of an international organisation for exchange clearing meets with much opposition.

An explanation is not an excuse. While it is easy to understand the reluctance of Governments to expose themselves to attacks on the part of the opponents of the clearing system, their excessive timidity can by no means be justified by their fear of perpetuating exchange clearing. After all, even though the system has been adopted and maintained as a purely temporary emergency measure to tide over passing difficulties, it is the duty of the Governments to do their utmost to

improve its working while it is in existence. In a number of countries exchange clearing has been in actual operation from three to four years, and, even on the assumption that the system will disappear on the return of normal conditions, it is quite conceivable that it might remain in force for another three to four years, if not longer. It is by no means a matter of indifference whether during the remaining period of its existence exchange clearing works deficiently or satisfactorily. What is more, even from the point of view of a relatively early return to the régime of freedom, it appears desirable to improve the working of the clearing system. The better the system works the sooner international conditions will improve to a sufficient degree to make possible the removal of those restrictions which were responsible for the birth of exchange clearing. Although the author is in favour of retaining exchange clearing as a permanent part of a planned economic system, even if he were in favour of returning to the régime of anarchy he would nevertheless hold the view that it is the duty of the Governments to do their utmost to improve the system while it lasts. It is unfortunate that responsible statesmen should yield to doctrinairism and sacrifice the real interests of trade to dogmatic considerations.

CHAPTER XVI

AUTOMATIC CLEARING

IN the foregoing chapter we dealt with the main elementary form of international exchange clearing—the form in which every multilateral clearing transaction would be subject to a special agreement between the parties concerned. As we pointed out, this scheme is likely to be criticised on the ground that it is not sufficiently ambitious. Most of those who advocate international clearing have automatic clearing in mind. In their opinion it would not be sufficient to arrange multilateral transactions through the intermediary of an international institution. What they want is a system whereby international clearing would take place automatically, without any special negotiations, through the mere fact that the debit and credit balances that arise are capable of offsetting each other. To their mind these debit and credit balances should be allowed thus automatically to offset each other. This would mean that the Governments concerned would relinquish their right to dispose of their debit and credit balances; they would be handled as a matter of routine by the international clearing office.

At first sight it appears unthinkable that any Government would be prepared to relinquish its right to decide whether or not the employment of its debit or credit balances for international clearing purposes is in accordance with the interest of its country. Equally, it may be considered unthinkable that the

Governments would be willing to pool their balances, let alone their individual debit and credit items, and be content with the arrangement made by the international institution. And yet this is exactly what takes place under a régime of freedom. The debit and credit items of all countries are automatically pooled in the international foreign exchange market and the credit balance of one country against another is automatically used to offset a debit balance of a second country against a third country. This is how extremes meet. The most advanced type of international exchange clearing, which is regarded as the most extreme kind of Government intervention, bears a strong resemblance, in substance if not in form, to the régime of freedom.

Automatic international clearing need not necessarily assume such an advanced form. We have seen in dealing with triangular clearing that in some instances a certain percentage of the credit balance of a country is placed by the debtor at the disposal of the creditor country and is transferable without limitation to a third party. Such agreements, as already noted, are actually in operation between Greece and Roumania and between Greece and Jugoslavia. Should a large number of similar bilateral exchange clearing agreements be concluded, and should an international institution be formed to operate international clearing, it is conceivable that these rights to deal freely with such balances would be placed at the disposal of that institution. Within a limited scope there would thus be automatic international clearing. For the rest, the arrangement would work in the way described in the previous chapter.

The parallel existence of non-automatic and auto-

matic international clearing is by no means impossible. Indeed, the normal working of the non-automatic clearing would in the course of time tend to lead to the development of such a partial automatic clearing. We pointed out in the previous chapter that in certain instances trade between two countries is always bound to produce a debit or credit balance. It may be assumed that the Governments, once they realise that the bilateral balancing of trade in those instances is impossible, would be prepared to liquidate the resultant balances by means of multilateral clearing operations. The representatives of the creditor countries at the international clearing institute would be authorised to swap their credit balances for the credit balances of a third country which in turn had a credit balance against the country concerned. In the course of time the employment of the recognised permanent balances for clearing purposes would become a matter of routine. From that state of affairs, the adoption of partial automatic clearing is only one step. The parties of bilateral clearing agreements arrive at an understanding about the figure which should represent approximately the normal debit or credit balance of the trade between the two countries. This would be placed at the disposal of the clearing office and would be subject to automatic clearing. Should any abnormal surpluses arise, their fate would be subject to special negotiations. The system would hardly have the merit of being logical, but then logical solutions are not always the most suited to existing circumstances.

This stage of development in international clearing can conceivably be attained even if there is no material decline in the wave of economic nationalism. In order that the partial automatic clearing should develop into

full automatic clearing, it would be necessary, however, for economic nationalism to give way to a large extent to a more international conception. The placing of clearing balances at the free disposal of an international clearing office would imply a complete renunciation of the policy of balancing bilateral trade by means of exchange clearing. Of course, there would still remain at the disposal of the Governments other means of approaching that end, such as quotas and embargoes on imports and exports, tariffs and compensation transactions. By relinquishing the use of exchange clearing for that purpose the Governments would, however, discard the most effective and at the same time the least inconvenient weapon for the execution of their policy. Once the Governments had agreed to full automatic clearing, they would no longer be in a position to insist that a Government whose clearing account showed a credit balance should liquidate this balance by increased imports from the debtor country, even if the creditor country should be well in a position to do so.

There is another reason why Governments would be reluctant to agree to automatic clearing. They would not like to expose themselves to the risk of relinquishing a claim against a good debtor in return for a claim against a bad debtor. This is the main argument against multilateral clearing put forward by the Italian Government in its reply to the League questionnaire. In international clearing, as in local clearing, the ultimate debtor with a net debit balance would pay to the ultimate creditor with a net credit balance. It is conceivable that this ultimate debtor might not be as dependable as the ultimate creditor's original debtor was, and consequently the ultimate creditor would be

exposed to a loss. This might be avoided by some form of joint guarantee, but that again would bring the system rather beyond the scope of clearing.

Thus even if a sufficient number of Governments were to agree to non-automatic international clearing, and even if this system were to develop into limited automatic clearing, there does not seem to be much likelihood that it would develop into full automatic clearing. It is a matter of opinion whether such a development would be desirable, even if it were possible. As we said above, it would mean that the Governments would relinquish exchange clearing as a weapon of commercial policy; the chances are that in consequence they would have to make more use of other weapons, especially quotas, embargoes and prohibitive tariffs. One of the great advantages of the exchange clearing system is that it can take the place of these weapons to a very large extent. Even the most prejudiced opponent of the system must admit that if the choice lies between these restrictions and exchange clearing, the latter is decidedly the smaller evil. It would perhaps be a mistake, therefore, to sacrifice the chances of replacing the most irksome forms of restrictions by exchange clearing. The advantages of full automatic exchange clearing over limited automatic exchange clearing are not sufficient to compensate for this disadvantage.

There may be two different kinds of automatic exchange clearing systems—the first where only the balances, and the second where the actual items of international payment are subject to the clearing. The difference between the two is largely one of degree. If the debit and credit balances accumulating on various bilateral clearing accounts are subject to

international clearing every day, then the system differs but little from that in which the actual debit and credit items of the balances of payments are pooled together for international clearing. In substance, the two systems would be practically identical, although in form they would differ materially. The system whereby every single item goes through international clearing would dispense with bilateral clearing agreements altogether. There is not the least likelihood that such a system will materialise, at any rate so long as political frontiers remain. It would mean that there would be no national clearing offices at all, but only one international clearing office. This system would be contrary to the elementary clearing principle that individual payments as such should never reach the clearing house except in the form of large totals representing the net balances of the various members. In internal clearing each bank adds together the total of its claims against the other banks, and it is only the difference between these claims and the counter claims that is subject to the clearing. If every single item were to go through the clearing house it would mean immense clerical work which would to a very large extent duplicate the work done by the member banks. The same would be true of international clearing. Moreover, Central Banks or other national clearing authorities would like to retain at least a supervision of the clearing activity of their country.

This form of automatic clearing has a distinctly Utopian appearance. In its efforts to discredit the idea of international clearing the League Committee did not fail to denounce this extreme form of clearing as utterly impracticable. Indeed, the greater part of the very brief section of Annex I of the report which

deals with multilateral clearing is devoted to criticising this form of automatic clearing. Such a system has never been suggested anywhere except in the League report which, having thus built up a dummy opponent, triumphantly demolishes it. Having done so, the report casually mentions that there is also another kind of multilateral clearing by which it is not the individual items but only the balances that are offset against one another.

