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Common Policy of Full Employment

Report
Committee on Economic Affairs and Development
Rapporteur: Mr Finn MOE, Norway, Socialist Group

Preface

The Consultative Assembly of the Council of Europe, meeting in August 1950 for its Second Session, unanimously adopted a Recommendation requesting Member States " to take all necessary measures to ensure full employment " in their own countries. The Assembly further instructed me to keep the Committee on Economic Questions regularly informed of the progress made by Member States in implementing their employment programmes.

This Committee had already requested the Secretariat-General to prepare " a study in detail of the means by which the measures recommended in the report of the five United Nations experts[1] should be applied within the field of the Council of Europe. »

The Committee of Ministers subsequently endorsed the general aims of the Assembly Recommendation on Full Employment in a Resolution adopted on the 4th November 1950. In implementing the instructions of the Assembly and the Committee on Economic Questions, the Secretariat-General had the benefit of consultations with a number of outside experts.[2] The experts participated in the work purely in their personal capacity and the opinions they have individually expressed on particular points do not necessarily reflect the views of the Organisations with which some of them are or have been connected. The experts were not called upon to endorse the report as a whole, which has been prepared and issued under the sole responsibility of the Secretariat-General.

J. C. PARIS.

Secretary- General

13th April, 1951.

1. PART I Introduction and Summary

1. The Consultative Assembly, in the Recommendation which has prompted the drawing up of this report, recorded " its solemn conviction that unemployment is the gravest of all economic diseases which can afflict modern States, " and it called upon " all Governments associated with the Council of Europe to take all necessary measures to ensure full employment. " There was widespread agreement, in the Assembly

1. National and International Measures for Full Employment, United Nations, December 1949.
2. The following economists were consulted : Mr. Nicholas KALDOR, Fellow of King's College, Cambridge, Mr. Anthony CROSLAND, M. P., late Fellow of Trinity College, Oxford, Mr. Robert TRIFFIN, late Instructor of Harvard University, Special Adviser on Policy, Office of Special Representative, Economic Co-operation Administration, and Mr. Richard DOWNING, International Labour Office. Mr. Kaldor and Mr. Crosland also assisted the Secretariat-General in the drafting of the report.

debates on this Recommendation, that no single step would so enhance the prosperity of the Council of Europe nations, and conduce to their closer economic unification, as the elimination of the considerable unemployment which still existed in the territories of some Member States.

2. This Report was therefore born of the desire to have a detailed study of the means by which this " gravest of all economic diseases " could be cured within the area covered by the Council of Europe.

3. The drafting of this Report was facilitated by the fact that there already existed the study by the U. N. experts on " National and International Measures for Full Employment " (referred to in the Assembly Recommendation). But this study was written for a body of more than 60 nations, with warying problems, and at very different stages of economic development.

4. When the recommendations of the U. N. experts come to be applied to a particular country or group of countries, they need not merely to be made more specific, but to be modified (at least in emphasis) to take account of the particular conditions prevailing there. It was for this reason that the Committee on Economic Questions of the Consultative Assembly decided that a separate Report was required, which would apply and interpret the findings of the U. N. report in the light of the special problems facing the Member States of the Council of Europe.

5. This attempt at re-interpretation is the more necessary since it is the declared aim of the Council of Europe to develop closer economic ties between its Member States, and there are many who look forward to the eventual economic integration of the whole area.

6. Close economic co-operation between a group of countries varying in internal structure, and to some extent in political outlook, raises the problem of co-ordination of full employment policies in a particularly acute form. Both pre-war and post-war experience has amply shown that even a limited degree of economic unification between nations can easily founder if the different members of the group pursue divergent policies, and fail to maintain their internal economies at stable and prosperous levels. This would apply a fortiori to schemes of economic unification of a more radical kind. Agreement on full employment and the maintenance of internal economic stability is therefore a necessary precondition of any successful advance towards further integration.

7. The Report was to attend primarily to the problem of full employment. This it does. But it would be unrealistic to ignore the fact that the major problem facing Europe in the next few years may be that of inflation rather than of unemployment even though large-scale unemployment may persist in particular countries. Since, in addition, inflation is as easily capable as deflation of imperilling the cohesion of an economically united Western Europe, attention has not been confined solely to the issue of full employment. The report seeks instead to adumbrate the sum total of stability conditions which must be fulfilled if attempts at freer trade are to be successful.

8. The Report thus deals with the wider problem of how to maintain economic stability in the face of increasingly close economic links between Member States of the Council of Europe. It should be emphasised, however, that this paper does not discuss the question of whether or not a higher degree of integration is in itself a desirable objective. Its aim is limited to an analysis of the conditions which must be fulfilled if either the existing arrangements or any contemplated arrangements for economic integration are to have any lasting success.

Summary of Recommendations

9. This Report does not attempt to cover every technical aspect of the problem; this has already been done at length elsewhere. Instead, it seeks to put forward practical suggestions which are relevant to the actual problems likely to face the nations of the Council of Europe.

10. The recommendations may be summarised as follows :

a. Member States of the Council of Europe should adopt the following objectives in their economic policies :

th e maintenance of full employment,

th e avoidance of inflation.

stabilit y in mutual trade relations.

accelerate d economic development of underdeveloped areas.

b. To this end each Member State should undertake the following obligations :

t o ensure that there are at all times sufficient employment opportunities available for all men and women seeking work, so that unemployment may be kept at the minimum dictated by the organisation of the labour market; and to this end to declare a full employment target, the attainment of which will constitute the aim of national employment policy (paras. 59-63).

t o ensure internal monetary stability by maintaining total expenditure at such a level that neither inflationary nor deflationary tendencies emanate from the side of demand, and by maintaining a stable domestic price-level to the extent that movements in import prices permit (paras. 68 - 72).

t o declare annually a target for its expenditure on imports from other Member States as a means of states of stabilising trading relations within the group (paras. 100- 102).

t o extend, under specified conditions, short-term credits to the European Payments Union (E. P. U.) over and above its present quota obligation (paras. 95, 103 (a), (e)).

to accept an agreed international code of behaviour under which disequilibria in the balance of payments will only be dealt with by methods which do not frustrate the objective of economic stability in the group as a whole; and in this respect to allow an increased latitude of recommendation to the European Payments Union (paras. 96 - 99, 103 (b) - {d), {f), 104 - 114).

t o create within the European Payments Union a system of " convertible accounts " (paras. 118 - 119).

c. A European Investment Bank should be set up as a step towards solving the unemployment problem of the underdeveloped countries of the Council of Europe; its task would be to accelerate the economic development of these countries and thus increase employment opportunities and spread more evenly through the benefits of economic prosperity (paras.127 -132).

d. A European Advisory Board, consisting of a small number of independent experts and maintaining close contact with other international organisations, should be established with the task of examining the policies of Member States, and commenting on the extent to which they are fulfilling the proposed national and international obligations (paras. 64-73).

2. PART II Statement of the Problem

11. The objectives of economic policy which are relevant to this report are the achievement of full employment and internal economic stability and the establishment of good-neighbourly trading relations between the nations of the Council of Europe.

12. These objectives may be specifically expressed in the following terms :

a. The maintenance of full employment.

b. The avoidance of inflation.

c. Stability in mutual trade relations.

13. This is not, of course, to say that many other objectives of economic policy do not exist. But these are the aims to which the Assembly of the Council of Europe is committed by the terms of its Recommendation on Full Employment, and it is with these alone that this Report is concerned.

14. Each of these three objectives raises problems : those of unemployment, inflation and external instability. In this part the problems are analysed under these three headings; and subsequent sections consider how best the objectives may be attained.

2.1. Unemployment

General

15. For over a century mass unemployment, occuring at more or less regular intervals, was passively accepted as a natural economic phenomenon at once inevitable and irremediable; and it was only in the nineteen-thirties that the abnormal severity of the depression forced the problem into the forefront of controversy and increasingly compelled governments to accept responsibility for its solution. In consequence a number of countries (notably the U. S. A., Australia and Sweden) launched new experiments in economic policy, and important fresh ground was broken. Side by side with this evolution on the political plane there

occu-red new developments in economic thought; the thirties saw the publication of a series of significant works in this field, which finally showed, by a more thorough analysis of its causes, that unemployment was in principle a curable evil.

16. The second World War served to demonstrate the fact that unemployment could in practice be reduced to negligible levels by sustaining an adequate pressure of demand, and full employment rapidly became an acknowledged goal of normal peacetime policy.

17. The formulation and acceptance of a new political and economic philosophy is thus an important legacy of the thirties and of the second World War. Previously the thinking of economists and also of the general public ?was dominated by a false analogy between the economic interests of the individual and that of community, which led to the belief that the proper response to business depressions was the adoption of economy measures rather than of an expansionary policy. This reasoning completely overlooked the fact that for a national economy, though not for an individual, income and expenditure are merely different aspects of a single magnitude and that a nation can, in fact, alter its own level of production and well-being by changing its level of spending. It was also believed-?though this was never properly substantiated either in theory or in practice ? that depressions were a necessary condition of economic progress, and that they represented an essential corrective element in the economy without which equilibrium in the cost-price structure could not be maintained nor inefficient producers be weeded out.

18. Quite apart from the fact that it is the financially weak rather than the inefficient enterprises which are the first to be driven to the wall, and that a business depression through its paralysing effects on capital formation hampers rather than fosters the progress of economic efficiency, it is now in any case generally recognised that any possible economic advantages of a state of mass unemployment?even if such really existed?are far outweighed by the amount of human suffering which it causes and the social upheavals which follow in its wake.

19. Since the war a number of European countries (though not all) have keptun employment at negligible levels, in some cases at less than 1 or 2 per cent of the wage earners. It has been contended that such low percentages of unemployment have hampered economic progress because they seriously reduced the flexibility and adaptability of the economy, and also because they were responsible for the persistence of inflationary pressures.

20. There is, however, no evidence in favour of the view that a higher level of unemployment in these countries would have brought about any marked improvement either in. total output or in productivity. Countries which maintained higher levels of unemployment did not experience a more rapid rate of improvement in productivity than those with low unemployment levels ; the available evidence points, in fact, in the opposite direction.. The experience of the last few years, if it has shown anything, suggests that the beneficial effects of a state of full employment on productivity ?through the incentive it affords to employers to introduce labour-saving devices and to both employers and workers to abandon restrictive practices, as well as through the general business confidence it engenders, which in turn facilitates long-term planning of production-far outweigh such adverse effects on the workers' performance as are sometimes attributed to the disappearance of the fear of dismissal. This is, of course, particularly true in those cases wbere the introduction of the full employment policy was accompanied by an active governmental policy to promote productivity both through central planning and control, and through the creation of the proper psychological atmosphere for increased production.

