The Establishment of an Arab Payments Union- Empirical Criteria and Economic Effects

by

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A Thesis presented to the Department of Economics at the American University of Beirut in partial fulfilment of the requirements for a Degree of Master of Arts

September 1954

C O N T E N T S

		Page No.
Chapter I	Introduction.	1 - 10
Chapter II	International Equilibrium and The Exchange Rates.	10 - 47

I. Balance of Payments Adjustment.

A. Equilibrium in International VS. Internal Payments.

B. Definition of Balance of Payments Equilibrium.

C. Importance of Balance of Payments Equilibrium.

D. Tendencies for Over-Expansion in the Arab World.

E. Balance of Payments Adjustment.

II. Problems of the Exchange Rates.

A. Definition of the Equilibrium Rate.

1. Purchasing Power Parity Theory.

2. Criticisms of Purchasing power Parity Theory.

3. Keynes's Definition of the Equilibrium Rate.

B. Criteria for the Practical Determination of the Equilibrium Rate.

C. The Need to Stabilize the Exchange Rate.

Page No.

III. The Case for Stable Exchanges.

A. Fixed VS. Flexible Exchange Rates, Historical Set-up.

B. Case for Stable Exchanges.

Chapter III — Trade and Payments in the Arab Middle East — 47 - 98

I. International Trade Activities in the Arab World.

A. Composition of Trade.

B. Direction of Trade.

II. Balance of Trade and Payments Problems.

III. Exchange Control and Exchange Stabilization in the Arab Middle East.

A. Syria and Lebanon.

B. Iraq.

C. Egypt.

1 X Chapter IV — The Requirements for a Regional Payments Union in the Arab Middle East — 98 - 131

I. Requirements for a Regional Payments Union.

II. Is a Payments Union Possible in the Arab Middle East.

III. The Need for a Regional Payments Union in the Arab Middle East.

2 X Chapter V — A Multilateral Payments Union in the Arab Middle East — 131 - 176

Page No.

I. The European Payments Union

II. Organization and Administration.

III. The Clearing Mechanism.

IV. The Settlement and Adjustment Mechanism.

V. Financing the Payments Union

Chapter VI — Conclusion — 176 - 183

Appendix — Total Value of Exports and Imports as Percentage of the National Income in Various Countries — 183 - 185

Bibliography

Chapter I

Introduction

The present paper deals with one aspect of the problem of regional economic integration in the Arab Middle East, namely, the organization of effective financial cooperation on a multilateral basis with the purpose of minimizing the effect of payments problems on the free movement of trade and resources. The conditions necessary for the establishment of a regional payments system as well as the economic implications of a payments scheme will be studied in some detail.

Regional economic integration may be defined as "an arrangement between sovereign states aimed at securing the same distribution of resources in the light of the total consumer and investment demand as might take place if the several states were combined into one political and economic unit."[1] Economic integration is thus looked upon in the light of the proper allocation of resources within a wider market for both products and productive factors.

It can of course be claimed that regional economic integration will in the long-run result in considerable gain to the whole Arab Middle East. It will

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1. R. Mikesell, United States Economic Policy and International Relations (New York, McGraw-Hill, 1952), p. 269

tend to increase factor mobility, to liberalize trade and to widen the market for the producer and thus bring into operation the benefits derived from decreasing costs. Yet advantages claimed for regional economic integration are not unassailable. It has been pointed out by critics of such schemes that in the short-run economic integration implies a radical change of conditions for the producing unit calling for equally radical adjustments. Thus, an industry which is no more profitable under the changed conditions will either be scrapped and the resources reallocated or subsidized by the government and run at a loss. Both alternatives entail considerable sacrifice in the short-run and are likely to be considered wasteful.[2]

Nevertheless, with the above issues the present paper is not concerned. It seemed more advisable to take it for granted that regional economic integration will redound to the benefit of the Arab Middle East. It is assumed that whenever a country decides to participate in such a regional organization, it has decided to shoulder the responsibility of minimizing the adverse effects of necessary short-run adjustments acting on the belief that long-run advantages outweigh short-run losses.