In the author's opinion, international clearing should not replace bilateral clearing but should be superimposed upon the latter. Every bilateral trade agreement should be negotiated separately, though it is conceivable that a group of countries forming an economic unit, such as the Scandinavian countries, the Baltic States or the Danubian States, could arrive at a joint multilateral clearing agreement and establish joint clearing accounts. The ideal state of affairs would be that every civilised country should have a bilateral agreement with every other civilised country, and that these agreements should cover every kind of international payments. This does not necessarily mean that a preliminary condition of international clearing would be the adoption of bilateral clearing by the whole world. Within a narrower scope a dozen countries or even less could work international clearing successfully. It is desirable that to some degree at any rate international clearing should become automatic, or at least that definite rules should be adopted and followed as a matter of routine. The degree to which it is possible and desirable to make international clearing automatic is a matter of opinion and could be ascertained only by experience.

CHAPTER XVII

BANKS AND EXCHANGE CLEARING

THE effect of exchange clearing upon banks is a question of importance, for opposition to the system in countries where it does not operate is largely due to fears that it might deal a fatal blow to well-established banking systems. Doubtless it might appear unduly risky to sacrifice an organisation which has amply proved its *raison d'être* for the sake of another which is at its experimental stage. If it were true that the adoption of exchange clearing would render banking unprofitable and that it would mean the end of the banking system, then the case against the new system would be very strong indeed.

Experience in countries which have resorted to exchange clearing does not confirm the fears entertained by banks in non-clearing countries. While bankers in clearing countries deplore the existence of that system and would like to return to the "good old days", it cannot be said that exchange clearing has deprived them of the possibility of working profitably. First of all, in every country purely internal trade provides by far the larger proportion of banking activity, and internal trade is unaffected by exchange clearing. Moreover, the banks are not eliminated from the financing of international trade under the exchange clearing system. They invariably act as intermediaries between the national clearing offices and the firms engaged in foreign trade. It would indeed be unthink-

able that the clearing offices should have direct dealings with the public. For them to do so they would require a huge office organisation, and the system would inevitably cause much delay. Instead, the banks remain in direct contact with their customers and simplify the task of the clearing offices by passing on to them the transactions in a uniform, convenient, and business-like form. Instead of having to deal with many thousands of importers and exporters, the clearing offices have to deal with only a few dozen banks. For this reason alone, the assistance provided by the banks is valuable and the commission they charge for it is well-earned.

This commission should go a long way towards compensating the banks for the loss of their profit on genuine commercial foreign exchange business, which inevitably declines through the adoption of exchange clearing. Foreign exchange departments have every reason to complain that exchange clearing gradually replaces activity in foreign exchanges. Doubtless, if all countries were to adopt the system, and if its application were to be universally extended over every current and capital item of the balance of payments, it would mean the end of the foreign exchange market. From the point of view of those highly skilled bank employees who have specialised in exchange dealing, such a development would undoubtedly be most deplorable, and like everybody who has to pay the price for the progress of mankind, they would deserve every sympathy. As, however, their number all over the world can hardly be more than a few thousand, this consideration of sympathy should not influence our judgment as to the merits of the system. In any case, the foreign exchange dealers displaced by exchange clearing could

well be employed by other departments of the banks, or by the clearing offices. As for the banks themselves, the loss of the profit obtained from exchange dealing would be more than offset by the advantages of a higher degree of stability and security, which would safeguard the banks against losses.

Apart from the effect of the universal adoption of exchange clearing upon the fate of skilled exchange dealers, there would be no reason to regret the passing of the free foreign exchange market. It is true that its organisation and activities are greatly admired by adherents of *laissez-faire*; the League report on exchange clearing goes out of its way to pay a high tribute to the "automatic clearing" through the free foreign exchange market as something infinitely superior to the "artificial" exchange clearing system. What they do not admit is that the normal functioning of a foreign exchange market necessitates a certain amount of speculative operations which form an indispensable part of the much-admired system. Indeed, from this point of view the foreign exchange market duly characterises the vices of the whole system of *laissez-faire*. Owing to the existence of a semi-sentimental attachment to the free foreign exchange market, many people are opposed to exchange clearing because they would regret to see the passing of that organisation. For this reason it is perhaps not superfluous to point out its inherent deficiency.

If on a given day genuine commercial and financial supply in a particular currency is smaller or larger than genuine commercial and financial demand, the difference has to be provided or taken up by speculators. These speculators are willing to take up the differences—at a price. Their intervention always means an

appreciation or depreciation of the currency concerned. If the movement assumes excessive dimensions, it leads, under the system of the gold standard, to an outflow of gold and to an increase of the bank rate, which interferes with the stability of home trade. This inconvenience can be avoided by the substitution of exchange clearing for the free foreign exchange market. If under exchange clearing there is at any given time a discrepancy between the debit and credit items of the balance of payments of a country there is no need to call in the assistance of the despised speculators. The discrepancy need not necessarily lead to a change in the exchange value of the currency concerned or to any change in its interest rate policy. If a one-sided trend in the balance of payments proves to be too persistent, it is for the authorities of the country concerned to decide what policy to adopt to meet the situation. They will not be forced into an action against their wish, and against the interest of their country, by a speculative movement of the exchange, which is exactly what happens under the régime of a free foreign exchange market.

Speculators whose activity under the régime of *laissez-faire* is raised to the dignity of an indispensable social function do not as a rule stop short where their work ceases to be constructive and becomes destructive. Even if they knew where the invisible line is—which is not necessarily the case—they would be tempted to go beyond it in the hope of profits. These speculative influences are sometimes in accordance with the requirements of legitimate business, but more often they work in the opposite direction. Even in the former case they may overstep the mark. On a small scale speculation may be a necessity; on a large scale

it is a danger. From time to time it assumes control of the foreign exchange market and influences the monetary policy of Governments, whether they defend themselves against the speculative pressure or whether they yield to it. This fact does not prevent orthodox economists from admiring the free market of exchanges as one of the great institutions of the system of liberal capitalism.

From time to time an attempt is made to stifle speculation, but in reality it is an indispensable part of the system, without which it would not operate at all. Let us consider, for the sake of argument, what would happen under the régime of free exchanges if by some miracle it were possible to eliminate speculation. Every time there was a discrepancy between supply and demand for foreign currencies the Government would have to provide the counterpart of the orders that could not be matched in the market. The result would be that gold reserves would fluctuate to a much larger extent than they do now, and, consequently, that international transactions would disturb trade to a larger extent. For, while speculation often accentuates disturbing movements, under the gold standard it often acts in a way as a shock-absorber. The reason why comparatively moderate gold movements are sufficient to prevent exchanges from moving beyond gold points is that, as soon as they touch the gold points, speculation takes a hand. If a currency depreciates to its gold point, under the gold standard it is taken for granted that it can depreciate no further. For this reason purchase of the currency in question offers reasonable possibility of profits without involving a corresponding degree of risk. Should speculation be abolished, the Govern-

ments would have to take over the rôle of the shock-absorbers. They would have to increase or decrease their gold reserves not only much more frequently than they do under the existing system but probably also on a much larger scale.

It is thus evident that the much-praised automatic character of the free foreign exchange market is largely dependent for its smooth functioning upon the services of speculators. The status of the speculator is not regarded as exactly dignified, but foreign exchange speculators are generally regarded as the worst type of all. They are denounced with every right as reckless gamblers who are unscrupulous enough to try to make money out of the "life-blood of nations". Justified as these accusations are, it ought to be borne in mind that speculators in the foreign exchange market as in other markets are a necessary part of the system. It is not without reason that the author considers the Kreugers and Hatrys and many smaller men in the same line as being inevitably associated with *laissez-faire*, an essential part of the system.

And this is the marvellous system which must not be sacrificed for the advantages offered by a rational system! Under exchange clearing there is no room for speculators. Some of them may doubtless survive and continue their sinister activity in the form of circumventing exchange clearing arrangements. It would be impossible to prevent evasion completely, just as it is impossible to put a stop to smuggling. Under exchange clearing, however, speculators engaged in evading clearing arrangements would be regarded and treated as outlaws just as smugglers are regarded and treated. It would no longer be possible to defend them on the ground that to some extent and in certain

circumstances they are a necessity. It would no longer be necessary to avoid taking drastic steps against them on the ground that it would penalise legitimate trade. Their elimination would be a strong argument in favour of exchange clearing, not an argument against it.

Nor would banks have any reason to regret having to do without the profit on speculative exchange operations. In any case, in recent times the view has gained ground that respectable banks should forgo this profit and avoid being used as the instruments of these gamblers. So long as they are largely compensated for the loss of profit on legitimate foreign exchange business through the commission charged on clearing operations, they should have no grievance against the system.