21. It must be recognised, of course, that excessive monetary demand resulting in inflationary pressure is normally accompanied by an acute shortage of labour, so that under inflationary conditions unemployment percentages tend, as a rule, to be lower than those consistent with the maintenance of monetary stability. Owing to the fact that the distribution of labour is never perfectly adjusted to the exiting structure of relative demand, and that changes are always going on, some unemployment is necessary if the fluidity of the labour market is to be maintained and acute bottlenecks are to be avoided. The problem is analogous to that of the housing market, where it is normally reckoned that some 2 per cent of available houses need to be unoccupied at any time if the market is to function normally? in the sense of being capable of providing accomodation to those in need within a reasonable period. When the number of vacant houses falls seriously below this percentage, an acute housing shortage is likely to be present, even though not every house is occupied at any one time.

22. In the same way, if the demand for commodities is stimulated Until unemployment literally becomes zero, there is likely to be an excess of demand over supply for many or most commodities?in other words, the complete elimination of unemployment could only be achieved at the cost of creating considerable inflationary pressure. There is no evidence, however, that the percentage rate of unemployment necessary for the

maintenance of the proper fluidity in the labour market, and thus for the avoidance of inflationary pressures arising from this source, is at all substantial. Various experts (such as Lord Beveridge in his " Report on Full Employment in a Free Society ") put the average rate of unemployment resulting from both seasonal and frictional causes (i. e. the rate necessary to maintain proper fluidity in the labour market) at around 2 per cent of the wage earners.[3]

23. It is possible that in some countries the actual unemployment rate in recent years has been lower than that required for the maintenance of proper fluidity in the labour market. It must be strongly emphasised, however, that ?such small differences are of very little relevance from the point of view of the practical issues involved. Only experience will show whether the most appropriate target for a full employment policy should be put at 97 per cent rather than 99 per cent of the wage earners; and the most appropriate figure, within such limits, will probably be found to vary with the circumstances of each country. But the practical issue which faces Member States of the Council of Europe is not whether the rate of unemployment should be kept at 3 per cent rather than 1 per cent but whether unemployment rates of 20 or 30 per cent or more, such as were experienced in the thirties, or of 10 to 20 per cent, such as have prevailed in some European countries in recent years, should continue to be tolerated.

24. This is not to imply that countries cannot experience inflationary pressures when their unemployment rates are at the level of 2-3 per cent or more. But what is contended is that the unemployment rate that is necessary to ensure adequate fluidity of the labour market cannot be put much higher than this, figure; and therefore inflationary pressure cannot be regarded as a necessary concomitant of a full employment policy under such circumstances. Inflation or inflationary pressure could prevail of course, and has been known to prevail, with much higher percentages of unemployment (as, for instance, in Italy during the post-war inflation) . In those circumstances, however, insufficient unemployment could not be regarded as a possible cause of the inflation nor increased unemployment a possible cure for it.

Causes of Unemployment

25. The last decade has produced a large measure of agreement on the nature and causes of unemployment. By far the most important cause of mass unemployment in industrialised countries has certainly been the chronic and sometimes acute deficiency of aggregate demand for domestically produced goods. While in the past most European countries experienced depressions as part of worldwide movements, originating usually in the United States, this synchronisation does not indicate that instability in the U. S. economy was the fundamental cause of these worldwide depressions. The importance of U. S. production and trade relative to that of the rest of the world certainly tends to give fluctuations in the American economy a strategic importance so far as the timing of the world business cycle is concerned. But the fundamental cause of fluctuations in employment still remains the fluctuations in each country of internal aggregate demand.

26. Thus, even if there were no fluctuations in aggregate demand arising on account of external trade, there would still remain the problem of movements in aggregate expenditure on private investment, including outlay on plant facilities and equipment, inventories and residential construction. In private enterprise economies these are the strategic element in aggregate demand, and are particularly liable to spontaneous fluctuations clue to institutional, monetary and psychological factors.

27. Unemployment can be shown to be caused by the fact that the incomes generated by production do not necessarily give rise to sufficient expenditure to ensure the full utilisation of resources. Unless there is deliberate planning by governments to ensure that the total of offsetting expenditure remains stable at a level high enough to absorb the savings of the fully employed economy, the level of income and employment must fluctuate in response to fluctuations in that offsetting expenditure.

28. However, maintenance of an adequate level of aggregate demand will not necessarily ensure that all available manpower can find work. Other types of unemployment of a non-monetary character, may also exist.

29. The first of these is frictional and seasonal unemployment, and the second unemployment caused by lack of complementary factors such as land, raw materials and capital equipment.

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3. Lord Beveridge's commonly quoted figure of 3 per cent included an additional 1 per cent to make allowance for unavoidable fluctuations in the export industry. It is interesting to note that the British Government, in the target which it has announced, has adopted the same figure ? a seasonal peak of 2 per cent, plus an allowance of a further 1 per cent for adverse factors emanating from abroad.

30. Normally, every country experiences a certain amount of unemployment, even when economic activity is at high level. This may take the form on the one hand of so-called frictional unemployment, which arises from the fact that a certain lapse of time is always necessary before a person who has voluntarily or otherwise left a job finds a new occupation. It may on the other hand take the form of unemployment which periodically recurs during certain months and in specific trades, and which is due to the fact that either possibilities of production, as in the building industry, or the level of demand, as in fashion goods, is affected by the season.

31. While this Report is not primarily concerned with the impact of such frictional and seasonal unemployment it nevertheless seems necessary to point out that in most Western European countries more could be done to reduce its incidence and that it should normally not exceed the levels suggested in para. 22 above. In dealing with such unemployment, the measures to be taken include improvements in the organisation of the labour market and in production methods, assistance to workers to move to new occupations or areas, and the institution of retraining programmes. It should be noted, however, that the incidence of seasonal and frictional unemployment itself varies with the general level of demand.

32. When changes in demand call for shifts in the distribution of the labour force, not only as between occupations but also from one geographical area to another, frictional unemployment may become a more substantial problem. This is because the mobility of labour is generally lower as between different regions than between different industries situated in the same area. The importance of this fact can, however, easily be exaggerated. Whenever a country is suffering from mass unemployment, this unemployment is normally concentrated in particular regions of the country concerned, because of the fact that industries are localised in certain areas and that the incidence of inadequate demand is more pronounced in some industries that in others.

33. It would be wholly erroneous, however, to conclude from the mere concentration of unemployment in particular areas that this unemployment can be cured without a general expansion of demand. In the first place?as is amply shown by past experience?the same areas that have been abnormally depressed by a contraction of general demand are likely to be relatived more stimulated by a recovery in the level of demand. An expansion of economic activity thus automatically tends to correct the apparent maldistribution of labour. In the second place, even in those particular cases where full employment does require some geographical redistribution of the labour force, it can be confidently expected that labour will tend to flow fairly easily towards job vacancies. The low geographical mobility of labour may be regarded far more as a consequence of unemployment than a cause of it. As is shown by available studies on labour migration, it is the prevalence of employment opportunities, rather than personal or psychological factors, which at any one time set a limit to the rate of migration of labour. Thus, in the United Kingdom in the interwar period, unemployment of 1 to 1.5 million was signified by the label " structural " (and was therefore thought to be not amenable to cure by general expansionary policies) simply because this amount of unemployment was concentrated in particular areas of the country. Experience has shown, however, that wherever plentiful employment opportunities existed, migration of labour did take place on a considerable scale. Finally provided aggregate demand is high enough to maintain full employment, it is reasonable to expect that there will also be a tendency for new industries to establish themselves in centres where labour is more readily available. The mere absence of surplus in other centres may be enough to encourage such a tendency which can, however, also be promoted by direct governmental action. Recent experience has shown that the location of industry can to some extent be planned to conform to the availability of labour supply without damaging effects on the efficiency of production.

34. At the present time there is a revival of the tendency in some European countries where the level of unemployment is high, to regard this unemployment as « structural » simply because it is not evenly distributed over all regions, but tends to be concentrated in particular areas. It needs to be stated emphatically that this case cannot be regarded as essentially different, either in respect of its cause or its cure, from the normal case of general demand deficiency. The existence of such localised unemployment cannot, therefore, provide any real justification for the failure to introduce an effective full employment policy.

35. The term " structural " unemployment is sometimes used also to describe situations in which the emergence of unemployment is due to an increase in potential output relative to demand?either on account of an increase in the working population or of increased productivity? rather than to an absolute decrease in the level of effective demand. Here again, neither the cause nor the cure for such unemployment is any different from what it would have been if the working population and productivity had remained unchanged, but the level of demand had fallen. The basic cause in both cases is a deficiency of aggregate demand relative to the requirements of full employment.

36. The second non-monetary cause of unemployment arises where workers cannot find employment because the materials or capital equipment which they need for their work are not available. This situation may arise in any country, although in industrially advanced countries shortage of equipment is not likely to be an important cause of unemployment, while shortage of raw materials is a cause only under exceptional conditions.

37. The problem thus arises most acutely in underdeveloped countries where capital equipment in industry is seriously inadequate in relation to available manpower. Unemployment in these areas is often disguised, labour?particularly in agriculture?being only partially employed. This is particularly true in Greece, Italy, Turkey and in the dependent territories. Here, agricultural production still remains in a primitive stage, farmland and the farm labour force being inefficiently used. At the same time, alternative employment opportunities are lacking on account of a deficiency of industrial capital and equipment. In Italy, this situation is aggravated by a rapid and continuous increase in population.

38. The solution of the unemployment problem in such cases must be sought partly in longterm plans for the accelaration of industrial development (starting with the processing of local primary products and with public utilities ?transport installations, power plants, etc.), and partly in a programme for providing agriculture with modern machinery and for stimulating up-to-date farming technique. The possibilities of further emigration must also be explored, though this must depend largely on the attitude of other countries. The whole question of the underdeveloped countries is further discussed in Part IV.

2.2. Inflation

General

39. Any policy which has full employment as its aim involves the risk of an inflationary process. This risk can be said to constitute one of the crucial issues of economic policy facing the countries of Western Europe.

40. The term " inflation " has in the past been associated with the violent currency inflations?" galloping " inflation?which occurred in certain countries after both the First and Second World Wars, and which resulted from a lack of confidence in money as a medium of payment and a standard of value. In view of the evolution of more efficient economic policies and government controls, the danger of such galloping inflations need not now be rated very high. However, the danger of inflationary-pressure still exists and in fact represents a serious threat to the attainment of the general objectives discussed in Part I. Even though it is possible to minimise the effects of such pressure on the price level by means of rigid controls, the adverse repercussions on the economy are not thereby necessarily avoided. The inflationary tendency will then show itself in an abnormal running down of stocks, and also in hidden price rises reflected in a successive deterioration in the quality of goods.

41. An inflationary process brings about, moreover, a redistribution of income between different sections of the community. Inflation favours entrepreneurs and debtors at the expense of creditors and those in receipt of fixed incomes (such as pensions, life insurance annuities and bond interest). The wage-earner is also likely to suffer from an inflation as wage increases never catch up with price rises.