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2. Thomas Balogh, "European Unification and the Dollar Problem", Quarterly Journal of Economics, February 1951, p.112

Of all aspects of regional economic integration the balance of payments problem was chosen for treatment in the present paper for several reasons:

1) Problems arising out of the balance of payments are probably becoming of increasing moment in the Arab Middle East. Impelled by a keen desire to attain the living standards of the West and by a feeling of insecurity to build up strong armies, the Arab countries invariably tend to buy from abroad more than what they can sell abroad. Naturally this situation calls for effective remedies which so far have been applied on a nation by nation basis rather than on a regional basis. The possibilities of regional cooperation along these lines is a subject that should be studied.

2) Recently a conference composed of the Arab Ministers of Finance met at Beirut to discuss the problem of liberalizing trade and payments among their respective countries. An agreement was then provisionally signed at Cairo providing for a freer movement of goods and a more liberal payments mechanism.[3] It is extremely important that at this stage of Arab economic cooperation there be complete realization of the problems a payments agreement can solve and the

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3. "Agreement Relating to Payments on Current Account and Capital Movements among Countries of the Arab League", from Al-Abhath, Vol.6, No.4, Dec., 1953, pp. 538-553 .

problems it cannot solve. A confusion of functions will only result in frustration which can be avoided by proper studies to define the objectives which are reasonably attainable.

3) Beside their inability to earn sufficient amounts of foreign exchanges to cover their purchases from abroad, Arab countries also suffer from the problem of incovertibility. In other words, foreign exchange acquired from the trade with one currency area may not be accepted in another currency area. This problem intensifies the shortage of foreign exchange and weakens the price mechanism in international trade.

4) Most of the Arab countries cover their import requirements by exporting a few primary products. Thus Saudi Arabia and Kuweit rely mainly on petroleum exports, Iraq on petroleum, dates and livestock products, Syria on cotton and cereals, and Egypt on cotton. Such a trade pattern creates balance of payments problems the effects of which could be minimized by regional financial cooperation. The tendency of foreign exchange acquisitions to be concentrated during certain seasons as well as the sharp fluctuations in the prices of primary products are among such problems.

5) Most of the Arab countries have, during the past few years, established institutions for the purpose of exchange rate stabilization. To the extent

that such institutions deal in Arab currencies, it is possible that the operations of one stabilization authority will be counteracted by the operations of another. Thus, suppose that the Lebanese exchange stabilization authorities decide to support the Lebanese pound in the exchange market by selling Syrian pounds of which they presumably have considerable sums. The Syrian Exchange Bureau is then compelled to purchase Syrian pounds in order to maintain its stability, and its action will defeat the policy of the Lebanese exchange authorities if Lebanese pounds are offered in exchange for the Syrian currency. Complications of this nature constitute a weighty case for close cooperation among exchange stabilization authorities.

While the present paper deals mainly with the payments problems arising out of international trade, account will be taken of such related problems as exchange rate stabilization, protective tariffs and other import restrictions, and overall monetary and fiscal policies. A proposed multilateral payments agreement is outlined and the requirments for the establishment and successful functioning of such a system will be studied. Conditions in the Arab World will then be analyzed to determine whether it is possible to establish such a payments system. Finally, the economic and political implications of the scheme will be discussed.

The method of treatment adopted is to a large extent determined by the availability of relevant statistical data. In fact, the paucity of balance of payments statistics in the Arab Middle East made a detailed empirical study of the payments problem rather impractical. Analytical tools and hypothetical examples were, therefore, relied upon more heavily to define the nature (though not the magnitude) of the variables involved. It is realized that while reading some sections or even some chapters of this paper, the reader would get the impression that the Middle East has been relegated to the background and that the arguments presented are too theoretical in nature. While this structure is well founded and cannot be dismissed by merely deploring the paucity of available statistical data, it must be noted that refined statistical information is essential for the operation of a payments union and not for a study of this nature.

An attempt was also made in the present paper to draw on the rich experience of other payments unions and stabilization funds. It must be recalled that most of the complications and problems posed by such institutions became clear only as a result of the functioning of some payments union or stabilization fund. A comparative study of such institutions will, therefore, illuminate many of the issues which a proposed regional payments union is likely to face.