It is argued sometimes that the general adoption of exchange clearing would kill the London bill market and the whole system of financing trade by means of acceptance credits. This assumption is entirely false. Just as internal clearing arrangements within a country do not obviate the necessity of financing internal trade with the aid of credits, so exchange clearing does not dispense with the necessity for financing international trade with the aid of acceptance credits. Technically there is nothing incompatible between exchange clearing and acceptance credits. If a bank or acceptance house undertakes to guarantee the payment for goods deliveries, the exporter is relieved of the risk or delay attached to the transaction, and also of the necessity of insuring the risk. Even the Government's guarantee would not do away with the necessity of financing the transaction with the aid of acceptance credits. All the Government can do is to guarantee that if and when

the debtor pays the amount due to the clearing office of his own country in his own national currency the creditor will receive a corresponding sum in his national currency. The official guarantee would safeguard the creditor against a delay or breakdown of the clearing arrangements, but not against the insolvency of the debtor. To that end it is necessary, in spite of a clearing arrangement reinforced by Government guarantee, to arrange acceptance credits.

On the maturity of the bill, the accepting banker would pay the exporter (or the holder of the bill) the purchase price in the currency of the contract. He in turn would be safeguarded against delay in the clearing arrangement by the guarantee of his Government. His only risk would be that of non-payment by the debtor into the clearing office. The acceptor's risk under exchange clearing reinforced by Government guarantee would thus be the same as it is under the system of free exchange. It is only in the absence of Government guarantee that the risk of the acceptor is greater than under free exchange, though even then it is not nearly so great as under exchange restrictions without exchange clearing. In addition to the risk of non-payment by the debtor, the acceptor has to assume also the risk of delay in obtaining payment under the clearing agreement. Since in all probability the amount would sooner or later be received through the working of the clearing, the extra risk would be merely one of delay. It would not be a risk of total loss or a total freezing-up of the claim and its eventual forced consolidation into a long-term loan, which frequently happens under exchange restrictions without clearing.

In practice, acceptance credits are mostly excluded from the clearing agreement, especially if they are

under a standstill agreement. Countries with exchange restrictions usually arrange for payment on maturity by sending "replacement" bills, the discounting of which provides the funds to meet the maturing bills. There is no reason, however, why acceptance credits should not come under clearing agreements. It is true that in the case of delay in the clearing the acceptor has to provide the funds, but since it is usually the banker who has to finance the exporters if the latter are inconvenienced by the delay in the clearing, the difference is not so material as it would appear at first sight. If exchange clearing is reinforced by Government guarantee the last argument against the inclusion of acceptance credits under exchange clearing agreements falls away.

The same conclusions hold good also for acceptance credits granted for the financing of trade between two foreign countries. There is no reason why under the exchange clearing system trade between, say, Germany and Brazil should not continue to be financed through the intermediary of the London acceptance market, provided that both countries have clearing agreements with Great Britain and provided that the necessary arrangements are adequately covered by clauses in the clearing agreements. If, however, Great Britain keeps aloof from the clearing system then it will be difficult to maintain the traditional rôle of the London acceptance market for trade between two countries with clearing agreements. As a matter of course, London banks refrain from granting new acceptance credits to countries with exchange restrictions; they could safely grant them if there were exchange clearing agreements between Great Britain and the countries concerned.

One thing is certain. The benefit derived by every

section of the community through a higher degree of stability and through the possibility of accelerating progress as a result of exchange clearing would unquestionably be shared by the banks. Their turnover would increase and their risks would decline. They would thus be bound to benefit by exchange clearing in spite of possible disadvantages to certain branches of their activity. It is, therefore, a short-sighted policy on their part to oppose the system.

CHAPTER XVIII

TRANSFER AGREEMENTS

EXCHANGE clearing is by no means the only method by which various Governments have sought to overcome transfer difficulties during the past four years. Several other kinds of devices have been resorted to with a varying degree of success. Amongst them the most important is undoubtedly the system of compensation or barter, which will be dealt with in the next chapter. In this chapter we propose to discuss the various types of financial agreements which can be classed under the heading of transfer agreements. The term "transfer agreement" is often used indiscriminately with the terms "exchange agreement" and "payment agreement". What is worse, several types of transfer agreements are sometimes referred to as exchange clearing agreements because they have some of the characteristics of exchange clearing. It is therefore desirable to define and examine the various types of transfer agreements.

There are, in the first place, debt agreements. These are concluded for the purpose of arranging for the repayment of overdue debts that have become frozen as a result of transfer difficulties. They are usually connected with a debt-funding operation, with the conclusion of a new credit, or with a general trade agreement. In most cases the debtor Government undertakes to release a certain amount of exchange for the purpose of part payment of overdue liabilities

to the foreign creditors. These types of agreement have no bearing on the main subject of this volume and we do not propose to dwell upon them.

There are three types of transfer agreements which deserve attention. These are the exchange agreement, the semi-clearing agreement, and the payment agreement. The exchange agreement is in substance a voluntary exchange clearing agreement; that is to say, a clearing system is established between two countries but their nationals are not compelled by law to make payment through that system. The semi-clearing agreement is an arrangement which is compulsory on the part of one of the countries and voluntary clearing on the part of the other. The payment agreement is an understanding by which a country with exchange restrictions undertakes to supply a certain amount of exchange in payment for imports from the other contracting party.

Exchange agreements became very popular in 1933 and 1934. Their initiator was Germany, which introduced this type of agreement at a time when the allotment of exchange for imports was becoming increasingly difficult. Germany concluded exchange agreements with Great Britain, Holland, Sweden, and other countries. In every case, with the exception of Great Britain, the exchange agreement was subsequently replaced by full exchange clearing agreements. In substance the exchange agreements amounted to voluntary exchange clearing agreements, but in form they differed materially from the clearing system. Although the various agreements may have differed in detail, in every case the system worked in the following way: The Reichsbank opened special accounts into which German importers of goods exported by the

other contracting parties paid the reichsmark equivalent of the amounts owed. At the same time, the Central Banks or clearing offices of the other contracting parties offered for sale the reichsmarks thus accumulating in the special accounts kept with the Reichsbank. Importers of goods from Germany were requested to buy these special reichsmarks—or, as they were termed, “sondermarks”—which they were able to use in payment for their goods. In order to induce them to do so the “sondermarks” were offered at a slight discount compared with free reichsmarks. In most cases the discount did not exceed 2 per cent.

The arrangement did not work satisfactorily in any country. In Great Britain it broke down a little over a month after its inauguration. The British “sondermark” balance with the Reichsbank soon exceeded considerably the agreed maximum of six million reichsmarks and the Reichsbank refused to accept any fresh payments into the account by German importers of British goods. There was a long waiting list for those desirous of making use of the arrangement, and British exporters who sold their goods against payment through the exchange arrangement had to wait for months before they received payment. The unsatisfactory working of the agreement was due to the fact that it was not compulsory for British importers of German goods to make use of “sondermarks” for the settlement of their accounts; nor was it compulsory for German exporters of goods to Great Britain to insist upon payment in that form. For this reason, although the German exports to Great Britain were considerably in excess of British exports to Germany, there was no adequate demand for “sondermarks”. According to the terms of the agreement, the discount

was not allowed to widen beyond 2 per cent, and the inducement provided by such a small discount was not sufficient to induce importers to make use of the facilities offered. Time after time the authorities appealed to the patriotism and public spirit of importers, and pointed out that in buying "sondermarks" they assisted British exporters. The futility of relying upon this method in the absence of any legal compulsion, however, soon became evident. The operation of the exchange agreement was suspended, and although it was resumed later on it never worked satisfactorily. It took many months to liquidate the frozen balance created by the ill-fated agreement. Other countries which had similar agreements with Germany had the same unfavourable experience.

Most Governments, realising the futility of trying to work a one-sided clearing on a non-compulsory basis, adopted exchange clearing proper. Not so the British Government. Although it is authorised by the Debts Clearing Offices Act of 1934 to adopt exchange clearing, it has persistently refrained from taking advantage of this authority. After the failure of the exchange agreement with Germany it resorted to other experiments. One of them was the semi-clearing agreement with Italy. By virtue of this agreement it is compulsory for Italian importers of British goods to pay the amounts due to British exporters into the clearing account with the Italian National Institute of Exchange. British importers of Italian goods are requested to pay the purchase price in sterling into the Italian clearing account kept by the Bank of England. The main difference between this agreement and the Anglo-German exchange agreement is that instead of endeavouring to sell the lire accumulated on the clearing

account with the Italian Institute of Exchange, the Bank of England endeavoured to accumulate sterling on its Italian clearing account and to use the proceeds for payment to British exporters. The arrangement has exactly the same failing as the Anglo-German exchange agreement. Since it is not compulsory for British importers to make use of the clearing, many of them pay for their goods by means of direct transfers. Apart from the fact that they prefer to follow their usual custom in making payment for goods purchases, in many instances the Italian exporters, wishing to leave at least part of the proceeds abroad, request them to circumvent the clearing to that extent. Since there is no British law against doing so, British importers see no reason why they should not oblige their Italian business friends.

The result is the accumulation of a substantial credit balance in favour of Great Britain. At the time of writing its amount is over £2 millions and is rising steadily. In view of the menace of economic sanctions against Italy, the fate of British exporters having claims under the arrangement is not exactly enviable. If they lose their money it will be largely due to the fact that the British Government refused to make the clearing compulsory on the British side.