42. The inflationary pressure thus tends to dislocate the structure of production and distort the distribution of income. It also causes balance of payments difficulties, since adjustments in exchange rates notoriously lag behind the rise in internal costs and prices; this aspect is discussed in Section C.

Causes of inflation

43. The mechanism whereby inflation is initiated and sustained is complicated in its details, but general agreement exists in respect of its major features. In general, a price rise can be traced to one of two causes. On the one hand, an inflation can be " demand-induced ", i. e. attributable to an excess of demand over supply at current prices. Such inflationary pressure may be general throughout the economy or may be localised in particular areas or industries. On the other hand, a price inflation can be " cost-induced ", where it is caused by increases in the prices of available factors of production for reasons other than the existence of excessive demand. Such increases can, for instance, be initiated by a general rise in import prices. But their most normal cause in an industrial society is the desire of organised groups?workers, farmers and businessmen-?to secure for their members larger slices of the national cake. Thus, for instance, in a fully employed economy labour is in a comparatively advantageous position in wage negotiations, since under these conditions it is relatively easy for employers to pass on higher wage costs to the consumer in the form of

higher prices. There is, consequently, a danger in a full employment economy that the rate of increase in workers' earnings will be faster than the rate of increase in productivity, thereby causing a continued rise in the price level.

44. Should such cost-induced inflations threaten they can only be prevented by measures which aim directly at preventing excessive rates of increase in personal incomes. This may involve considerable changes in the prevailing systems of wage determination, which are often more appropriate to the unemployment conditions of the past than to the full employment conditions expected to prevail in the future. In the same way, an effective anti-inflationary policy under full employment would also require additional measures for limiting the power of monopolies and cartels to exploit the consumer by a rise in profit margins; and similar restraints might have to be applied to farmers' organisations.

2.3. External instability

45. So -far only the internal effects of economic instability have been discussed : the loss of wealth, the burden of unemployment, unwanted shifts in income. But, at least, as important is the damage which the economic instability of one country causes to others. Any sharp movement in a single economy must communicate itself, through its repercussions on the flow of trade, to other countries also.

46. Depression and deflation, involving as they do a fall in national income, must also involve a fall in imports; if people are made poorer, they buy less, not only from industries at home, but also from industries abroad. Thus unemployment will occur in the export industries of other countries, the depression spreads across frontiers and is transmitted with cumulative force to all the nations of the trading world. Conversely with inflation: a runaway rise in prices, or any excessive weight of monetary demand, cannot be confined to the territory of a single country; they too must exert a damaging effect abroad.

47. Thus the onus on a Government to maintain a high and stable level of employment is not merely a duty to its own people : it is also a duty owed to its trading partners. All suffer from the instability of one : and the achievement of internal stability is therefore a first principle of good-neighbourly conduct.

48. Moreover, this is the more important, the freer the trade and the more multilateral the system of payments between the different countries. Tariffs and quotas, bilateralism and discrimination, while they all restrict the scope of international trade and thereby hinder the rational utilisation of the world's resources, serve at the same time as barriers against the spread of economic contagion. The rise of protective nationalism and the breakdown of the international gold standard in the last twenty years cannot be ascribed merely to human folly; the relatively free international system of the nineteenth century collapsed precisely because it denied the possibility of defence against instabilities emanating from the dominant trading countries of the world. Unemployment and instability transmitted from abroad are now regarded by most as too high a price to pay for the advantages of free and multilateral trade.

49. The nations of the Council, therefore, assuming that they wish to increase their mutual trade, must accept as a prior condition the obligation to maintain stability in their economies. It would be wholly impracticable to ask countries which now have full employment to accept more liberalisation of trade (let alone the goal of full economic integration) without some guarantee of internal stability on the part of the group as a whole.

50. Hence the primary problem is the acceptance of obligations concerning the maintenance of full employment and economic stability, and the pursuit of mutually consistent monetary policies. The nature of these obligations is outlined in Sections A and B of Part III.

51. But a problem will still remain. Although the general achievement of internal stability will immensely facilitate a high and stable level of foreign trade, it will not by itself eliminate all possible reasons for disequilibria in the balance of payments of individual countries. Such disequilibria, and the attempts made by individual countries to eliminate them, could in turn create instabilities not only in the internal affairs of other countries, in the manner described above, but also in their balance of payments.

52. This latter effect arises of course, from the simple truism that the balance of payments deficits of some countries are a reflection of the balance of payments surpluses of others, and vice-versa. Such favourable or unfavourable balances may arise from many causes, including a failure on the part of some countries to live up to their stability obligations. For example, an expansion of effective demand in one country relative to others will affect its own balance of payments position unfavourably and that of the others favourably; while conversely, a relative contraction in its own effective demand will improve its own balance of payments and cause a deterioration in those of the others. It is possible, therefore, for a country which pursues an appropriate policy designed to maintain full employment and economic stability to run into balance of

payments difficulties merely on account of the failure of other countries to pursue the same objective. It is equally possible for a country to run into balance of payments difficulties (and thus for other countries to encounter balance of payments surpluses) because it permits inflation to occur within its own territory at a time when other countries have succeeded in maintaining their economies at stable levels of prosperity. Balance of payments deficits and surpluses may also be the result of accidental causes, such as a failure of the harvest, changes in the relative scarcity of different kinds of food, or changes in tastes. Unless adequate institutions are created to cope with this problem, and unless the participating nations evolve a code of behaviour that ensures the Use of mutually satisfactory methods of adjustment, the emergence of such trade disequilibria will jeopardise the economic stability of the entire area.

53. It has already been pointed out that this is all the more true the greater the degree of economic co-operation between members of the group. For if Member States succeed in their attempts at greater unification, they will in so doing necessarily deny themselves the use of many traditional weapons for the avoidance or cure of disequilibria in the foreign balance which in the past served to minimise the internal repercussions of changes in the conditions of foreign trade.

54. Thus trade liberalisation, through the abolition of quantitative controls, deprives countries of the most efficient method by which they can influence the relation of imports to internal income and consumption. Similarly, the multilateralisation of payments makes it impossible for particular countries to stabilise their trade relations in relation to third countries through bilateral arrangements. Finally progress towards a unified currency area inevitably entails that movements in the trade balance should lead to inflationary and deflationary tendencies of a localised character unless they are offset by compensating capital movements of an automatic nature. It is clear, therefore, that any progress towards economic integration inevitably entails a certain restriction on national independence of action, just because the domestic economic situations of the participating countries will necessarily become more closely bound together.

55. The recommendations in Section C of Part III of this Report aim at providing a solution to this problem. They are based on two principles. First, that relative freedom of trading can only be combined with economic stability, if sufficient provision is made for international credit, so that countries are not forced to take immediate or violent measures whenever for any reason their external balance is disturbed, and. thus opportunities are afforded for orderly adjustments in trading relations. Secondly, that the actual method adopted by any country for bringing its own balance of payments into equilibrium is not a matter od indifference to others, since some forms of adjustment will be consistent with the maintenance or restoration of economic stability while others will not. Hence there is need for something in the nature of an international code of behaviour to ensure that the necessary adjustments are made in such a manner as conduce to the best interests of the group as a whole.

3. PART III Objectives and methods

Introduction

56. The argument of the earlier sections suggested that there is need for agreement between the Member States of the Council of Europe on the pursuit of mutually consistent economic policies. The problem can consequently be reduced to the question of whether Member States, having accepted the necessary objectives, can give these a sufficiently concrete expression to afford a clear criterion by which success or failure can be measured. It follows from what has been said that mutually consistent policies are necessary in respect of the maintenance of full employment, the maintenance of monetary stability, and the creation of satisfactory trade and payment relations; and it is in these spheres that agreements between the nations of the Council are required.

57. In the following sections suggestions are made as to the most appropriate forms which such agreements might take and as to the means at the disposal of governments for carrying them out. Sections A and B will be devoted to the domestic aspects of the problem, i. e. to the maintenance of full employment and monetary stability, and to the policy implications of these objectives; while Section C will treat the problem in its international aspect.

3.1. The First Objective : Full Employment

58. As regards the first objective, governments are already committed, through various international agreements such as the Charter of the United Nations, the Havana Charter and the Bretton Woods Agreement, to the pursuit of full employment policies within their own borders. Recently the Economic and Social Council and the General Assembly of the United Nations have adopted resolutions which go some way

to giving concrete expression to this obligation. It remains, therefore, to examine in what respects the Member Nations of the Council of Europe could or should undertake more far-reaching and specific obligations than have so far been adopted.

59. The most appropriate manner in which concrete expression can be given to an agreement to maintain full employment would be the acceptance of a formal obligation along the following lines :

60. " Eac h participating country shall undertake to ensure that there are at all times the maximum of employment opportunities available for all men and women seeking work, so that unemployment may be kept at the minimum dictated by the structural limitations of the economy and the problems of organisation in the labour market. To this end each participating country undertakes to declare a full employment target which will define the meaning of full employment in the country concerned in operational terms, and constitute a standard to the attainment of which national employment stabilisation measures will be directed. This target should be defined in terms of the smallest percentage of unemployment of wage-earners which the country in question can reasonably hope to maintain in the light of seasonal movements, and in the light of such structural limitations and changes in the economy which may give rise to unemployment which cannot in the short run be eliminated by public policy. Each participating country further undertakes to do its utmost to remove unemployment due to structural-limitations. For the purpose of the definition of the full employment target, the term " unemployment " should include all workers without work and seeking work as wage-earners, irrespective of the type of industry or occupation and irrespective of whether or not they are classified as unemployed for the purpose of social insurance schemes. Account should also be taken of those involuntarily working part-time. "

61. The above recommendation follows closely on the lines of the U. N. report, but gives the full employment obligation a more concrete expression than did the recent resolution of the Economic and Social Council. It follows the U. N. report in particular in leaving each country free to establish the employment target best fitted to its own circumstances, instead of suggesting a uniform employment target for all. The reason why the adoption of a uniform criterion valid for all Member States cannot be recommended lies partly in the fact that different countries are at different stages of economic development. While in some countries large-scale unemployment, if it arises, may be entirely ascribed to insufficient effective demand, in other countries lack of complementary resources, in particular of capital equipment, makes it impossible to eliminate unemployment within a foreseeable period by means of internal policy alone.

62. The other reason is that owing to differences in the nature of employment statistics, unemployment figures or percentages of different countries are not at present comparable, so that the adoption of a common figure would not carry the same implications for all countries. Moreover, inadequate statistics in some countries make it difficult to determine whether a full employment policy is being pursued more successfully in one country than in another. It is obviously important that governments should take the earliest practicable steps not only to make their employment statistics more comprehensive and accurate, but also to reduce them to a more uniform and therefore more comparable basis.