In defining the area which this plan might comprise, neither geographical extension nor feelings of brotherhood are *per se* guiding criteria. A payments union will only be effective if adherence to it is completely voluntary. Indeed the purposes of a payments union will not be advanced if a few members are made to adhere, motivated by brotherly feelings or by considerations of pure philanthropy . "Men's sympathies and less calculated impulses are drawn from their memories of comradeship, but their contemporary acts are generally directed towards influencing the future and not pensioning the past."[4]

This provision of completely voluntary adherence is of extreme importance for the success of a regional payments union in the Arab Middle East. Oil producing countries will probably suspect in this regional union a disguised attempt to appropriate a part of the oil royalties to the whole region, and unless it becomes clear to all countries concerned that adherence to the union is not desirable except for considerations of mutual benefit, the union is likely to be weak and unstable. The area studied here will comprise the seven

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4. Keynes, J.M., "The Anglo-American Financial Agreements", *The New Economics*, (Dobson: London, 1949) p. 384.

countries of the Arab League. For the Arab League provides a vehicle for the agreement on fundamental political and military problems among its member countries. But due to the lack of statistical data, Saudi Arabia and Yemen will not figure out throughout the discussion.

The present paper is divided into six chapters. In Chapter II some financial and economic problems arising out of international trade are discussed. This includes a definition of the equilibrium rate of exchange and of the criteria for the determination of such a rate, analysis of the problem of balance of payments equilibrium and finally the discussion of alternative exchange rate policies. Chapter III includes a study of trade and payments in the Arab countries and of the impact of the international financial mechanism on the Arab economies. A brief description of Arab trade is followed by a discussion of the payments problems arising out of trade and capital movements. Finally, measures introduced to deal with payments problems will be discussed and emphasis will be placed on exchange control and exchange stabilization in the different Arab countries. In Chapter IV an attempt is made to study economic conditions in the Arab Middle East with a view to determine the extent to which such conditions are conducive to the establishment of a regional payments union. In Chapter V the

broad lines of a suggested payments union for the Arab Middle East are outlined. This chapter includes a discussion of the European Payments Union, analysis of an offsetting mechanism for a suggested Arab payments union, and a discussion of a settlement mechanism, an adjustment mechanism and other related problems. The paper is then concluded in Chapter VI with a discussion of the main problems of a prospective payments union and of its political and economic implications for the Arab Middle East.

Chapter II

International Equilibrium and the Exchange Rates

The present chapter presents a discussion of some financial and economic problems arising out of international trade. The problem of balance of payments equilibrium is discussed in Section I. Section II presents a definition of the equilibrium rate of exchange and of the criteria for the determination of such a rate. Finally, Section III presents a discussion of alternative exchange rate policies.

I. Balance of Payments Adjustment

The balance of payments may be defined as that account which "concerns only those economic activities of a country and its people which overflow national boundaries and enter the realm of international transactions."[1] More narrowly conceived, the balance of payments may be defined as "a summation of all the transactions between (a country) ... and the rest of the world wherein it receives or expends cash."[1]

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1. A.E. Kahn, Great Britain in the World Economy, (New York: Columbia University Press, 1946), p.1.

A. Equilibrium in International VS. Internal Payments

The distinction between internal and international transactions is essentially arbitrary, but is far from meaningless. It derives its meaning from the existence of political and social divisions in the world. Thus, the existence of separate currencies between countries and of separate systems of political and economic control are among the facts which make this distinction meaningful. Furthermore, such problems as the type of action necessary to adjust an adverse balance of payments and of the liquidity in the banking system are more pronounced when they refer to international rather than to interregional transactions.[2] This probably explains why much more attention has been given to international rather than to interregional transactions. In the latter type of transactions, the existence of one currency eliminates the problem of exchange rates; and the loss of liquidity by the banking system of one regian need not result in a net loss of liquidity by the whole banking system since this loss will probably be offset by a gain of liquidity in some other region.[3] Furthermore, the adjustment of a

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2. F.W. Paish, "Banking Policy and the Balance of International Payments", Reprinted in Readings in the Theory of International Trade, (London: Allen and Unwin, 1950) p.38 .

3. This will be true if the loss of liquidity in one region is not due to withdrawals from the banking system as a whole.

regional balance of payments with the remaining regions is usually effected more smoothly and subject to a minimum degree of control on the free movement of resources and the means of payments.