A third type of transfer agreement resorted to in order to avoid exchange clearing is the payments agreement, of which the Anglo-German payments agreement is a characteristic example. This agreement dispenses altogether with clearing arrangements. It amounts to an undertaking on the part of the German authorities to guarantee the transfer to British exporters to Germany of an amount equivalent to 55 per cent of the proceeds of German exports to Great

Britain. Of the 45 per cent which remains at the Reichsbank's disposal, 10 per cent is earmarked for frozen commercial debts and out of the balance the German Government undertakes to meet the service of the Dawes and Young Loans held in the United Kingdom. This arrangement has worked reasonably satisfactorily. The commercial arrears have been liquidated, and although there is still a delay in the payment for current exports to Germany, exporters have fared better than either under the exchange agreement or under the semi-clearing agreement concluded with Italy.

The fact that in the case of Germany the result of this agreement has been on the whole satisfactory is due, however, to special circumstances which should not be overlooked. In the first place, part of the German purchases from Great Britain have been diverted to countries with which Germany has exchange clearing. As Germany has been able to run up a substantial debit balance on all her clearing accounts, the cash position of the Reichsbank has become less pressing. A much more important circumstance is that, for political and politico-financial considerations, the Reich authorities considered it advisable to establish satisfactory commercial and financial relations with Great Britain. Having realised that the default on commercial debts and on the service of the Dawes and Young Loans was largely responsible for the development of a strong anti-German feeling in British opinion, the National Socialist Government desire in the interest of a *rapprochement* with Great Britain to turn over a new leaf and liquidate the arrears. Apart from this, Dr. Schacht entertains hopes that sooner or later it might be possible to approach the London

market for new loans or credits, and to that end he is anxious that British commercial and financial creditors of Germany should receive particularly favourable treatment. Last but not least, Dr. Schacht is anxious to avoid the establishment of exchange clearing between Great Britain and Germany. Being essentially an orthodox banker, he probably feels that if Great Britain resorted to exchange clearing, the system would be adopted universally. While he does not mind applying the system where it is to the interest of Germany to do so, he is anxious to prevent its universal adoption and is even prepared to make sacrifices for the purpose.

It should not be inferred that because it is possible for Germany to carry out the terms of the Anglo-German payments agreement it would be possible for her to base all her external relations on the same system. Still less would it be justifiable to conclude that what is possible for Germany in one instance would be possible for other countries. The reason why the Reichsbank can afford to undertake to pay over to British commercial and financial creditors about 75 per cent of the proceeds of British exports to Germany is that the German exchange restrictions are practically watertight. German exporters' chances of circumventing the exchange decree which compels them to surrender the proceeds of their exports to the Reichsbank are negligible. This cannot be said to be true in other countries. Even in Italy, where a high degree of economic discipline prevails, the control of the proceeds of exports is far from watertight. In other countries a substantial portion of the proceeds of exports could always be retained abroad in circumvention of the law; in that event the monetary author-

ities would not be in a position to carry out their undertaking to transfer a given percentage to their creditors. In this respect the advantages of exchange clearing over payment agreements are obvious. According to several replies to the League of Nations' questionnaire to various Governments, exchange clearing goes a very long way towards making exchange restrictions watertight. In many countries it is practically the only method by which the monetary authorities can make sure that no substantial part of the proceeds of the exports of their nationals is left abroad.

On the assumption that exchange restrictions in all financially weak countries are brought to perfection, it might be possible to replace exchange clearing by payment agreements similar to the Anglo-German agreement. A watertight system of exchange control, coupled with all-round agreements regulating the percentage of imports to exports in the bilateral trade relations between the countries, would indeed go a long way towards removing fears of a depletion of the gold reserve as a result of an unfavourable trade balance or the difficulty of collecting commercial arrears abroad. Even in such hypothetical conditions, which are most unlikely to materialise, a network of bilateral exchange clearing agreements is to be preferred to a network of bilateral payment agreements. Under the latter system the foreign exchange market would remain, and would inevitably provide an opportunity for speculation. In any case, the shifting of funds between countries without exchange restrictions would remain a constant source of instability.

Thus even the least unsatisfactory of substitutes for exchange clearing compares unfavourably with that system. In the circumstances it is to be deplored that

in one or two instances the unsatisfactory results of bilateral exchange clearing agreements have induced the contracting parties to consider the advisability of replacing these agreements by payment agreements. They were unduly encouraged to do so by the relatively favourable results of the Anglo-German payments agreement, although as we pointed out above, these were due to special circumstances. To replace exchange clearing agreements by payment agreements would be a retrograde step, not only from the radical point of view of those who favour a high degree of planning in the sphere of international transfers, but also from the orthodox point of view of those who seek a return to a régime of freedom. After all, under exchange clearing the contracting parties are at liberty to buy and sell within the limits of the existing exchange and trade restrictions. The payment agreement, on the other hand, introduces an additional type of restriction, for it seeks to fix a definite proportion of imports to exports between two countries. This restriction would further curtail the small degree of freedom that is left by the various quotas, embargoes, and tariffs. While it would amount to an increased degree of planning in international financial and commercial relations, it would be planning of an undesirable type. Generally speaking it could not give satisfactory results in the long run, and would postpone the moment when the Governments can afford to relax the existing restrictions.

In any case, the tendency in favour of payment agreements is likely to be reversed when, after the devaluation of the gold currencies, international exchange conditions once more become unsettled. Payment agreements presuppose a higher degree of

confidence between Governments than do exchange clearing agreements, for under the latter collection of claims is in the hands of the creditor, who need not depend to any large extent upon the guarantees and promises of the debtor. In more than one instance these promises have been broken and the payment agreements have not been carried out by some debtor countries. While during a period of comparative exchange stability, such as has been experienced during the greater part of 1935, confidence in the promise of some debtor Governments may increase, a new period of exchange chaos is bound to reverse the tendency.

Rather than experiment with unsatisfactory methods the Governments should aim at improving the exchange clearing system. The temporary substitution of payment agreements for exchange clearing agreements is detrimental to the progress towards the improvement of the system, since it interrupts the course of experience which alone can serve as a basis of satisfactory reform.

Before concluding our survey of these transfer agreements, it is necessary to deal with the so-called "private clearing" practised in Austria and some other countries. This private clearing is in reality no exchange clearing at all. It is not based on any agreement with another country, but is carried out internally within the foreign exchange market of the country concerned. It is a particular form of exchange restriction. Exporters, instead of having to surrender to the Central Bank the total proceeds of their exports, are authorised to dispose of the whole or part of them in the foreign exchange market. They are entitled to sell the foreign currencies to authorised buyers. Importers, instead of having to apply for the allotment of foreign currencies,

apply only for permits, with the aid of which they are in a position to buy foreign currencies from authorised sellers. Since the latter have to account for the exchange sold in the so-called "private clearing", the system differs but little from the usual form of exchange restrictions. The only difference is that the rate is a matter of negotiations between authorised buyers and authorised sellers, but even in this respect there are in some cases limits to be observed. Apart from this minor difference, private clearing is substantially an exchange restriction. It is true that, strictly speaking, the arrangement provides for the clearing of debit and credit items arising from international transactions; but the same may be said also about the completely free foreign exchange market. It is misleading to call the arrangement "clearing" at all, and the object of dealing with this form of exchange restriction is merely to guard against any misunderstanding as to the meaning of the term, which is sometimes used incorrectly. The system should not be confused with exchange clearing nor with "private" compensation to be dealt with in the next chapter. Nor should the term "private clearing" be used to indicate what is in reality exchange clearing proper carried out under semi-private auspices. This is the case of the Polish arrangement, by which exchange clearing is managed not by the Government or the Central Bank or any official clearing office, but by a private company known as the Polish Compensation Trade Company. Although the company is private, its functions are identical with those of an ordinary clearing office and the system works in exactly the same way as in other countries. Although the operations of the company do not engage the responsibility of the authorities, the

latter give it their full support in the same way as if it were a Government department. Thus, the Polish Government withholds import permits for goods exported by countries where the proceeds of Polish exports are blocked unless the Polish importer undertakes to pay the sum due for the imports into a blocked account. The balances on this account are used for the payment for Polish exports to the countries in question. It is misleading to refer to this arrangement as "private" clearing.

CHAPTER XIX

COMPENSATION AGREEMENTS

SIMULTANEOUSLY with the evolution of the exchange clearing system the system of compensations—or as it is sometimes called, barter—has also developed all over the world. Owing to the fact that they developed simultaneously and that they pursue the same end, the two systems are often confused with each other. This is the case especially in French literature, and in Latin literature in general, owing to the fact that compensation is the equivalent of the term clearing in the Latin languages. For this reason, in some of the replies to the League questionnaire the term compensation is frequently used with reference to exchange clearing. In reality, the two systems differ materially.