63. None of the above should be taken as modifying the conclusions reached in para. 22, namely that unemployment arising from problems of the organisation of the labour market (i. e. due to seasonal and frictional factors) should not exceed 2-3 per cent of the wage-earners (as measured by statistics which are sufficiently comprehensive to include all workers without work and seeking work as wage-earners). Only the lack of complementary factors should be considered as a legitimate reason for a higher figure.

64. In this connection it would seem desirable for Member Governments to agree to the creation of a European Advisory Board. This Board should consist of a small number of independent experts who would examine and comment on the extent to which governments were fulfilling this employment obligation, and also the other obligations which it is suggested later that the nations of the Council of Europe should jointly undertake. The Board would also be available to advise countries both on the determination and the fulfilment of their full employment target and should maintain close contact with other international organisations (such as the I. L. 0.) which are particularly concerned with these problems. The Advisory Board should make periodic progress reports on these matters to the Council of Europe, and these reports should be published.

3.2. The second objective ; Monetary Stability

65. With regard to the avoidance of inflation and the maintenance of general monetary stability no such commitments have been accepted by Governments as is the case with full employment. Governments have hitherto been reluctant to assume international obligations with regard to their domestic monetary policies, partly because monetary matters have been traditionally regarded as being primarily a domestic concern, and partly because it has in practice proved difficult to find a mutually acceptable basis for international

agreement. In some international agreements, such as the Bretton Woods Agreement, Governments have assumed the general obligation to maintain financial equilibrium or, at any rate, to avoid such domestic financial and monetary policies as would render difficult the maintenance of international equilibrium in the balance of payments. No attempt was made, however, to define in positive terms the desirable objectives of monetary and financial policy.

66. Yet it should be obvious from the foregoing analysis that agreement on this matter is of first-class importance for the successful pursuit of international economic collaboration. If Governments attempted to maintain equilibrium in their external relations while pursuing different objectives in the field of monetary policy?for example, some favouring falling, others: constant and yet others rising prices? their respective endeavours are bound to be mutually frustating and thus prevent the attainment of the separate national objectives.

67. The main problem in this field is that while all countries are agreed on the general objective of monetary stability and wish to avoid the ravages of either inflation or deflation, they find it difficult to give concrete expression to this objective in terms of any single indicator applicable to their own situation, let alone choose an indicator that would be internationally comparable and acceptable to different countries with varying economic and political structures. Thus, if the maintenance of the stability of some price index (for example, of retail prices or of the cost of living) were selected as a criterion, it would at the same time be too restrictive and too much open to evasion. As the experience of many countries since the war has shown, the maintenance of a stable cost of living index is by no means adequate as a criterion of the avoidance of inflationary pressures. On the other hand, situations may occur in which a rising cost of living index (due, for example, to rises in the price of imported foodstuffs) would not indicate inflationary tendencies nor call for corrective action in the domestic field.

68. The recommendations of this Report rest on the belief that the basic factor, causing inflationary and deflationary tendencies in any country are inappropriate movements in total expenditure on home-produced goods and services (that is, domestic expenditure on home-produced goods and services, plus foreign expenditure on home-produced exports, as measured in terms of the home currency). Inflationary tendencies are at work, and can only be at work, when the level of total expenditure rises faster than the level of production. Deflationary tendencies are at work when the level of total expenditure has fallen either absolutely or relatively to the potential supply of goods and services. From the point of view of co-ordinating domestic monetary policies, the most appropriate expression which could be given to these ideas would be the acceptance of a formal obligation on the following lines :

69. " Eac h participating country shall pursue a policy that will permit the total expenditure on domestically produced goods and services in terms of its own domestic currency to be initially large enough to ensure full utilisation of the labour force at the existing level of domestic costs and prices and to rise annually in proportion to the increase of the working population and the increase in the productivity of labour. "

70. This formula needs to be discussed both in terms of its implications for policy and its measurability in practice. It clearly excludes any inflationary or deflationary tendencies emanating from the side of demand. It would automatically ensure the stability of the domestic price level over the whole range of domestically produced goods and services, except insofar as domestic costs and prices vary as a result of changes in the price of imported goods. Together with the obligation relating to the maintenance of full employment, it would also exclude a cost-induced inflation (that is, an inflation originating in an excessive increase in the rate of money wages or of other types of incomes), since in this case the two objectives could not be simultaneously fulfilled. It would also exclude policies aiming at absolute stability in money incomes (so as to allow prices to fall with increases in productivity) and policies which seek to make deliberate use of general price increases as a means of attaining specific economic objectives. In order to carry out such an obligation, governments would be obliged to offset excessive movements of expenditure in particular sectors of the economy by compensatory movements in other sectors ?for instance, by reducing domestic expenditure in face of an improvement in the foreign balance, or by imposing higher taxes to offset increased public expenditure or a higher rate of investment.

71. It should, of course, be realised that such compensatory movements do not necessarily imply the adoption of restrictive measures on expenditure. When, for example, a country experiences an improvement in its terms of foreign trade through, for instance, a rise in foreign demand for its products, it will also experience a favourable balance in its foreign transactions. The proper remedy in this case is a relaxation of import restrictions (achieved either through a reduction in tariffs or a relaxation of existing quantative controls) which will increase imports in relation to the level of domestic income and thereby divert expenditure out of domestic incomes from home-produced goods to imports. À relaxation of import restrictions sufficient to eliminate the potential surplus of exports over imports would, in these circumstances, also be adequate to

secure a sufficient diversion of expenditure from domestic goods to maintain the total expenditure on domestic goods at a steady level. In other cases, the opposite policy is called for?for example, when an unfavourable balance of payments compels a country to impose additional import restrictions. In that case, the restriction of imports will divert expenditure out of domestic incomes from imports to home-produced goods and will thus cause an undue expansion in the total expenditure on domestic production unless positive measures are taken-?-in the form of increased taxes for example?to keep this at the requisite level.

72. The obvious objection that could be raised against the adoption of the above obligation is that it would require governments to measure movements in the national expenditure, in working population and in the level of productivity, and that some of these are not in practice easily measurable. This objection loses much of its force when it is borne in mind that even a general acceptance of this obligation, in broad terms which would not require accurate measurement, would represent an enormous improvement in comparison with the present situation. Thus, as regards total national expenditure, most Member States of the Council of Europe now make more or less detailed records of their national expenditure, and it would not be difficult in the case of any country to state some potential level of the national income consistent with full employment at the existing level of domestic prices. It is true that improvements in total national expenditure can ordinarily only be measured accurately with a considerable time-lag. But many partial indicators exist (e. g. various indices showing the movements of retail sales, of government and investment expenditure, of the value of exports, etc.) which would give a rough month to month indication of movements in total expenditure on domestic production. In the same way most governments, although they cannot forecast changes in productivity and the working population with exact precision are certainly in a position to assess the rough orders of magnitude involved. If particular countries were to agree to limit the growth of monetary expenditure on domestic production to a rate of 5 to 10 per cent per annum?the higher figure being chosen in those countries where the working population and lab our productivity is increasing relatively fast, and the lower one in the opposite case?this would already confine possible inflationary or deflationary movements to much narrower limits than have been experienced in the past. The adoption of this principle, therefore, even if account is taken of the limitations on its practical mea-surability and hence on the exact degree to which it Could be implemented, would represent a very considerable advance.

73. The European Advisory Board, the creation of which is proposed above in para. 64 would also in regard to the obligation of monetary stability assume the task of analysing and commenting on the policies of the individual Member State.

A Policy of Internal Economic Stability

74. The successful fulfilment by all countries of the two objectives described above under sections A and B would ensure that each country followed, within its own jurisdiction, a policy of economic stability : that there would be sufficient consistency between the policies adopted by each to make possible their successful pursuit by all : and that the policy of no one country would become a source of disturbance to the others.

75. It has not been deemed desirable or necessary to consider what administrative machinery should be set up on the national level for the implementation of these objectives. This was thought to be entirely the concern of each individual government. Nor has an attempt been made here to describe in any detail the various means at the disposal of governments for influencing the level and direction of economic activity. It is generally accepted that available techniques in this regard have, in the last decade or so, become successively more varied and more subtle, both on account of improvements on the administrative apparatus and statistics, and of a deeper understanding of the inter-relations between economic phenomena. The nature of the new techniques and the manner of their manipulation have been set out in detail in the U. N. Report on Full Employment, and there is little new that to be added in this field.

76. There is fairly general agreement that in addition to what may be termed the classical instruments for influencing economic activity ?adjustments of interest rates and foreign exchange rates?a number of other " levers " are available of which the most important is the deliberate use of fiscal policy, i. e. changes in the level and direction of public expenditure and of the level and incidence of taxation, as well as in the relation between the two. In addition to these overall levers, governments have instruments at their disposal for influencing particular sectors of the economy by means of direct controls such as the control of imports by means of a licensing system, the control of international capital movements, the control of long-term investment by such means as building licences, regulation of capital issues, raw material allocations and the planning of public investment, etc. Governments are in some cases also evolving methods of influencing the overall movement of personal incomes.

77. It is now increasingly recognised that the system of settling wages through collective bargains between trade unions and employers' associations in individual industries, acting separately and largely independently of each other, is inadequate in a full employment economy for two main reasons : firsts (though the practical importance of this factor still remains to be proved by further experience), under full employment conditions such unco-ordinated wage bargaining may involve an excessive rate of increase in money wages. Secondly, in a full employment economy it is particularly necessary to find the right relation between relative wages in different industries and occupations, since in these conditions wages become a far more important factor in determining the distribution of labour between occupations. Under the traditional system of wage bargaining, the scale of relative wages is unlikely to reflect the relative importance and attractiveness of different occupations and will therefore not afford the proper inducements to the labour force to move into the different occupations in the required proportions. Conditions inevitably vary from country to country; but it may be found that in general there is need in a full employment economy for some authority on a national level to propose a scale of priorities for wage increases, and thus to influence both the movements of relative wages and the rate of increase in the general wage level as a whole.

78. Attention must equally be paid to such questions as the level of farm prices in relation to industrial prices, and the control of profit margins fixed by cartels and trade associations ??in fact to all cases where rates of earnings are normally determined through the collective action of organised groups acting independently each in its own sectional interests. This problem is obviously one of the most difficult which faces democratic societies; it involves the question of the distribution of income within the community under conditions when this distribution can no longer be said to be determined by the blind operation of market forces but is the outcome of deliberate efforts on the part of organised groups to protect the interests of their members. In the past the dilemma resulting from the mutually inconsistent pressures exercised by such groups was only resolved by the fact that monetary policies were tolerated, if not deliberately pursued, which limited the general level of demand below existing industrial capacity. This solution was further aided by the fact of periodic economic depressions which tended to exercise a dampening effect on farm prices and business profits.