The fact that interest is aroused in the payments problem only when any mechanism of international adjustment ceases to function automatically or with any reasonable degree of smoothness is amply demonstrated from the workings of the gold standard. Thus during the 19th century, London was the central money and credit market of the world. The gold standard reduced the external value of national currencies to a common denominator which fluctuated within the narrow limits of the gold points. Furthermore, no restrictions on the payments mechanism were imposed by the different trading countries, and it was assumed that the international transfer of purchasing power was sufficient, in a system of flexible prices, to restore equilibrium in the balance of payments. Consequently, the discussions of balance of payments equilibrium during the 19th and early twentieth century were restricted to the exposition and elaboration of the gold standard rules of the game. Only occasionally, and in periods of major economic disturbance, did the problem of balance of payments equilibrium become a controversial

issue.[4]

However, all practices which have approximated the international payments mechanism to an interregional payments mechanism were radically changed after World War I. Throughout the 19th century the rate of growth in the demand on money equated rather closely with the rate of increase in the production of gold. But the rate of production of gold slackened during the early 20th century and did not keep pace with the rate of increase in the demand for gold. The emergence of Paris and New York as important money markets deprived London of its position as the central money market of the world.[5] Furthermore, increased restrictions on payments and trade

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4. Among such periods may be mentioned the post-Napoleonic era on the resumption of specie payments in 1817. Large unilateral transfers such as the Franco-Prussian war indemnity, the Canadian balance of payments problem between 1900 and 1913 and the German transfer problem were discussed by economists. The general trend of thinking in this respect was that, though the gold standard will ultimately bring about the adjustment, the fact that such transfers involved huge sums made the time element very significant.

5. The emergence of Paris and New York as international money markets competing with London decentralized the gold standard and by the mere fact of creating three rather than one international clearing center greatly reduced the efficiency of clearing activities in international payments. The increase in the number of centers increased the demand for international reserves and resulted in a scramble for gold which was destructive of both internal and external stability. In addition, both the Paris and New York money markets were less adapted than the London money market for international clearing . The New York market proved to be more responsive to speculative movements than to movements in trade while the Paris money market proved to be insensitive to gold movements. Furthermore, the French banking system was handicapped by the legal prohibitions on open-market operations. See, P.T. Ellsworth, The International Economy, (New York: Macmillan, 1950), pp.456-61.

and the increased emphasis put on domestic stability deprived the gold standard of its smooth mechanism of adjustment. The restoration of the gold standard by most countries in 1925 and 1926, therefore, symbolized attachment to the letter and not to the spirit of the system, and the gold standard could not function. Its renunciation by most countries between 1931 and 1936 consummated a trend towards a financial mechanism removed from an international system of payments to a national system of payments.

The problem of equilibrium in the balance of payments then became the subject of keen interest on the part of economists and statesmen. It was essential in a system of managed inconvertible currencies to study the structure of the balance of payments more closely in order to determine the most desirable means of adjustment.

B. Definition of Balance of Payments Equilibrium

Obviously, the term equilibrium used above does not refer to the necessary accounting identity between payments and receipts. The statement that the balance of payments is necessarily always in balance has no analytical value.

> "If transactions are being effected, whether easily or with difficulty, the balance will continue. And, if a country is bankrupt, if it has neither gold nor foreign assets, if foreigners will not accept its currency, and transactions are therefore not affected, debits will still equal credits. The fact of continuous balance thus

> offers not the slightest presumption of stability in a given situation and no means of evaluating that situation. Behind its facade may lurk all degrees of instability or breakdown." [6]

On the other hand, a statement to the effect that a group of persons who have, through larger current expenditure than receipts, depleted a portion of their liquid reserves or incurred some debts - such a statement is certainly of greater analytical value and is probably in closer accordance with the use of the term equilibrium. It has therefore been customary to divide the balance o f payments into the balance on current account and the balance on accommodating account. The relationship between the two is one of reverse equality. In other words if the current account develops a favorable balance equal to X, the accommodating account develops an adverse balance equal to -X .