The system of compensation is often referred to as “private compensation”. This term is somewhat misleading. It, too, originates in the peculiarity of the Latin languages just mentioned. To distinguish between exchange clearing and compensation agreements in French and other Latin languages, the second type is often referred to as “private” compensation in contrast to clearing which is “public” compensation. The use of the adjective “private” is not altogether justified. It is true that clearing agreements are usually managed by some official organisation, while compensation agreements are usually carried out by private undertakings. In the case of Poland, however, the administration of exchange clearing is placed in

the hands of a private company with official backing, so that there is at least one instance in which exchange clearing is in a sense in private hands. At the same time there have been many instances in which barter agreements have been concluded by Governments on behalf of State railways, tobacco monopolies, etc. Even when the contracting parties are private firms, the Governments are very often behind them. For example, Italy exchanged warships for coal and other products; although the Italian shipyards and the Polish coal exporters were private firms, the transaction was arranged by the two Governments. In many instances one of the contracting parties is a Government, while the other contracting party is a private firm. It is difficult to draw a line between compensation arrangements transacted by Governments and those transacted by private individuals. From the economic point of view there is really no difference between the two types and there is therefore no need to discriminate between public and private compensation in this sense.

Compensation means the direct exchange of goods for goods between two countries. In the majority of cases an agreed quantity of a definite commodity is exchanged against an agreed quantity of another definite commodity. As is well known, in the case of exchange clearing buyers of both countries have the free choice of the goods available in the other country. This is not, however, the main difference between the two systems. After all, in some cases compensation agreements provide for the purchase of an agreed quantity of a definite commodity on one side and the freedom of choice for the creditor country to buy an equivalent amount of goods from the debtor country

on the other side. The essential difference is that while in the clearing system money plays an important part, in pure compensation it plays no active part at all. While in the clearing system the importers have to pay the purchase price in national currency into the clearing account and the exporters of the same country receive payment from the proceeds of that clearing account, in the case of compensation no money changes hands. In practice it happens sometimes that there are some small differences to be paid in cash but these can be disregarded for the purpose of our discussion.

In substance and in form compensation is barter. It is frequently referred to as such in a sarcastic or critical sense by those who disapprove of the system, with the object of denouncing it as something essentially barbaric and backward. Indeed, many people have conceived a strong prejudice against compensation owing to the mere fact that it is a form of barter. Since barter was a characteristic of a primitive age, they think that to revert to it is essentially humiliating and that those practising it ought to be made to feel ashamed of themselves just as if they had reverted to totem-worship or cannibalism. In reality there is nothing degrading in barter. Admittedly, it is a cumbersome method of exchanging goods, and has obvious disadvantages compared with monetary economy. The fact, however, that in spite of its obvious drawbacks and inconveniences it has been resorted to on a large and increasing scale during the last four years casts no aspersion on those who have assumed direct responsibility for what is evidently a retrograde step. The blame must rest with the shortcomings of the modern monetary system, which has proved to be unequal to the task for which it was created. The

return to barter is a strong indictment of the orthodox monetary policy which has thus reduced the monetary system to absurdity.

However tempting it would be to enlarge upon the metaphysical aspects of the compensation system, we propose to confine ourselves largely to its practical aspects. Casting dogmatism aside, it is evident that if compensation is capable of improving trade it is a system worth having. If the choice lies between trade through compensation and no trade at all, then the judgment whether the system is justifiable cannot be difficult.

As we have noted, compensation implies a goods transaction between two countries without the intermediary of money. For this reason the arrangement by which exporters in countries with exchange restrictions are authorised to spend the whole or part of the proceeds of their exports on raw material purchases abroad cannot be considered as compensation. It is simply a particular method of allotment of exchange under exchange restrictions. Nor can the use of blocked proceeds of exports for purchases from the importing country be termed compensation. Although such transactions amount to official regulation of the flow of international trade, they do not belong to the category either of exchange clearing or of compensation arrangements. They are simply manifestations of exchange restrictions, discussed in detail in the author's book, *Exchange Control*.

The relations between exchange clearing and compensation have been subject to much controversy. According to one opinion, compensation is an alternative system to be preferred to exchange clearing. According to another opinion, the two systems com-

plete each other. Those who prefer compensation to exchange clearing argue that, thanks to the application of the former system, goods can be exchanged between two countries on a natural basis in spite of the existence of an uneconomic rate of exchange. Indeed, compensation transactions do not allow for the over-valuation or under-valuation of a currency compared with its economic parities. The barter is concluded largely on the basis of the world market price of the commodities which are exchanged. In countries with an over-valued exchange this is highly beneficial to exporters, who would otherwise be unable to sell their goods abroad. If the internal price-level in the countries concerned is above the world level, then the goods imported in return for the exports can be sold at a higher price, so that the exporters can cover their cost of production and make a profit. From this point of view, compensation compares favourably with clearing, though in this connection it is well to recall the fact that the latter's deficiency can and should be remedied by fixing the exchange rate for clearing purposes at its economic parity.

While it is impossible not to recognise the advantage of compensation for countries with artificial exchange rates, the idea that compensation on an extensive scale results in the development of a natural ratio between the price-levels of the two countries cannot be accepted without reserve. Although the terms of the barter are largely determined by the world market price of the commodities which are exchanged, very often other considerations play an important part. Much depends upon the relative degree of keenness of the two parties to conclude the transaction. While coal has a fairly definite world market price, and the value

of warships can also be stated in terms of money, it is difficult to be very accurate about the exact value of warships in terms of coal. If one of the parties is very keen on buying the coal or on selling the warships, then it will accept less coal. If the other party is anxious to liquidate its coal surplus and to acquire warships, then it will be prepared to give far more coal in exchange than would be warranted on the basis of the price of both warships and coal.

The fact that it is often difficult to be precise about the value of one commodity in terms of another opens a channel for using compensation for the purpose of circumventing exchange restrictions. In countries where exporters have to surrender the proceeds of their exports to their monetary authorities, they can evade this regulation by concluding compensation deals on the understanding that the other party will deposit abroad in cash part of the value of the goods received. It is much more difficult for the authorities of the country with exchange restrictions to check the *bona fides* of the terms of a barter transaction than to compare the declared sale price of exports with market prices. From this point of view, compensation compares unfavourably with exchange clearing.

Another important disadvantage of compensation is that its conclusion requires lengthy and complicated negotiations. While occasionally it is a simple matter to arrange such a deal, in the majority of cases it is by no means easy to find buyers for the goods obtained in payment for those exported. Both parties are confronted with this problem, and since they are not as a rule acquainted with the market in the commodity they are to receive, they have to reckon with delays and losses arising from their inexperience. Compared

with the cumbersome procedure of compensation, the individual transactions under exchange clearing are extremely simple. While formalities and red tape are attached to them, all that becomes a matter of routine involving little more than simple clerical work. There could be no question of replacing exchange clearing by compensation. The latter system can work satisfactorily only in staple products and in a very restricted number of manufactures. The arrangement of compensation transactions as an everyday practice in foreign trade in general is simply unthinkable. Compensation can seldom be made to pay unless it is done on a large scale. The system cannot therefore be regarded as an alternative to exchange clearing. The latter would remain necessary even if the application of compensation were to expand. Beyond a certain limit, exchange clearing would always be a more convenient method for foreign trade.

It is frequently stated that compensation provides a corrective to the exchange clearing system, since it facilitates the liquidation of frozen clearing balances. This is the view held by the League report on clearing agreements, and it is stated also in some of the replies to the League questionnaire. In reality, the transactions which the report referred to—those undertaken to liquidate a frozen clearing balance—do not constitute compensation. They are simply special purchases of commodities under a clearing agreement. Compensation implies the exchange of goods against goods. If a clearing balance is liquidated through a large single goods transaction arranged under official auspices, then the goods are not bartered against goods but are paid for through the channels of the clearing agreement.

If it is incorrect to say that exchange clearing can be replaced by compensation, the view that the two systems are incompatible with each other is equally erroneous. Admittedly, the operation of compensation agreements is sometimes detrimental to the satisfactory working of clearing agreements. The exporters who accept goods in return for their goods obtain payment more speedily than creditors under a clearing arrangement which show a large credit balance. As a result of their operations, delay for other exporters in receiving payment under the clearing agreement becomes further prolonged, since part of the country's imports, payment for which would in the ordinary course find its way into the clearing account, is paid for by barter transactions. It would be a mistake, however, to exaggerate the importance of this argument. In the majority of cases, the import and export arranged through compensation would not come about at all but for the compensation agreement. In any case, the authorities of countries with exchange clearing keep a close watch on compensation agreements; usually a special permit is required from the clearing authorities, so as to prevent compensation from becoming detrimental to the working of clearing.