79. The maintenance of economic stability requires the combined operation of these various " levers " at the disposal of the governments. The use of mechanical analogies in this connection, though apt, must not, however, be pressed too far. À policy of economic stabilisation is not simply an engineering problem, with each situation calling for a clear and definite quantitative combination of corrective measures. The successful use of the various correctives which governments can employ requires also the exercice of judgment and a certain degree of intuition, and thus is more in the nature of an art than of a science. To recognise this fact involves admitting that the criteria of economic stability cannot in practice be fulfilled with the same degree of exactitude as in the case of an engineering problem. The success of economic policies, therefore, can only be measured within certain limits. It must nevertheless be stressed that such fluctuations or instabilities as will occur if the above policies are adopted will be small as compared to those which would occur if governments, as in the past, were to play a purely passive role and not to exercise a purposeful direction of economic activity.

80. If these ideas are applied to the actual situation which has faced Western Europe since the end of the war, the following points emerge.

81. The Nations of the Council of Europe can be divided into three groups so far as their post-1945 employment problems are concerned. First, there are those industrialised countries which have maintained full employment, and indeed have suffered from a shortage of labour rather than unemployment and whose major problem will continue for some time ahead to be that of inflation. Secondly, there are some industrialised countries, such as Germany and Belgium, where there has existed a considerable reserve of unemployed labour alongside idle industrial capacity. Finally there are nations such as Italy, Greece and Turkey where in addition there exists a large amount of disguised unemployment in agriculture, the elimi-mination of which would primarily require a relatively large expansion in their industrial capacity.

82. It is frequently contended in regard to the first group of countries that they receive their inflationary and deflationary impulses from abroad, communicated mainly through fluctuations in the demand for their exports. It is important to make clear, assuming this contention to be true, to what extent exactly this fact reduces the efficacy of internal policies, and thereby relieves the national governments of the responsibility for maintaining monetary stability in their own economies. In the past, though cyclical impulses may have been largely communicated through exports, national policies (or rather the absence of such policies) tended to exaggerate the effect of changes in export demand by induced fluctuations in the remainder of the economic system. Clearly governments are in a position to counteract the induced effects of export fluctuations. They are normally also in a position to moderate considerably, even if not entirely to eliminate, movements in productions and employment in the export industries themselves. If the exports of a particular country consist

of a wide assortment of goods, it is normally possible to stimu'a-late domestic demand for such goods. Where exports are specialised in a few commodities and are quantitatively large, relative to domestic consumption of such articles, governments may need to take positive action to find temporary or permanent employment opportunities for labour thrown out of work by the fall in exports. (The international, and in particular the balance of payments, aspect of this problem will be treated in the next section). Where inflationary tendencies are communicated from abroad by means of a rise in import prices, rather than in the value of exports (either of which might set up inflationary tendencies for different reasons) governments could compensate for this through variations in the level of taxation or in the nature of internal controls. It is thus not true that governments are powerless to take measures to soften or counteract the impact of economic disturbances emanating from abroad.

83. Much of what has been said above equally applies to the second group of countries, i. e. those which require an expansion of economic activity for the absorption of their unemployed (such as Germany at the present time). But in the case of this group it is in addition frequently contended that such expansion could not be accomplished by domestic policies alone, since it would involve association with higher imports of raw materials or of finished goods, and these would need to be internationally financed.

84. It is quite true that increased employment may involve increased imports of raw materials that are consumed in the production of the goods whose output is rising. What is not true is that this necessarily constitutes a limitation on the rise in home production, in those cases where international aid is not available. Where less essential goods were previously being imported, it would be feasible for the country in question, as its home production and therefore raw material imports rise, progressively to reduce the volume of these inessential imports by quantitative restrictions, so as to keep the overall level of imports constant. This use of controls to limit imports, so that domestic production can expand relative to imports, is clearly preferable to the alternative of holding down production (and employment) on the grounds that the higher imports cannot be afforded.

85. There may be other cases, however, in which the solution does require the provision of international finance. This would be the case where additional domestic production necessitates additional raw materials imports, but where imports cannot be financed by reducing inessential imports. The solution of the full employment problem would then require short or medium-term credits.

86. The third group of countries, where unemployment exists because of a shortage of industrial capacity, poses the general problem of the underdeveloped areas in Europe; and this is discussed in detail in Part IV.

87. From a long-term point of view, the general obligation of governments to pursue a policy of economic stability does of course leave considerable freedom to each government to choose its own directions of advance and the particular objectives to be given priority. Some nations may, for instance, wish to accelerate their rate of economic development by maintaining a lower rate of consumption in relation to production than others. Again, some governments may wish to enlarge the public sector of the economy, while others may wish to maintain private enterprise. Some governments may wish to develop town and country planning and invest large resources in residential construction, while otherswill concentrate on industrial investment. In all these matters the co-ordination of economic policies here recommended would not limit the freedom of individual nations to choose the kind of policy they wish to pursue.

3.3. The third objective :? external stability

General

88. The main objective of policy so far as external trade is concerned was defined by the U. N. Report as the creation of conditions under which no country will behave in its international economic relations in such a way as to prevent other countries from maintaining the stability and prosperity of their economies. The recommendations of the U. N. Report were inspired by the desire to protect countries against the international spread of deflationary pressures such as in the past, repeatedly, had led to cumulative contraction both of trade and production throughout the world. To this end they proposed that each country should stabilise its own external currency disbursements on current account?i. e. the amount of its own currency which it makes available to other countries by the imports of goods and services. It was suggested that each country should accept the obligation, within a permanent international scheme, of replenishing the monetary reserves of other countries where it could be shown that these reserves had been depleted by a fall in that country's imports due to a decline in internal effective demand.

The E. P. U. System

89. The terms of reference of this report concerned the adaptation of the basic ideas and recommendations of the U. N. Report to the special conditions of Western Europe. Whereas the U. N. Report was primarily concerned with the conditions necessary for the establishment of a multilateral system of trade and payments, the Western European countries among themselves have already achieved a considerable measure of trade liberalisation and are now in the process of extending it further. They have also achieved a complete multilateralisation of payments among themselves with the creation of the European Payments Union. It seemed evident that any more ambitious scheme for the promotion of inter-European trade, and the creation of stable trading and financial relations should be built on the foundations already created. This Report therefore specifically discusses the question of how the existing arrangements, and in particular E. P. U. could best be adapted to serve the long-term needs of Member Nations of the Council of Europe.

90. Though it is too early to base any considered judgment on the brief experience of the operation of the E. P. U., it is clear that its creation has already had highly beneficial effects on intra-European trade, and it must have played a considerable role in the spectacular increase in the volume of trade between Member countries in the latter half of 1950. Even more significant, however, is the fact that the E. P. U. substituted a new approach to the whole problem of intra-European settlements. In the eighteen months preceding its creation, more than 90 per cent of intra-European surpluses and deficits were covered by expedients of a purely temporary character. 32 per cent of the deficits and surpluses were covered directly by American grants in aid. 60 per cent were covered by bilateral claims and debts under payment agreement. Such a system could obviously not be sustained for long. Intra-European trade could not be indefinitely financed by American subsidies nor by continued extension of bilateral credits by surplus countries to debtor countries. There was always the danger that the gradual disappearance of such ad hoc expedients would compel a return to bilateral barter in all intra-European trade and payments relations.

91. The major contribution of E. P. U., to this problem was to permit some 50 per cent of these bilateral deficits and surpluses to be covered automatically by the compensating machinery of the system. Finance had to be found not for the total bilateral surpluses and deficits, but only for the net deficits and surpluses of each country with the rest of the group and in this way the problem reduced to only half its previous size. The second contribution of E. P. U. was to deal with these residual net surpluses through automatic and fully multilateral credits.[4]

92. The first of the achievements?multilateralisation of payments between Members?? constitutes a definitive advance of a long-term character. The second, however?the automatic credit extension via the E, P. U. quotas ?can necessarily only provide a limited solution. No country can expect to receive from the others a blank cheque to cover a persistent deficit in its own balance of payments indefinitely. The system therefore only provides credits of a limited amount and it puts increasing pressure on debtors to undertake necessary adjustments. To the extent that creditors are called upon to provide credits automatically, the system may also be said to put a certain pressure on creditors to make adjustments. The question to be considered is how the present system could be further strengthened so as to make it a more powerful long-run instrument for the maintenance of both multilateral and stable trading relations.

93. Such an evolution necessarily presupposes an increase in the discretionary lending powers of the E. P. U. which would enable it to discriminate in the application of pressure between deficit or surplus countries according to the causes of disequilibrium in the flow of payments, and in the overall interest of the maintenance of economic stability in the area. The discretionary powers already inherent in the functions of the E. P. U.?particularly those relating to extraordinary assistance to debtors in difficulties and to the provisions for further credits beyond the limits of existing quotas?point the way in which the system might be further strengthened and the sphere of responsibility of E. P. U. gradually enlarged.

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4. Under the E.P.U. system each participating country has been alloted a quota which expressed the overall deficit or surplus which it can incur through E.P.U. The working of this quota mechanism is as follows : Surplus quota : A country whose balance of payments shows a surplus with the E. P. U. will have to grant a multilateral credit to the E.P.U. corresponding to 20 per cent of its quota. For the surplus exceeding this figure, the country will receive in payment 50 per cent in gold and 50 per cent in claims on the E.P.U. Deficit quota : A debtor country can incur a deficit of up to 20 per cent of its quota without making any payments, but for each subsequent slice of 20 per cent gold payments will be required on an ascending scale until 80 per cent will be paid in gold for the last slice of 20 per cent. The lack of immediate correspondence between the inflow and outflow of gold payments is made possible by the initial E. C.A. fund of 350 million dollars. In the case where debtor countries have exhausted their quotas, the agreement implies that settlements will have to be made in gold to 100 per cent unless the Organisation decides otherwise. There are no stipulations laid down in the agreement with regard to a creditor country which has exceeded its quota.

94. As yet the discretionary powers inherent in the E. P. U.'s functions have not been put to a full test since in the majority of cases the automatic facilities of the agreement are still adequate to cover individual countries' surpluses or deficits; but as and when these automatic facilities become finally exhausted?as should indeed be foreseen in any multilateral system of payments confined to a regional group?it will become desirable to review the original provisions and to couple the creation of further credit commitments and credit facilities with an increase in the E. P. U.'s jurisdiction over Members' policies and a clearer statement of principles to guide the operations of the E. P. U.

95. Any such developments in the E. P. U. machinery would require agreement among Member States not merely on the powers of E.P.U. and the resources to be put at.its disposal, but also on the nature of the correct policies to be followed in individual cases. In regard to this latter aspect, progress must of necessity be slow and gradual. So long as considerable differences exist between different Governments as to the objectives of economic policy, there is unlikely to be sufficient unanimity among the Members of the group as to the proper remedial measures to be applied in given cases, nor will any one country necessarily submit to a group decision with which it does not agree.