The distinction between the above two types of balances may be drawn according to the type of payment induced by each. The accommodating account consists of payments "which take place only because the other items in the balance of payments are such as to leave a gap of this size to be filled. On the other hand, the distinguishing feature of autonomous payments is that they take place regardless of the size of the other items in

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6. A.E. Kahn, op. cit., p.9

the balance of payments."[7] Accommodating payments may be either automatic and unplanned or they may be discretionary and planned. Thus the "changes in the balances of private exchange dealers or the loss of gold reserves by a central bank" are examples of automatic accommodating payments. On the other hand, such payments as the Anglo-American loan of 1946, some payments made under the European Economic Cooperation, and dealings of exchange stabilization funds are planned and discretionary. Autonomous receipts "would contain all normal commercial exports, gifts such as emigrants' remittances or reparations payments which are made for motives quite other than to put the balance of payments into balance as well as all those normal capital movements which are taking place on the initiative of private entreprise because it appears more profitable to invest capital in one country rather than in another."[8]

The above distinction is indicated by the following balance of payments figures for Egypt in the Years 1951 and 1952. The figures are roughly arranged by classifying all items as either completely autonomous or completely accommodating.

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7. James Meade, The Balance of Payments, (London: Oxford University Press, 1951), p.11.

8. Ibid. p.11 .

Table I

The Balance of Payments of Egypt (In £E mil.)

1951 - 1952

	1951		1952	
	Debits	Credits	Debits	Credits
Current Transactions				
1. Visible Exports		201.9		145.6
2. Visible Imports	241.9		210.5	
3. Invisible Exports		90.3		73.1
4. Invisible Imports	65.5		61.6	
Total	307.4	292.2	272.1	218.7
Balance of Trade	15.2		53.4	
5. Net Capital outflow	4.6		2.0	
Total Deficit	19.8		55.4	
Accommodating Transactions				
1. Sterling Balances		54.4		40.1
2. Other Foreign Exchange Holdings	9.9			17.7
3. Monetary Gold	26.6			
4. Non-resident Bankers Account		1.1		0.1
5. Other Accounts and Liabilities		0.8	1.9	
6. Errors and Omissions			0.6	
Total Balance of Payments Accommodating		19.8		55.4

Source: National Bank of Egypt, Economic Bulletin, Vol.VI, No.2, 1953, p.94 .

The balance of payments is said to be in equilibrium if, over a period of time autonomous payments and receipts balance without the need to resort to accommodating finance. This equilibrium condition is satisfied only when the government does not avoid a deficit (or a surplus) by adopting some internal deflationary (or inflationary)policy, or by imposing additional restrictions on payments and trade. To the extent that the government interferes in the payments mechanism, the actual deficit (or surplus) is likely to be smaller than the potential deficit and the amount of accommodating finance required is thus reduced. The amount of accommodating finance reflected in the balance of payments of Egypt above, namely £E 19.8 million in 1951 and £E 55.4 million in 1952 does not reflect the potential deficit in the balance of payments. Measures of exchange control, commercial policy and fluctuating exchange rates tended to reduce the potential deficit.

The term equilibrium should also be related to a definite duration of time. If the period defined is very short, such as a week or a month, equilibrium will be maintained by considerable fluctuations in exchanges and a minimum amount of accommodating finance. It will also imply considerable instability in the export and import trades and greater erratic movement of prices.

Under such conditions speculative activities may intensify this instability and may even effectively prevent the attainment of equilibrium in the balance of payments. Evidently, then, the term balance of payments equilibrium does not imply continuous equilibrium but rather equilibrium over a certain period of time defined in terms of such factors as the degree of fluctuation in the balance of payments and the availability of foreign exchange.

C. Importance of Balance of Payments Equilibrium

For developing economies, such as the Arab countries, equilibrium in the balance of international payments is of special importance for internal stability and for the planning of developmental projects. The problem of international equilibrium in such countries is inter alia to arrive at the correct investment ratio (or expansion ratio)[9] so that the direct and indirect increase in imports due to the investment does not exceed the foreign exchange resources made available by exports and long

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9. The above analysis is taken from J.J. Polak, "Balance of Payments Problems of Countries Reconstructing with the Help of Foreign Loans". Polak defines the "maximum expansion ratio" as the actual ratio of the rate of investment over the initial rate of capital inflow. This is equal to $1 - c\,(1-m)/m$, where (c) stands for the marginal propensity to consume, and (m) stands for the marginal propensity to import. In a country where both (c) and (m) are large, a condition which is probably true of all Arab countries, the maximum expansion ratio will tend to be small. To illustrate let (c) = 0.5 and (m) = 0.45, the maximum expansion ratio will then be equal to 1.6. With (c) = 0.4 and (m) = 0.3, the maximum expansion ratio will be equal to 2.4 .