Compensation fulfils a useful role even between countries with bilateral exchange clearing agreements, especially in cases where the parties are particularly distrustful towards each other. Although clearing agreements contain every assurance that any credit balances which might accumulate would be liquidated in case of a breakdown of the arrangement, many Governments and also many exporters prefer not to rely upon this written promise. If they conclude a compensation transaction, they know exactly where

they are and they know when and how they will be paid for their exports.

Compensation agreements need not necessarily be bilateral. Triangular compensation arrangements are known to have been concluded and carried out to the satisfaction of the parties. Thus, although bilateral compensation tends to divert trade into bilateral channels to an even larger degree than bilateral clearing, there are possibilities for the development of compensation where bilateral transactions would be impracticable. So far, examples of such transactions have been very rare. The procedure is, needless to say, even more cumbersome than in the case of bilateral compensation. It would be none the less possible to encourage the development of the system in the same way as the development of multilateral clearing could be encouraged. To that end, it would be necessary to establish an international compensation office, preferably in conjunction with an international clearing office. Needless to say, international compensation could not in any circumstances become automatic. It requires special negotiations. The existence of an international organisation for that purpose would, however, greatly facilitate this otherwise difficult and complicated task.

The proposed international compensation office should function in the following way: Every participating country would have a national compensation office to which exporters and importers would communicate their requirements. The national compensation office would have its representative at the international compensation office and these representatives would be in constant touch with one another, exchanging notes about the various exporting and importing

orders they had received. By such means bilateral compensation would also be facilitated, but the main object would be to arrange triangular and multilateral compensation agreements. It would thus be possible to increase the volume of international trade considerably without at the same time running the risk that a similar increase would involve under an anarchic economic system.

Admittedly, if the exchange clearing system functions properly there is no need for compensation. It is only because many parties do not like to rely upon exchange clearing that compensation is necessary. Should the working of the exchange clearing system be improved by the adoption of international clearing, the necessity for compensation would gradually decline, for all parties would realise sooner or later that they are safe in relying upon the clearing system. In the meantime, however, until confidence in the clearing system is sufficiently established, compensation is a necessity. In spite of its difficulties and disadvantages, it serves a useful purpose, and should not, therefore, be discarded simply for doctrinaire reasons.

CHAPTER XX

THE FUTURE OF EXCHANGE CLEARING—THE SHORT VIEW

IN the foregoing chapters we have tried to describe the exchange clearing system as it is and as it ought to be. We have expressed our views upon the direction in which exchange clearing should develop. There only remains for us to express our views upon the direction in which exchange clearing is likely to develop. If the author's wish were father to his thought, he would conclude unhesitatingly that the financial history of the next few years will be marked by a steady expansion and improvement of the exchange clearing system until it becomes universally adopted and managed on international lines. This is the optimistic view held by some advocates of the international clearing system. They imagine that since the world depression is likely to go from bad to worse, statesmen will eventually realise that the only way out of the economic deadlock is the adoption of the international clearing system. Accordingly, they predict, there will be a huge international conference at which all participants will agree that this is the best solution, and will decide to put it into practice.

Things just do not happen that way in real life. In the majority of cases the right thing is done for the wrong reason; statesmen tumble on the right solution by mistake; changes of fundamental importance are adopted without anyone realising what is being done. This is how international exchange clearing will be

adopted if and when it does become reality. The number of bilateral clearing agreements will, in the long run, increase. There will be a growing demand for their co-ordination into an international system and for the improvement of facilities for multilateral clearing. Before the statesmen realise where they are, they will find one day that bilateral agreements are operating between practically all civilised countries and that most of these agreements have been made so comprehensive as to include practically every item of international transfer. The number of triangular clearing arrangements will increase, and it will then become possible to conclude multilateral agreements, especially between countries belonging to the same economic group. The need for some central organisation to facilitate the conclusion of these multilateral agreements will become increasingly evident. Eventually steps will be taken in that direction, not because it was suggested by a financial expert or by any one particular organisation, but because a large and increasing number of Governments realise the practical need for it. All Governments are not likely to fall in with the scheme from the very outset, but its satisfactory operation by a relatively small group of participants will result in a gradual increase in the number of adherent countries. A stage will be gradually reached when the activities of the international clearing organisation will extend over the whole civilised world.

Having pointed out the excessive optimism of some supporters of the scheme of international clearing, we must beware of the same error. The desired result is not likely to be achieved in a year or two. Indeed, in dealing with the future of exchange clearing, it is

essential to distinguish between the short and the long view.

Admittedly, as it stands, exchange clearing is anything but popular. Most of the Governments which have adopted the system or have inherited it from their predecessors consider it a necessary evil, and would be only too glad to abolish it as soon as possible. This accounts partly for the strongly adverse attitude of the League Joint Committee on Exchange Clearing and the endorsement of its conclusions by the Second Committee of the League Assembly in September, 1935. If the Governments were in a position to abolish exchange clearing to-morrow they would doubtless do so without hesitation. As things are, however, they are unable to do without exchange clearing, and they know it. They realise that in order to be able to abolish the system it is necessary to remove the causes responsible for its origin. What they do not realise is that these causes are very deep-lying. They mistake the symptoms for fundamental causes. They think that all that is required is to remove restrictions on trade and exchanges, when the need for exchange clearing will fall away. What they fail to realise is that while these restrictions were the immediate causes of the adoption of exchange clearing and are still the causes which necessitate its maintenance, these causes are themselves the effect of more profound causes.

The conclusions of the League report on exchange clearing are characteristic of this prevalent error of mistaking the surface symptom for the fundamental cause. According to the Joint Committee of the League, all that is wanted in order to enable the world to do without exchange clearing is the complete abolition of exchange restrictions, coupled with the funding of

external debts and a less restrictive commercial policy. There is not a word said about the removal of the causes which led to the adoption of restrictions on transfers and trade. Obviously the League Committee is suffering from the delusion, so prevalent in the orthodox camp, that the Governments have adopted these restrictions out of ignorance or malevolence, and that they are in a position to revert to the pre-crisis state of affairs by a stroke of the pen. They refuse to realise that, given the fundamental disequilibrium between fictitious wealth and real wealth and between exchanges and price-levels of various countries, together with the many other disturbing factors described in Chapter II., the régime of freedom could not work satisfactorily if it were to be restored unless pre-war equilibrium were simultaneously restored. Such considerations are completely disregarded by those who urge the abolition of exchange clearing. Doubtless progress is being made towards the enlightenment of public opinion. Indeed, even in such ultra-conservative quarters as the editorial columns of *The Times*, views were recently expressed that it is idle to demand the removal of exchange and trade restrictions so long as the fundamental causes of their imposition remain. It will be a long time, however, before this opinion gains sufficient ground to counteract the chorus of those who demand the immediate abolition of restrictions in order to abolish exchange clearing. Judging by the endorsement of the report of the Joint Committee by the League Assembly in September, 1935, the Governments are still far from having realised the true implications of the problem.

In the circumstances, it would be idle to expect that the Governments will make any deliberate efforts to

improve the exchange clearing system in the near future. As we have pointed out in earlier chapters, the opponents of exchange clearing are anxious to avoid any improvement of the system for fear that if public opinion realises that it can work satisfactorily there will be a strong movement in favour of its retention. At the Geneva meeting of the League Assembly in September, 1935, the committee dealing with the problem of clearing passed a resolution proposing the arrangement of consultation between the League and the Bank for International Settlements with the sole object of trying to put into operation the recommendations of the Joint Committee's report as to the means for an early abolition of exchange clearing. As is well known, if there is one quarter where exchange clearing is even less popular than at Geneva, it is Basle. At a Board meeting of the Bank for International Settlements in 1933, the Central Bank governors controlling the destinies of that bank arrived at an understanding that they would do everything, individually and collectively, to hamper the development of exchange clearing. No constructive step can, therefore, be expected from that quarter.

Notwithstanding this, there is no likelihood of an early abolition of the system. Doubtless, the disappointment caused by the unsatisfactory results of clearing agreements with Germany has led several Governments to the conclusion that the arrangement should be replaced by some other system. It is conceivable, therefore, that some of the exchange clearing agreements may be discontinued, and that the number of agreements in operation will be less in a few months' time than it is at the time of writing. Taking a somewhat longer view, however, it appears to be extremely

unlikely that within the next year or two the tendency towards the abolition of exchange clearing will make any material and lasting headway. On the contrary, it is conceivable that after a temporary setback caused by the unsatisfactory result of the clearing agreements with Germany, the number of agreements will increase once more, partly because the alternative arrangements that are experimented with will prove to be even less satisfactory than clearing, and partly because of the probable revival of acute currency troubles in a number of countries.

This is not the place to examine in detail the international monetary position and prospects. That subject has been dealt with in detail in the author's books *Bankers, Statesmen and Economists*; *World Finance since 1914*; *The Future of Gold*; and *France's Crisis*. Here let it be sufficient to remark that in the author's view the devaluation of the remaining gold currencies is a mere question of time; a further depreciation of sterling and the currencies of the Sterling Bloc is inevitable; and, probably, even the dollar may also have to be devalued once more sooner or later. The author arrived at these conclusions before the present acute troubles in international politics had arisen. The Abyssinian war has introduced a new and powerful disturbing factor in the field of international finance. It is now certain beyond any shadow of doubt that there will sooner or later be a revival of the currency troubles which followed the suspension of the gold standard in Great Britain and the subsequent depreciation of the dollar.