96. In the suggestions made below it was assumed, as in the rest of this Report, that in time sufficient agreement will emerge among Member Governments on the objectives of economic policy to make such co-ordination possible. These recommendations, therefore, are not in the nature of a scheme for immediate adoption, but are rather intended as indications of the lines along which the system must gradually evolve if it is to prove adequate for harmonising the requirements of internal stability and intra-European economic co-operation. At the same time, it has been recognised that individual governments will not be prepared fully to abandon national monetary sovereignty within any foreseeable period of time so that provisions need to be made also for such cases where Members refuse to accept the decisions of the E. P. U.

97. The recommendations consist firstly of a proposal that Member States should assume an important additional obligation, and secondly of a number of suggestions for extending the scope of operations and increasing the responsibilities of E. P. U.

Obligations of Member States

98. The additional obligation which it is suggested that Member States should undertake is an essential counterpart in the international field to the obligations of internal economic stability and may as a general principle, be formulated as follows :

99. " Eac h participating country undertakes, as far as it is within its own power, to maintain stable trading relations and to promote expansion of trade with other members of the group. For this purpose each participating country undertakes to declare annually the minimum amount in its own currency which it expects to spend in the coming year on the purchases of goods and services from other members of the group. In arriving at this minimum figure each country must pay due regard both to the need for promoting an orderly expansion of inter-European trade and the need for maintaining overall equilibrium in its own balance of payments; but, save in exceptional circumstances, the minimum to be declared should not fall below the value, in terms of E. P. U. units, of its actual rate of purchases of goods and services in the past year. Each participating country further undertakes to regulate its own trade controls and policies in such a way as to ensure as far as possible that its actual rate of purchases does not fall below the declared minimum. »

100. It is obvious that under conditions of competition and private trading, no country could undertake any binding obligation as regards the total value of purchases of its citizens from the other countries of the group for any future period ? any more than the trading values envisaged in the bilateral trade and payments agreements in the past constituted binding obligations of purchases on the countries concerned. It should nevertheless be evident that the declaration of minimum values of imports may prove extremely useful both as a guide to the country's own trade policies and also as an indication to others as to the likely size of the available market. This would, in fact, constitute a most important step in the progress towards greater economic co-operation and the attainment of more stable trading conditions. It would also constitute an essential element in the reform and extension of E. P. U.

Reform of E. P. U.

101. The suggestions for the reform of E. P. U were guided by the following main principles :

a. A satisfactory system must provide resources that are adequate to furnish on a continuing basis sufficient credit facilities to make possible the orderly adjustment of trading relations between Member States. It must, at the same time, provide adequate protection against an indefinite continuance of balance of payments disequilibria.

b. The system must combine both automatic and discretionary elements. The present E. P. U. agreement was envisaged as being fully automatic in its operation (at any rate within the framework of the existing quotas) and it leaves no discretion to the E. P. U, to influence in any way the rate at which Members utilise the credits provided. In the case of special assistance to countries which have exhausted their quotas, the E. P. U. has discretionary lending powers but no automatic rules for guiding their exercise. It would be desirable to increase the effective powers of the E. P. U. in regulating the amount of credit provided to borrowers, but at the same time clear administrative standards should be laid down for the exercise of such discretionary powers.

c. The E. P. U. should thus be in a position in any concrete instance to put a varying degree of pressure on either debtor or creditor states in accordance with its current analysis of the causes of the disequilibrium (whether this be between Member States or in relation to the outside world), and not merely, or even mainly, as an automatic result of the accumulated creditor or debtor position of particular States with the Union.

d. The discretionary powers of the E. P. U. should as far as possible be confined to the analysis and interpretation of the facts ; while its powers to bring pressure on Members should be circumscribed by the initial agreement. This refers both to the circumstances in which the E. P. U. should grant new credits to debtors, and make policy recommendations to them, and also to the circumstances in which the E. P. U. may call on creditors to place fresh credits at the disposal of the system and make policy recommendations as to their creditor position.

e. In accordance with the above principles it is suggested that automatic credit facilities of the kind embodied in the present quota system should be provided only in limited monthly amounts in order to finance moderate imbalances of an accidental character. Credit facilities in excess of these monthly amounts, or beyond a certain total, should only be provided by the E. P. U. in accordance with the guiding principles laid down in the initial agreement and, according to the nature of the case, these should be accompanied by appropriate recommendations as to the remedial action to be taken by the borrowing country. Such credits should be furnished out of the general resources of E. P. U. It is hoped that the proposal for the institution of a system of convertible account made in para. 118-119 below will considerably extend the ability of the system to provide credit. If the resources initially provided should prove inadequate, Member States as a body may be called upon to enlarge these resources to the amount that is shown by experience to be necessary for the efficient functioning of the system. Individual creditor countries should only be obliged to provide additional credit to E. P. U. in those special cases where the persistence of a credit balance can clearly be traced to the inadequacy of their own internal monetary policy.

f. If a Member State refuses to accept the policy recommendations of the E. P. U. and foregoes the use of the credit facilities that were conditionally provided, it should be free to select its own methods for restoring its balance of payments equilibrium. However, so long as it continues to remain a member of E. P. U. and thus enjoys the facilities which E. P. U. provides for multilateral settlements, and the protection against discriminatory action by other Member States, it must itself refrain from the application of measures that effectively discriminate between Member States, except at the initiative or with the explicit consent of E. P. U. Disregard of this commitment should cany with it the exclusion of the State in question from E. P. U. membership.

102. The administrative standards for the exercise of these powers may best be set out by analysing various possible cases of disequi-libria.[5] Ignoring such movements of balances as are due to capital movements of a speculative nature, the emergence of debit balance presupposes a rise in imports or a fall in exports, and

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5. A fow words neod to bo said on tho meaning of « balanco of paymonts disequilibria » in tho context of intra-European trade and paymonts rolations. It is obviously not desirable that Membor Countries of tho Council of Europe should necessarily aim at a balanco in their trading relations with other European countries, sinco some countries may have deficits in their current account with other E.P.U. countries which are offset by surpluses earned outside tho area, or vice-versa. A country may be said to bo in balance of payments equilibrium when its overall transactions with the outside world are in balance, rather than its transactions with other E.P.U. countries taken as a group. Nor is a lack of balanco in tho overall transactions on current account a necessary indication of disequilibrium, sinco a country may be a lender or a

conversely the emergence of credits balances a fall in imports or a rise in exports. Each of these movements may in turn be attributed to legitimate or illegitimate causes originating either in the country concerned or in other countries. The policy to be pursued by the E. P. U. should then depend on its interpretation of the situation. For this purpose governments should undertake to provide E. P. U. with all necessary information concerning movements of constituent items of their balances of payments. The following is merely intended as a brief sketch of the most appropriate methods of dealing with the various possible situations.

Policies to be followed towards debtor countries

103.

(1) I f a country gets into a debtor position with E. P. U. as a result of an abnormal increase in its imports, which in turn can be traced to the prevalence of inflationary pressures in its domestic economy, the country in question should be granted only strictly temporary credits on condition that definite anti-inflationary measures (in the form of higher taxes or higher interest rates, credit control, etc.) are adopted. If the inflation has resulted in a rise of domestic costs and prices in relation to foreign goods, so that the mere elimination of inflationary pressure will not reduce imports to their normal level, the country should be recommended to devalue its currency accordingly. If these recommendations are not followed, further credit should he withheld.

(2) I f a country gets into a debtor position as a result of an abnormal increase in its imports at a time when it is evidently not suffering from inflationary pressures (and possibly even considerable unemployment and industrial idle capacity prevail in its domestic economy), the E. P. U. should be advised to grant credits in amounts and on terms depending on its analysis of the circumstances. Where a rise in imports is clearly due to temporary causes (such as a failure of the harvest) credits should be granted without additional conditions. In other cases, where the rise in imports is not of an obviously temporary character but where it can clearly be assigned to causes operating within the country concerned (e. g. higher import propensity due to a change in tastes or in technique) the granting of credit should be made conditional on the country adopting positive measures for rectifying disequilibrium either in the form of devaluation or of import restrictions. In each case the remedial measures should not exceed those necessary for the re-establishment of equilibrium.

(3) I f the emergence of the debtor position is due to a fall in exports and if this fall can be traced either to inflationary pressures operating within the country or to a rise in internal costs of the country clue to past inflation, the policy of the Board should be analagous to case (1),

(4) I f a country gets into a debtor position through a fall in exports which is due to deflationary tendencies in and consequently diminished purchases by other countries of the group it should be entitled to new credits for the period until internal economic stability is re-established by the countries in question.

(5) I f the emergence of a debtor position is due to a fall in exports which can be traced to specific internal causes, the policy of the E. P. U as in case (2) should depend on its analysis of the circumstances. If the fall in export is due to strictly temporary causes (like the failure of a harvest) credits should be granted to tide over the emergency. In other cases the granting of credits should be conditional on appropriate remedial measures being taken to re-establish equilibrium. When a fall in exports is due to a fall in a country's export potential on account of technical causes operating either within or outside its territory, (e. g. the exhaustion of mineral reserves, or technical changes reducing outside demand for specific export products, etc.), a country should be free to choose whether it desires to stimulate its exports by devaluation or merely reduce imports to the current level of its exports. In this particular case the country would be justified in lowering its declared " minimum purchases " from the remainder of the group.

Policies to be followed towards creditor countries

(6) I f a country becomes a creditor on account of a failure to maintain internal effective demand at a stable level?which would manifest in growing unemployment, falling prices, or a fall in total expenditure on home-produced goods-?and consequently there is a fall in its current disbursements below the declared minimum level, it should grant new credits to the system automatically to the extent necessary to bring these

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borrower of longterm capital. Hence deficits and surpluses in transactions with other E.P.U. countries are only an indication of balance of payments disequilibria in so far as they are not offset by surpluses or deficits in transactions with the outside world, or by longterm capital movements, but give rise to financial transactions of gold movements of a « compensatory » rather than « offsetting » character. In the following pages the terms « deficits » and « surpluses » in the balance of payments, and the terms ((debtor » and « creditor » countries in relation to E.P.U. are used in this special sense,

disbursements up to the minimum level. At the same time it should take measures to re-establish a full employment level of demand. While this situation lasts it should not be in a position to reduce its declared minimum purchases below the level declared in some particular past period determined by the E. P. U.

(7) If a country gets into a creditor position on account either of a rise in its exports or a fall in its imports which can be traced to inflationary tendencies prevailing in other countries, the country should not be asked to undertake any remedial measures and settlements should continue to be made in accordance with basic quota provisions and in 100 per cent gold payments when its quota becomes exhausted. The country in question may, however, be asked to assist E. P. U. by depositing part or all of the current gold payments due to it in a convertible account with E. P. U. (see paras. 118-119).