term borrowing abroad. If expansion is allowed to proceed at so rapid a rate that it will give rise to a demand for foreign exchange which is far in excess of the quantities available, the government will be forced to resort to measures which will restore equilibrium in the balance of payments but which are likely to result in the instability of investment expenditure and in considerable contraction of trade. However, while this tendency for over-expansion creates some balance of payments problems which are of a cyclical nature, the main problems which it poses are primarily secular in nature. The implications of this distinction on commercial policy and on regional economic and financial cooperation will be discussed in chapter IV below.

D. Tendencies for over-expansion in the Arab World

Indeed, there is much reason to believe that the Arab world as a whole is susceptible to this tendency for over-expansion which makes for a heavier investment expenditure than is justified by the availability of foreign exchange. This may be due to the following reasons of which the first is a universal one:

1) Banks, individuals and governments invariably plan their expenditure without taking account of the secondary effects of such expenditures. To the banks net acquisitions of foreign exchange are likely to be considered as permanent additions to reserves and thus

to justify a short-run expansion of credit which will in the long-run involve the country in balance of payments problems.[10] However, neither commercial banks nor individuals can, even if they would, plan their action in such a way as to take account of the indirect effects of such action. It remains for the central bank or the government to perform that function. Yet it is doubtful whether the governments of the Arab countries realize and plan for such secondary effects. To illustrate, the Iraqi government assigned to the Board of Development all the oil revenues to be used for developmental projects.[11] Subsequently, budgetary and balance of payments difficulties compelled the government to reduce this ratio to 70 per cent of the royalties and to use the remaining 30 per cent to discharge current obligations.

2) The tendency for over-expansion in the Arab countries may also be due to the great emphasis placed on the role of capital in economic development. In fact, there seems to be some confusion in public opinion between the technical aspects of economic development and economic development in general.[12]

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10. J.J. Polak, op. cit., p. 467 .

11. IBRD Mission to Iraq, The Economic Development of Iraq, (Baltimore: Johns Hopkins Press, 1952), p.169.

12. Even some U.N. experts were implicitly guilty of this misconception. Vide U.N, Measures for the Economic Development of Under-Developed Countries, May 1951 and S.H. Frankel's criticisms of the book "United Nations Primer for Development" in the Quarterly Journal of Economics, August 1952.

With the problem of economic development thus inordinately simplified, capital imports will inevitably be elevated in the hierarchy of social desiderata. The living standard becomes thus uniquely correlated with capital goods and the desire for economic development is immediately interpreted in terms of increased capital imports. It is therefore inevitable that the desire for rapid economic development will under the above conditions create a persistent disequilibrium in the balance of payments.

3) The desire to build up strong and well equipped armies further intensifies the balance of payments problems of Arab countries. Considerable amounts of the foreign exchange resources have thus to be set aside for the importation of armaments and of other military equipment.

E. Balance of Payments Adjustment

Nevertheless, whatever the causes or nature of the disequilibrium in the balance of payments, they must bring into operation corrective measures adequate to restore equilibrium. The adjustment mechanism may be largely automatic or may require a considerable degree of discrectionary action. The following are the main corrective measures:

1) Transfer of purchasing power and/or change in short-term balances held against foreign countries.

2) Measures of exchange control.

3) Restrictions on trade.

4) Fluctuations in the exchange rates and price movements.

5) Inflationary or deflationary policy.

The effectiveness of each of the above five measures in dealing with a balance of payments disequilibrium depends on such factors as the causes and nature of the disturbance, the magnitude of the deficit or surplus, the availability of foreign exchange and other liquid reserves, the frequency and regularity of the disturbance, and the terms of trade.