Assuming this view to be correct—and it would require an unwarranted degree of optimism to doubt its correctness—it is impossible to get away from the

conclusion that the next twelve months at any rate will experience the reinforcement and not the weakening of exchange and trade restrictions. Feverish rearmament all over the world will lead to new defaults on foreign debts and new transfer difficulties. In the circumstances no Government would deem it advisable to abolish exchange clearing, for it would be the only means of maintaining a certain amount of trade and collecting a certain amount of debts amidst immense difficulties. Indeed it is reasonable to suppose that even the Governments which have hitherto kept aloof from the system will have to revert to it. It is doubtful whether the British Government among others will be able to continue to swim against the tide. The chances are that the British Dominions, in order to be able to sell their products, will have to take up clearing and compensation to an increasing degree, and their policy in this respect may conceivably force the hand of the motherland, even if the disadvantages to her own exporters and investors of remaining outside the clearing do not in themselves lead to a change of policy. Thus it seems reasonable to expect that while the number of exchange clearing agreements may decline within the next six months, it will rise within the next twelve months or so.

This does not, however, necessarily mean that exchange clearing has definitely come to stay. Thinking in terms of years, it is possible and even probable that we shall witness a gradual disappearance of the system. Its opponents are numerous and influential, not only among theoretical economists, but also in Government offices and Parliaments. They will do their utmost to abolish exchange clearing as soon as conditions have improved sufficiently to enable them

to remove exchange and trade restrictions. It is reasonable to assume that unless the world is plunged into another European war there will be a gradual recovery within a few years. This in spite of the existence of that fundamental disequilibrium which did not prevent the establishment of a surface equilibrium between 1925 and 1929 and which will not prevent the return of another spell of superficial calm. Indeed, but for the acute international political complications, the recovery could have been expected to take place soon after the devaluation of the gold currencies. The Italo-Abyssinian war has introduced a new disturbing element, and it would be as yet premature to form definite views as to how world economics and world finance will be affected by it. One thing, however, is certain. It has postponed the date at which conditions will appear to be sufficiently normal to make it possible to remove restrictions. Instead of arriving at that stage in, say, 1936, the world will reach it perhaps in 1938. Barring the possibility of another world war, the return of comparatively normal economic and financial conditions, is however, a question of time.

Once conditions are sufficiently settled to enable the Governments to remove restrictions, they will undoubtedly do so. Even though there is no likelihood of restoring the degree of freedom that existed before 1931, in all probability the most unpopular forms of intervention will be abolished. Amongst them exchange clearing is certain to be included. World opinion has not advanced sufficiently to realise that even under conditions of surface equilibrium it would be to the interest of mankind to regulate international transfers and trade, and that among the various methods by which this can be done exchange clearing

is the one which comes nearest to the ideal. It is unfortunately doubtful whether the experience of the present depression will be sufficient to teach the world a lesson. The desire for the return to liberal anarchy is still predominant. *Laissez-faire* will probably be given another chance.

Thus the short view on the future of exchange clearing may be summarised as follows: In the immediate future several exchange clearing agreements are likely to be discontinued and replaced by other forms of transfer agreements. Quite possibly by the time these lines have appeared in print this may already have taken place in one or two instances. In the somewhat more distant future there will probably be a revival of the tendency towards a wider application of exchange clearing. If and when economic conditions have improved and relatively normal surface equilibrium is attained, however, exchange clearing will in all probability be abolished. Whether or not its disappearance will be final remains to be examined in a concluding chapter.

CHAPTER XXI

THE FUTURE OF EXCHANGE CLEARING—THE LONG VIEW

THE fate of the exchange clearing system in the long run is closely linked with the fate of economic planning in general. In an economic system which is substantially based on the principles of *laissez-faire* exchange clearing would not be tolerated except as a temporary emergency measure. Under a managed economic system, however, exchange clearing is indispensable. Without it, endeavours to achieve economic planning would be one-sided and incomplete and could not possibly produce satisfactory results. In order to form an opinion about the prospects of exchange clearing in the course of the next few decades, it is necessary, therefore, to make up our minds whether the trend of evolution during that period will be towards planning or whether it will revert to freedom and anarchy. We have expressed the view in the foregoing chapter that, as a reaction from the high degree of intervention forced upon the world by the series of crises experienced since 1931, *laissez-faire* is likely to be given another chance as soon as the return to relatively normal conditions makes this possible. In the course of the next four to six years the tendency towards planning will probably suffer a reverse.

This does not, however, mean that with the return of relative surface-equilibrium mankind will return to the same degree of economic freedom as existed

before 1914, or even before 1931. In some countries, at any rate, State intervention and planning has come to stay. In Russia, where it has attained a very high degree, nothing short of a violent reversal of the political régime—an extremely unlikely contingency—would restore a liberal economic system. The same may be said to be true of Germany and Italy, although in these two countries economic planning has not proceeded so far as in Russia. In both these countries, however, Government economic planning is an integral part of the fundamental political philosophy of the existing régime. In a number of other countries planning has been resorted to as a matter of expediency in time of crisis. This has been the case in almost every civilised country, though the extent to which planning has been applied varies widely. In the United States under President Roosevelt, in Belgium under M. van Zeeland, in Portugal under Senor Salazar, a relatively high degree of interventionism has been or is being introduced. In these cases, however, the interventionism is largely due to the personal policy of the three statesmen, and may not necessarily survive their tenure of office, at any rate not to the degree to which it is applied at present. In Japan interventionism does not consciously form part of the programme of any particular party, but is thoroughly in keeping with the disciplined character of the nation.

In most other countries, planning is less deeply rooted than in any of the countries mentioned above. Nevertheless, even Great Britain, where the nineteenth-century mentality of *laissez-faire* dies hard, has resorted in an unobtrusive way to measures of economic planning. Even France, the home of extreme individualism, is on her way towards a hitherto un-

dreamt of degree of State intervention. The question is whether in these countries the pendulum will not swing back once the emergency is passed. The answer is a somewhat hesitating "no". While many irksome emergency measures will doubtless be abolished at the first opportunity, a certain degree of economic planning will in all probability remain. The pendulum will not be allowed to swing back altogether. The change in the economic and political philosophy of the British nation and other nations where a high degree of economic freedom continues to survive is slow, but progress is undoubtedly being made in the right direction. Planning may well be denounced as a "cheap catchword" and as the "latest fashion in economic literature", but whether or not most people realise it, subconsciously it is taking root in the nation's mind. It will take a long time, however, before it displaces the orthodox teachings of so many generations.

Whether or not the struggle between *laissez-faire* anarchy and economic planning will end with the latter's victory will depend not only on the force of arguments put forward by the adherents of both schools but on developments in real life. The decisive battle will be fought not in the Press, the Universities, or in the debating societies, but in the factories and fields of producers, in the homes of consumers, and in the whole economic mechanism that is between production and consumption. *Laissez-faire* will be given another chance. If, as adherents of the orthodox school are convinced, it should lead to a lasting, even though not uninterrupted, improvement of world economic conditions, then a return to planning would be out of place. If, on the other hand, as the adherents of planning are convinced, it should lead to another

severe crisis, possibly even more disastrous than the one experienced in 1931 and subsequent years, then the world would sooner or later fall back upon planning as its only salvation.

The author is convinced that the latter alternative will materialise. Even if prior to the return to *laissez-faire* the fundamental causes of disequilibrium were to be removed, it would give the system only a temporary respite. Owing to its inherent defects amidst the changed conditions, a high degree of fundamental disequilibrium is certain to develop in the course of time. The chances are, moreover, that the existing fundamental disequilibrium will not be removed prior to the return to *laissez-faire*. Judging by the attitude of orthodox economists and statesmen, they do not adequately realise even the fundamental character of the disequilibrium that is at the root of our present troubles. They honestly think that by fighting symptoms, such as exchange clearing or restrictions, they will be able to restore the conditions in which the liberal system can work satisfactorily. While it is possible and even probable that a return to *laissez-faire* will be preceded by or will coincide with the stabilisation of currencies at levels which reduce considerably the disequilibrium between exchanges and prices, it seems highly improbable that the more important problem of fundamental disequilibrium between fictitious wealth and real wealth will be tackled. In all probability the financial inheritance of the last war will not be liquidated. Indeed, the new paper wealth created in connection with the present war, and the rearmament race associated with it, may be added to the legacy of the last war. In addition to its inherent deficiencies, *laissez-faire* will have to take

its last chance handicapped by this immense burden. The excessive amount of paper wealth will increase the vulnerability of the system and will further reduce its chances of producing satisfactory results.