(8) Finally , if a country gets into a creditor position because of specific causes analogous to those mentioned under (2) and (5), and if the disequilibrium can be traced to internal causes, it may be requested by E. P. U. to undertake positive remedial measures, either in the form of currency revaluation or a relaxation of existing import restrictions, as a condition of its continued participation in E. P. U. Exclusion from E. P. U. would be tantamount in these circumstances to an authorisation to other Member States to impose discriminatory measures against the country concerned.

Principles and Methods of Operation

104. The above suggestions arc in conformity with two important principles the adoption of which is considered essential for the successful operation of a stable multilateral system. The first of these is that in any major disequilibrium in the flow of payments it is important to distinguish between the country or countries which can be said to provide the initiating cause of the maladjustment and the other countries which merely reflect it and that the onus of responsibility for adjustment should as far as possible be thrown on the country responsible for the maladjustment rather than on the others. The pressure for making adjustment should therefore not be put on debtors as such or on creditors as such : it should be put on the country or countries which can be shown to be responsible for it. The second principle is that monetary causes of disequilibria (i. e. inflationary or deflationary tendencies) should be sharply distinguished from other causes and that the nature of the remedial measures to be adopted should be adapted accordingly. Disequilibria which can be traced to monetary causes in the country concerned should be dealt with by policies influencing internal effective demand andnotby measures which affect the underlying trading conditions, except to the extent that a change in exchange rates is justified where an inflationary tendency has clearly resulted in a rise in domestic costs and prices in relation to other countries.

105. The extent to which these principles could in fact be carried out obviously depends very largely on the amount of information which the E. P. U. will have at its disposal concerning current économie trends in various participating countries and on its ability to interpret and evaluate this information so as to form a definite judgment in each case. An obvious objection to these proposals is that the degree of knowledge necessary for operating such a system could not possibly be obtained under present conditions. As against that, it may be pointed out that the difficulty of interpretation is in inverse ratio to the degree of disequilibrium; it is very much easier to assign responsibilities in cases of large and spectacular changes than in cases of small ones. In the absence of clear definition of the policies to be followed by individual countries in various conditions and of the principles which should guide the operation of E. P. U. it is just as likely that the wrong kinds of adjustments will be undertaken in cases of large maladjustments as of small ones. Moreover, once the E. P. U. is clearly charged with the responsibility of forming judgments of the kind described, its ability to do so, however imperfect at first, is bound to improve with continued experience.

106. The above analysis presupposes that the movements of balances of individual countries with E. P. U. are primarily caused by movements in trade and service transactions rather than by speculative movements. Past experience has sometimes shown that the movements of financial balances tends to be more violent than the underlying movements in current transactions would have justified, owing to financial transactions of a speculative character. It is one of the important requirements of good-neighbourly conduct that each country should, as far as possible, take steps to prevent such speculative movements, and it is not recommended that the credit facilities should be provided for such deficits as originate in the movements of " hot money ".

Alternative Methods of Adjustment

107. The above proposals suggested that disequilibria which originated in monetary causes (i. e. inflationary or deflationary ten dencies in the trading countries) should as far as possible be dealt with by monetary remedies and not by measures that Would restrict the scope of trade between Member countries. In cases of disequilibria of a non-monetary cha-racter, however, which do necessitate the adoption of measures which

affect the underlying trading conditions between the different coun tries, the proposals of this report left considerable latitude as to the particular method of adjustment to be recommended for adoption by the country concerned. This was in recognition of the fact that the most appropriate method of adjustment may differ with the concrete circumstances of each case and the particular position of the country undertaking it. Thus, if a country has balance of payments deficit due to structural causes, the elimination of which involves a reduction in its imports, there is no necessary reason for pre-ferring any one method of achieving this reduction (such as currency devaluation) to others (such as quantitative import restrictions or the use of differential exchange rates applies to different classes of imports). The only weapons of commercial policy which must be definitely ruled out are those which discriminate between different trading countries. Given the existence of a fully multilateral payments system, the main justification for such discriminatory practices in any case disappears. Countries might still be tempted, however, to impose, or threaten to impose, discriminatory restrictions in the hope of thereby extracting trading concessions from other countries. It must be clearly under-stood that the use of such practices must be effectively ruled out (unless, as indicated in para. 103 (f) above, they are introduced on the initiative or with explicit consent of the group as a whole)if economic co-operation between the Members of the group is to bo at all effective.

108. Barring the use of such discriminatory methods, possible methods of adjustment may be classified according to whether they are " protective " Or " non-protective " (i. e. whether they operate on the side of imports Only or simultaneously on the side of imports and exports), whether they are " sélective " or " non-selective " (i. e. depending oil whether they affect the trading conditions in particular commodities, exported or imported, or whether they affect the overall trading conditions), and finally whether they are " administrative " or " market " techniques, this depending on whether they make use of administrative controls or whether they operate through the price mechanism. The respective advantages in the use of these different methods need to be discussed in more detail.

109. From the point of view of securing the maximum international division of labour and thus the best allocation of resources, the " non-protective " method of adjusting a deficit?i. e. currency devaluation?which affords a stimulus to exports at the same time as it tends to restrict imports, is clearly preferable to " protective " methods, which merely restrict imports, but quite apart from the fact that a change in exchange rates is not a weapon that can be recommended for frequent use, there is clearly no virtue in requesting countries to eliminate balance of payments deficits by a non-protective method of adjustment in those cases where they cannot hope to enlarge the volume of their exports significantly through a lowering of prices. In those cases where for technical reasons a country has only limited export capacity, or where the foreign demand for its products is inelastic, the bulk of the quantitative adjustment would in any event largely fall on the side of imports rather than of exports. In such cases a " protective " policy of restricting imports in some manner is clearly preferable to the " non-protective " method of devaluation, since the former avoids the adverse change in the terms of trade and the associated inter-regional transfer of real income.

110. In the same way there can be no necessary objection to the use of "selective" as against the use " non-selective " policies. Thus, if a country is justified in restricting its imports in the interests of re-establishing balance of payments equilibrium, it should also be free to select commodities whose importation it wishes to restrict?provided such restrictions are fully non-discriminatory as between different exporting areas-?rather than apply the same degree of restriction (as in the case of devaluation or a uniform ad valorem duty) to commodities of all kinds. It must be understood that " selective " policies in this sense can by no means be considered protective merely because they indirectly result in a changed geographical pattern of imports.

111. Finally, there is no valid general objection to the use of " administrative " techniques (as, for example, quantitative restrictions, either in the form of import licences or currency allocations, etc.) rather than the more traditional " market " techniques such as import duties or currency devaluation. Provided the measures adopted in either case are quantitatively not greater than is necessary for the re-establishment of equilibrium, it cannot be said that one type of technique is more restrictive to international trade or more damaging to the best allocation of resources than the other; nor is there any reason to suppose that it need be any more discriminatory. Under conditions of bilateralism, quantitative restrictions are of course administered in a discriminatory manner. But under a system of multilateral payments, provided that the licences issued do not specify the country of origin of the commodity to be imported, but entitle the importer to buy anywhere in the trading area there is no real difference, from this point of view, between the use of quantitative restrictions or, for example, of tariffs. The great advantage of administrative techniques is their flexibility. For this reason they are in general much better adapted for dealing with short period adjustments, while the advantages of the traditional market techniques are more apparent in the case of prolonged disequilibria which necessitate permanent adjustments. The objection to the use of administrative techniques is that in some countries whose administrative apparatus is not particularly efficient, the use of such techniques may lead to abuses of all kinds and create large windfall profits to middlemen or to those who manage to evade the controls. Such

countries might be well advised to make use of some combination of administrative and market techniques that makes it possible to combine the flexibility of the former with the advantages of a free market inherent in the latter. Thus many of the disadvantages of quantitative import controls in such cases might disappear if they were combined with a system of auctioning of licences whereby the right to import any particular commodity was sold by the government to the highest bidder. Alternatively, the same objective might be achieved through the introduction of differential exchange rates for different classes of imports. Under this system the importers of, say, nonessential goods, purchase foreign exchange at a different price from other importers. The desire to proscribe the use of such methods in the interest of the general welfare or of a more liberal system of international trade is not infrequently based on faulty reasoning. Such methods, if correctly applied, should without being more restrictive than others be more conducive to an efficiently functioning system than the others.

112. It is suggested, therefore, that the international code of behaviour to be elaborated and mutually adopted should be concerned not so much with particular weapons of international trade policy, as with the circumstances in which adjustments should be applied and the nature of the adjustments that are appropriate to them. Past efforts in this field concentrated almost exclusively on having some weapons outlawed to the exclusion of others, without recognising that particular weapons as such are not necessarily either good or bad, and that what really matters is whether they are applied in the right way or in the wrong way.

Relations with the outside world

113. A policy of internal economic stability coupled with a system for the orderly adjustment of trade relations such as is recommended in this report would go a long way towards protecting Member countries from the effects of economic fluctuations and instabilities emanating from outside; but it would be idle to pretend that, in the case of a group of countries so dependent on overseas trade as the countries of Western Europe, internal stability can ever be complete so long as external economic relations continue to be unstable. Changes in world raw material prices or in the world demand for European goods will continue to exert a disturbing influence which may easily generate inflationary or deflationary tendencies within the area unless adequate compensatory measures are taken. Such measures may take various forms. Thus in the case of an inflationary trend in the outside world, the most appropriate counter-action may be found in the revaluation of the currencies of the Member States in relation to the currencies of non-Members. In the case of a deflationary trend, devaluation may bo the appropriate compensatory remedy. In the case of a world shortage of certain raw materials, the disturbing effects may be minimised through their joint purchase and allocation among Member States.

114. The extent to which the effects of disturbances emanating from the outside can be successfully counter-acted will obviously depend on the degree to which Member States are willing to co-ordinate their economic policies vis-à-vis the outside world. Progress in this direction is bound to be gradual since, on account of the close ties which some of the Western European countries, particularly the United Kingdom, maintain with countries outside, they may be unwilling to undertake far-reaching commitments at the outset. For this reason (and also for the reason that this report was not intended to concern itself with proposals concerning further economic integration of the area) it was not thought appropriate to examine such proposals as, for example, the creation of a preferential tariff system for the Western European area, the co-ordination of trade policies, the creation of a common dollar pool for E. P. U. Members, etc. It is desired, however to put forward two concrete proposals in this field which are less far-reaching but which would represent obvious improvements on the existing situation.

115. One of these is the institution of joint consultations concerning exchange and trade policies in relation to the outside world whenever the E. P. U. (cither on its own initiative or at the request of a Member State) thinks that in the interests of the economic stability of the area some joint action is called for. This proposal would not deprive individual Member States of the right, for example, to alter their exchange rates individually whenever their overall balance of payments situation requires it. It would ensure, however, that in cases where it is appropriate to bring about adjustments for the area as a whole and not only for individual countries, machinery will exist to facilitate its execution. Advance consultations (within the framework of IMF) are of course already provided for in the Bretton Woods Agreements. The events of the past few years have demonstrated, however, how purely formal such consultations can become if the ground is not adequately prepared. While leaving to the IMF jurisdiction on exchange rate adjustments from a world point of view, the consultation could become far less formal and more meaningful if there were some advance preparation on such matters within a closely linked regional group such as the E. P. U.