The transfer of purchasing power and the change in short-term balances held against foreign countries is probably the first measure which operates to correct a balance of payments disequilibrium. This device is adequate to maintain equilibrium in the balance of payments against minor discrepancies, seasonal fluctuations and even cyclical fluctuations provided that the country is possessed of a sufficient volume of international liquidity to iron out such fluctuations and that over a sufficiently long period the total deficits do not exceed or fall short of the total surpluses in order that the country's international reserves will not be subject to a persistent drain. The availability of international reserves will render superfluous the application of other

corrective measures on account of either seasonal or cyclical fluctuations.

However, if either for the lack of sufficient reserves or because the disequilibrium is persistent, equilibrium in the balance of payments cannot be maintained by the mere transfer of international reserves, other means of adjustment have to be applied. The transfer of purchasing power itself implies the application of other corrective measures such as the availability and conditions of credit. Such measures will come into operation or become more active once the international reserves of a country are drained to a dangerously low level.[13]

Restrictions on foreign trade and exchange control are measures applied by the government in an attempt either to attain equilibrium in the balance of payments or to preserve equilibrium by directly interfering with the flow of goods and payments. Such restrictive measures are resorted to in order to avoid the deleterious effects of other means of adjustment such as a deterioration in the terms of trade; or they may be resorted

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13. It will be noted that the discussion in the text of the thesis is conducted mainly in terms of a deficit rather than a surplus country. This procedure seems to be preferable for exposition purposes, because the system of international finance is not symmetrical in operation and seems to suffer from "an inherent bias towards deflation". Adjustment problems are therefore more distinct in the case of a deficit country than in the case of a surplus country.

to if adjustment by other means will either take a long time or be subject to constant speculative movements. In this connection, inter-war experience indicates that equilibrium in the balance of payments is very difficult to attain if short-run capital movements are not subjected to some sort of control. The effort on the part of foreigners and nationals to withdraw capital in large quantities is likely to result in a pattern of exchange rates which does not reflect underlying cost and demand conditions.[14] To attain equilibrium in the balance of payments under such conditions of short-run speculative capital movements, measures of exchange control will be more effective than either fluctuating exchanges or monetary and fiscal policy.

In the absence of destabilizing short-term capital movements exchange rate adjustment is a sufficient device to bring about equilibrium in the balance of payments through its effects on prices and incomes, provided that the elasticities of demand for imports and supply of exports are large.[15]

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14. P.T. Ellsworth, The International Economy, (New York: Macmillan, 1950), p. 515 .

15. If the elasticity of demand for imports and the elasticity of supply of exports are both low, a greater measure of exchange adjustment will be necessary to bring about equilibrium in the balance of payments. In fact, under some conditions of export and import elasticities, adjustment of the exchange rates should work in a reverse order to bring about equilibrium. In other words, a deficit in the balance of payments calls for appreciation rather than depreciation of the currency.
    Under such conditions, measures of exchange control are likely to prove more desirable politically than wide fluctuations in the exchange rates.

To the Arab countries import and export prices are not flexible, because the whole area accounts for only a small share of world commerce and cannot by its own action affect the prices of the goods it exports or imports.[16] Price flexibility is therefore brought about by fluctuations in the exchange rate.

However, the resort to exchange rate adjustment in dealing with balance of payments problems implies the use of criteria according to which a certain rate of exchange is deemed as an equilibrium rate. The definition of an equilibrium rate of exchange and the criteria that should be taken into consideration both for the determination of such a rate and for its adjustment whenever conditions are materially changed forms the subject of the following section.

II. Problem of the Exchange Rates

A. Definition of the Equilibrium Rate

The period following World War I witnessed a spirited controversy on the conceptual and operational definition of the equilibrium rate of exchange and on the causes for the fluctuation of exchange rates. During the twenties and early thirties, the controversy

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16. Petroleum and dates are the only goods which the Arab countries produce in sufficiently large quantities compared to world production.

centered on the purchasing power parity theory which Gustav Cassel had revived from earlier writings and propounded in explanation of the equilibrium rate of exchange. The theory was then generally accepted despite the fact that numerous modifications were introduced into it. This widespread acceptance may be ascribed to the following reasons: first, the theory is extremely useful though it yields only rough conclusions. However, conditions in Europe during the early twenties were such that a rough doctrine was useful in throwing light upon such problems as inflation, budgetary deficits, and balance of payments problems. Secondly, purchasing power parity lends itself to easy calculation, and thirdly, the theory is highly plausible and easy to understand.[17]