In the circumstances the experiment of putting the clock back is bound to fail. Sooner or later the world will be taught another painful lesson in common sense as a result of another series of violent crises and another prolonged depression. It is then that the chance for economic planning will come. If even that lesson should be insufficient to make mankind realise the inherent defects of an anarchic economic system, then the crises will repeat themselves over and over again. Sooner or later the world will have to see reason and seek its salvation in planning.

When the world was plunged into the crisis in 1931 hardly anyone realised that there was an alternative system—other than Communism—to *laissez-faire* anarchy. Even in Italy, where economic planning under a capitalist régime was gradually developing, the idea was adopted subconsciously rather than consciously. The crisis and the prolonged depression have, however, made the world aware of the existence of this alternative. When the world enters the phase of its next crisis it will possess a knowledge and experience infinitely superior to that which it possessed in 1931. Instead of wasting much time and energy in lamenting the fall of economic liberalism, the nations will be in a position to proceed straight away with the application of the alternative system. Doubtless they will have to proceed through trial and error. They will nevertheless be in an incomparably more favourable position than they were in 1931, when they were ignorant not only of the details of planning but even

of its fundamental principles and of the inexorable necessity for its adoption.

The author is firmly convinced that on the occasion of a future economic crisis, economic planning will come to stay. If this assumption is correct, then it may be taken for granted that exchange clearing will form an integral part of the system of planned economy. It has developed gradually during the past few years, but its progress then will be much more rapid. After all, the Governments will have the benefit of past experience and will be in a position to learn through the inevitable mistakes made by their predecessors. It will be possible to adopt from the outset a highly advanced type of clearing. There is no reason why the application of the system should not be resumed at least at the point which it had reached when it was abolished. What is more, during the period between the two crises, an adequate theoretical background for the new system will doubtless be created, and discussion of its merits and deficiencies will lead to many improvements for which there was no time during its hasty application as an emergency measure. A large number of bilateral clearing agreements will spring up, and most of them will be of an advanced type, covering the widest possible range of international transfer items. Efforts towards triangular and multilateral clearing will be resumed and will lead eventually to experimental establishment of international clearing. In Chapters XV. and XVI. we tried to enumerate the alternative methods by which the international clearing system can be operated. It would be too bold to try at the present stage to forecast in detail the system that is likely to be adopted. Whatever its details, its fundamental principle will be that of replacing trans-

fers through the foreign exchange market entirely by transfers through international clearing. The ideal which may be attained sooner or later will be international clearing arrangements including every civilised country and extending over every kind of international transfer, both current items and capital items.

Such an international and universal clearing could be made practically watertight and made to cover every kind of transaction which at present is carried out by the foreign exchange market. It would not necessitate any fundamental change in the currency and banking system beyond the substitution of exchange clearing for the free dealing in exchanges. Some of the adherents of the system suggest it as an alternative to the gold standard. In reality, exchange clearing and the gold standard are by no means incompatible. The only difference exchange clearing would make to the working of the gold standard is that the latter would cease completely to be automatic. There would be no shipments of gold by arbitrage. Gold would continue to be used for the settlement of balances which are incapable of being liquidated by clearing, and for the purpose of granting cash loans abroad. For this reason it would remain essential to maintain gold reserves, which would be valuable also as tending to preserve confidence in the note circulation and the credit structure.

This change in itself would not be so revolutionary as it may appear at first sight, for, during the period of post-war stabilisation, gold movements largely assumed the form of special transactions arranged by the Central Banks themselves. At the time of the establishment of the Bank for International Settlements, in 1930, the idea of dispensing altogether with free gold movements through arbitrage was already

gaining in popularity. It is true that, in the absence of the automatic working of gold points, the barometer provided by gold movements would cease to operate. It would be replaced, however, by a more dependable barometer in the form of daily changes in clearing balances. Changes in the gold reserve do not clearly indicate the causes responsible for them. It would be possible, however, for the international clearing office to trace down the cause of any one-sided tendency in the clearing accounts of any particular country. A glance at the figures of the clearing office would be sufficient to diagnose the trouble, and to ascertain whether a country were over-lending or over-borrowing, over-trading or over-spending.

Gold would continue to fulfil its part as the one commodity against which any country is prepared to exchange any kind of goods. It is indeed essential that gold should be retained for that purpose. Gold standard and international clearing are in fact complementary. The gold standard could work much more satisfactorily if the disturbing effects of speculation and the unnecessary international movements of funds were eliminated, as they would be by the supersession of the free foreign exchange market. It is a mistake on the part of some supporters of international exchange clearing, such as for instance the London Chamber of Commerce, to agitate in favour of the abolition of the gold standard. In doing so they convey the impression that the choice lies between the two systems and thereby antagonise quarters which might otherwise be inclined to view exchange clearing favourably. Apart from any other reason, the maintenance of the gold standard in combination with exchange clearing is essential to enable financially strong countries to

grant cash loans to financially weak countries. In the absence of the gold standard, it would be impossible to grant such loans under the exchange clearing system. While it would be possible to consolidate accumulated debit balances on clearing accounts with the aid of a loan, or to place at the debtor's disposal a clearing balance which would be available for spending in the lending country, exchange clearing by itself would provide no means of financing long-term contractual work or the industrialisation of financially weak countries. This would mean that exchange clearing would practically put a stop to any further progress in comparatively undeveloped parts of the world. This in itself would be a very strong argument against exchange clearing. If the system were combined with the gold standard, however, it would be possible to grant cash loans in the form of gold shipments.

Here again the change would not be nearly as revolutionary as may appear at first sight. After all, even under the system of the free gold standard, unless the proceeds of the loan serve to consolidate earlier spendings abroad or are used for the purchase of goods abroad, they have to be repatriated in the form of gold shipments. Under the gold standard this simple fact is concealed by the complicated apparatus through which international transfers pass. Under exchange clearing combined with the gold standard, the matter is simplified and clarified. No country would grant cash loans unless it were prepared to lose a corresponding amount of gold. Had this rule been operative before the crisis, over-lending on the part of Great Britain would have been avoided.

It is true that, under this combined system of exchange clearing-cum-gold standard, every single capital

transfer would have to receive the consent of the authorities of both countries. This, however, is one of the strongest arguments in favour of the system. It is one of the reasons why economic planning could not possibly be complete without exchange clearing. Those who realise the immense mischief caused by the absence of planning in international capital transfers during the last few years will have no tears to shed for the passing of the old system. Already, under the régime of freedom, most countries have adopted some sort of control over public issues on foreign account. There are, however, many channels through which this control is circumvented and as a result of which the Government's policy is rendered ineffective. It is one of the merits of exchange clearing that it would close all these loopholes. It would no longer be possible to place foreign loans privately, to grant foreign short-term credits, to buy securities in foreign stock exchanges, or to deposit funds abroad without the consent of the authorities concerned. Those who place economic freedom above the stability and prosperity of mankind will doubtless deplore such a curtailment of freedom. It may well be asked, however, whether it is really to the interest of the progress and welfare of mankind that every speculator should be at liberty to gamble abroad if he wants to, and that every miser should be at liberty to send his capital abroad for the sake of an additional yield of $\frac{1}{8}$ per cent. There are many more important interests at stake which are worth considering and which should take precedence over this freedom.

There is another reason why exchange clearing should be an indispensable part of a system of planned economy. Since planning on an international scale is

not yet attainable, it will have to be done—to begin with at any rate—on a national scale. In order to be able to expand production and consumption undisturbed, the nations will have to find means to safeguard themselves against the repercussions upon their monetary systems of such differences as may arise between the degree to which various countries have expanded. Under a system of *laissez-faire*, any country which expanded excessively would soon have to pay the penalty in the form of loss of gold, which would be followed by contraction of credit and decline in trade. The adoption of the exchange clearing system would not, of course, eliminate the effect of over-expansion upon the gold reserve or upon the balance of indebtedness of the country concerned. It would, however, reduce to a minimum the disturbance caused internally and internationally. There would be no need to contract credit if a country lost gold or if its clearing accounts showed a persistent debit balance. The danger signals would not give rise to speculation and a flight of capital which would otherwise exaggerate any slight disequilibrium. Such disequilibrium as might arise from time to time could be corrected if necessary by a corresponding adjustment of the rate of exchange. The international repercussions of such adjustments, which in any case would not be resorted to too frequently, would be infinitely less disturbing than those of the suspension of the gold standard or the devaluation of a currency under a régime of free foreign exchange markets.

International exchange clearing would enable the nations to cast aside their excessive timidity in matters of finance, and would enable them to take full advantage of technical progress for the improvement of their

standard of living. The risks attached to a progressive monetary policy, accompanied by economic planning, would be reduced to a minimum through the application of international exchange clearing. The truth of this is bound to be realised sooner or later, if not under the weight of arguments, then under the weight of facts. The author is fully confident that exchange clearing is the system of the future.

THE END

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