116. The other proposal concerns the creation of what might be termed " convertible accounts " within E. P. U. Under this proposal E. P. U. countries which incurred surpluses would receive all, or a certain proportion, of the gold payments to which they would otherwise be entitled in the form of a claim on a convertible account with E. P. U. The creditor country would be freely permitted to draw on this account for the purpose of current transactions with countries outside the E. P. U. area, though not for the purpose of increasing its own gold reserve. The main advantage of this proposal would be that it would constitute a starting-point for the creation of a central reserve of E. P. U. countries, since E. P. U. would no longer be compelled to maintain 100 per cent cover against all gold or dollar claims. The institution of such a system of convertible accounts would improve the reserve position of the area as a whole?since in any normal situation not all European countries incur deficits simultaneously with outside areas ?and protect individual Member Governments against the effects of outside shocks. Moreover, such convertible accounts might be one of the means by which effective resources are put at the disposal of the E. P. U. for the implementation of the policies discussed above.

117. If this proposal were followed, a creditor country would be paid in cash (i. e. gold or dollars) for some proportion of its surpluses within the E. P. U. area. Its remaining claims on E. P. U. would then take two forms :

a. a transferable account to be used to cover any deficit within the area?and in fact identical with present credits under the quotas of E. P. U;

b. a convertible account, drawings on which would be permitted in order to be used for the payment of current transactions both within and outside the area, but not to add to the gold or exchange reserves under the direct and unqualified control of the country. Such convertible accounts would definitely form part of a country's reserve since they could be drawn on freely to meet any payments deficit anywhere in the world. The only measure that would be barred would be to shift the composition of a country's reserve by depleting the convertible account with the E. P. U. in order to increase its direct holdings of gold and dollars.

118. There has becen little reference in the above to the position of the International Monetary Fund, and its connection with the E. P. U. A full discussion of this problem would lie outside the scope of the present report. A few points, however, may be touched upon :

118.1. Norma l transactions of the International Monetary Fund may now include the sales of one E. P. U. currency against another E. P. U. currency. It is quite obvious, however, that it is indifferent to the E. P. U. country which requests another E. P. U. currency from the Fund what specific currency the Fund will sell to it. The currency will enter into the E. P. U. compensation machinery at the next monthly settlement and will result in a general improvement of the country's position with the E. P. U. There would therefore be a strong case for a close co-ordination between the E. P. U. and the Fund whenever such operations are being considered. In this connection it might be pointed out that, from the point of view of the E. P. U. it would be preferable for its debtors rather than its creditors to borrow E. P. U. currencies from the International Monetary Fund. This procedure woidd tend to reduce existing disequilibria within the E. P. U. system. Ultimately it would be desirable that all transactions involving two E. P. U. currencies should first be channelled into E. P. U. transactions rather than through the Fund.

118.2. Th e strength of the resources of the E. P. Undiscussed above can also be increased by appropriate action undertaken by the Fund. Thus, for instance, the convertible accounts mentioned above may be underwritten by the I. M, F, In these and other operations the I. M. F. can mobilise, of course, the contributions already paid in to its own capital by the various E. P. U. countries involved.

118.3. A most essential point will be the problem of linking the E. P. U. system with the outside world. This question is, of course, intimately linked with the problem of the transferable Sterling accounts, but also affects other currencies. Here again, close co-operation with the I. M. F. would be essential in the interests of all countries?both European and non-European? concerned. The ultimate and idéal form of the co-operation suggested above would undoubtedly require some administrative, or even legal, re-adjustment in the status of both the I. M. F. and the E. P. U.

4. PART IV The problem of Development and long-term Investment

Foreign Lending

119. It has been one of the most disturbing features of the European economy in recent years that the international flow tif long-term capital has largely dried up. Domestic invest-ment has, in many countries, been pushed to a high level; and some investment has been undertaken by the major world Powers in

underdeveloped areas outside Europe. But within the Council of Europe countries the movement of long-term capital has recently been at a very low ebb, and there seems little prospect of its revival unless special and positive measures are undertaken.

120. This diminution in foreign lending has, most obviously, an adverse effect on the volume of international transactions. It forces countries to aim at a more exact balance between imports and exports and thus inevitably reduces the total volume of trade. Proposals have been made above for ensuring a more substantial flow of short-term credit through the medium of E. P. U. It is equally desirable to induce the resumption of long-term investment among the Member Nations of the Council of Europe.

121. But an even more serious consequence follows from the lack of foreign lending. It was pointed out above that one of the possible causes of unemployment was the lack of complementary factors, i. e. a shortage of land, materials, or capital in relation to the total labour force. At the present time this is perhaps the most important single cause of unemployment in Europe. Italy, Greece and Turkey in particular are relatively underdeveloped countries in which the capital equipment to employ the whole labour force simply does not exist. The consequence is unemployment (often disguised) : and the problem is further complicated by the fact of high birthrates.

Migration and industrial development

122. It is sometimes suggested that migration should be the primary answer to this situation. Buttoo much reliance should no t be placed on this solution. Not only is the capacity or willingness of other countries to receive immigrants limited, but emigration may engender new problems. Experience shows that it is mainly male persons in the working age groups that emigrate. This means in fact that the mother country will lose the most dynamic and useful part of her population while at the same time the remaining and reduced working population, where women will be in surplus, will be saddled with the task of taking care of a growing number of old and very young people. This distortion in the age and sex structure ?if it goes far enough?may bo as serious as overpopulation.

123. The solution must therefore be found in a large expansion of industrial capacity, directed to the ends outlined in para. 38. The question immediately arises of Avhere the new capital is to come from. Clearly the underdeveloped countries themselves should make every possible effort to tap internal sources of new capital, and it may well be that more could be done in this direction. Rationalisation and tightening-up of the fiscal system to reduce tax-evasion and make a larger budget surplus possible; the prevention of capital flight abroad; the restoration of confidence in the currency as a condition of encouraging internal savings? these are all measures requiring urgent attention. In addition, it must be emphasised that if, in these countries, unemployment is at a higher level than that dictated by the shortage of industrial equipment, a further source of savings is available. A policy of expanding demand will normally create higher savings in the process of creating higher incomes; and to this extent the problem will be eased.

124. But nobody pretends that these countries can finance the whole of their industrialisation programmes from internal savings. Aid must be given from abroad. Now it is most unlikely that this aid can come from private sources. Many factors exist which hamper a revival of international movements of private capital : political instability, fear of exchange-rate movements or of nationalisation, inadequate profit opportunities. Nor indeed would it be desirable, even if it were possible, that private capital should play the major role. It has been shown in the past that private foreign investment tends to be most unstable, and in particular to dry up in periods of depression. It cannot, for these reasons, bear the major share of the burden.

European Investment Bank

125. This must therefore be borne by the Governments of the Council of Europe, and in particular by those of the mature industrial countries which have high rates of saving and so the possibility of foreign investment. It is here that scope exists for a major act of European co-operation, with significant effects both on the unity and the prosperity of democratic Europe. This report therefore proposes the setting-up of a European Investment Bank, as a step towards the attainment of Full Employment for all the peoples of all the Council nations.

126. It might, of course, he argued that one should leave it to each Member State to determine the direction and volume of its own exports of capital. However, in this case there is no guarantee that the capital will be channelled to the countries where it will be most efficiently used from a Western European point of view, nor is the timing of the foreign investment in this case necessarily the most advantageous. It appears, too, that the putting of an international intermediary between lending countries and borrowers is highly desirable from a general political point of view.

127. Again, it might be contended that the E. P. U. could assume also the role of investment bank. But the function of E. P. U. differs fundamentally in scope and character from the tasks envisaged for the development programme. The task here envisaged for the E. P. U. is to maintain the balance of transactions and to provide stability in trading relations between Member States, whereas that of the Bank would be to analyse and compare the development schemes submitted to it, to finance them, and to supervise their execution. It is, on the other hand, quite obvious that close links will have to be established between the E. P. U. and the Investment Bank in particular in order to solve the problem of relations between credits granted by the Bank and the clearing operations of the E. P. U.

128. These functions thus demand the creation of a European Investment Bank. This proposed institution woidd differ in various ways both from the International Bank and from the so-called Petsche Plan, which is at present being considered by the 0. E. E. G. In contrast to the Petsche Plan, its role would not be to grant commercial credits direct to enterprises, nor would its primary object be to contribute to the integration of Europe. Its primary role would be to further the aim of full employment in the Member States, and to grant financial assistance to the underdeveloped nations. Moreover, such assistance would be granted mainly to central Governments rather than to particular private enterprises. In contrast to the International Bank, credits would be granted for general development purposes and need not be tied to specific projects.

129. The following suggestions are merely intended as a brief general outline of the functions and the proposed manner of operation of the European Investment Bank.

Financing

(a) The Bank should have a basic capital provided by direct contributions from Member Governments in their respective national currencies and to be subscribed over a period of years laid down in advance. It is suggested that the bulk of such contributions should come from the industrially more advanced countries and in proportions determined in the initial Agreement.

(b) The Bank should have the power to increase its lending capacity beyond its basic capital through additional loans from individual Governments or through the issue of bonds on the capital markets of Member States or other markets.

(o) Losses arising out of the lending activities of the Bank which cannot otherwise be covered should be apportioned between subscribing Member States by a proportional writing down of the basic capital.

Lending

(d) Loans of the Bank which are granted to Governments should be made on the basis of general development programmes submitted by them. Such programmes should be laid down for a period of years ahead, and the Bank's contribution should similarly be determined on a long-term basis, so that the country in question can foresee the amount of assistance forthcoming from the Bank for a reasonable period ahead. Such loans should be of a long-term nature, and the amortisation payments should be deferred for an initial period.

(e) In its loan policy the Bank should primarily be guided by the effect of a particular country's development programme on its total production, export capacity and taxable income, these being the factors which determine its capacity to repay the loan.

(f) Loans should be made at uniform interest rates which would include allowance for operating expenses and normal losses,

(g) Th e borrowing Government should establish a separate capital budget which would show in detail the progress made in implementing the doA'elopment programme.

(h) The borrowing country may be permitted to postpone the amortisation payments in the face of a decline in its earnings of foreign currencies which can be traced to legitimate causes (as specified in paras. 105-106 above).

130. No one can doubt that the industrial development of the poorer and less developed regions of Europe is one of the most urgent problems facing the Council of Europe nations today. If unemployment in these regions could be eliminated by a great co-operative effort, it would not only represent a significant step towards a higher standard of life for the peoples concerned : it would also, by spreading the benefits of prosperity more evenly, be the best possible contibution to the unity, the strength, and the political stability of free Europe as a whole.