1) Purchasing Power Parity Theory

To define the rate of exchange, Cassel goes behind balance of payments criteria to relative changes in the price level. Abstracting from all other conditions, the equilibrium rate of exchange is defined as that rate which will equate the purchasing power of currencies. Thus, suppose that an Egyptian pound will buy nine times as much goods in Egypt as a Lebanese pound will buy in Lebanon, then the parity between the two currencies

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17. A.I. Bloomfield, "Foreign Exchange Rate Theory and Policy", from the New Economics, (London: Dennis Dobson, 1949), p. 294 and also P.T. Ellsworth, op. cit., p.589

will be LL. 9 = £E 1. Suppose that a sudden movement of capital from Egypt to Lebanon makes the exchange rates LL. 8 = £E 1. This means that goods worth nine Lebanese pounds could be purchased for one Egyptian pound in Egypt; hence traders will make a profit margin from conducting trade along these lines. The demand for Egyptian pounds and the supply of Lebanese pounds will consequently increase until the parity between the two currencies approaches equilibrium again.

Because purchasing power parity is measured by price indices, only relative changes in exchange rate equilibrium can be measured, thus

$$R_p = R_e \times \frac{P_1}{P_2}$$

Where (R_p) stands for purchasing power parity between two currencies, (R_e) stands for the equilibrium parity, and (P_1, P_2) stand for the relevant price indices in the two countries.

2) Criticisms of Purchasing Power Parity Theory

Though accepted by most economists during the twenties, purchasing power parity theory was subjected to heavy criticism by some. Thus in his Tract on Monetary Reform, Keynes maintained that:

1) The theory is a "truism and as nearly as possible jejune" if applied to the goods which enter international trade only.[18]

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18. A.I. Bloomfield, Ibid., pp.294-95

2) If applied to the general price level, then the theory rests on the implicit assumption that the prices of goods and services which do not enter international trade move in the same direction and to the same extent as the prices of internationally traded goods. That a lack of parallelism is possible and even probable arises from the existence of such forces as shifts in the demand for certain commodities, capital movement, labour efficiency, and government action. "There is no reason", wrote Pigou in 1922, "to expect that the prices of the various sorts of non-traded and partially traded goods will bear the same ratio to the prices of traded goods in different countries."[19]

3) Purchasing power parity theory implies that the sequence of causation runs from prices to exchange rates and ignores the possibility that the sequence may also work in reverse.[20]

The theory was also criticized on the following grounds:

4) Once it is admitted that not only goods which enter international trade are to be included in the computation of the price index, the question arises as

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19. A.C. Pigou, "The Foreign Exchanges", Quarterly Journal of Economics, Vol. 36, 1922, quoted by P.T. Ellsworth, op. cit., p.594 .

20. A.I. Bloomfield, Loc. cit., p.295

to where to draw the line in order to derive the relevant price index. Should the price index be a wholesale or a cost of living index and what are the goods and weights that should be used to construct it. Furthermore, the mere averaging of prices into a price level index may not yield the significant criterion. Rather the dispersion and relative movement of the components of this average may be more important. However, such difficulties do not detract from the conceptual validity of purchasing power parity. They affect its operational validity only.

5) Probably the main criticism levelled at purchasing power parity theory is that it fails to take items other than merchanidse trade and services into consideration. Notably, it leaves out of account short-term and long-term capital movements. Such payments do not arise out of differences in price levels, but rather out of such factors as political stability, remuneration on capital investments, and speculation.

6) Purchasing power parity ignores trade restrictions which have a distorting effect on prices and exchange rates. It is the type of trade restrictions which affect trade irrespective of the price level which detract from the validity of purchasing power parity theory.

3. Keynes's Definition of the Equilibrium Rate

Owing to the above defects purchasing power parity

theory was finally discarded[21] and a new concept of the equilibrium rate of exchange was defined in terms of the balance of payments.[22] Keynes defined the equilibrium rate:

> "We have to consider, on the one hand, a country's balance of payments on income account on the basis of the existing resources, equipment, technique and costs (especially wage costs) at home and abroad, a normal level of employment, and those tariffs, etc. which are a permanent feature of national policies; and on the other hand, the probable readiness and ability of the country in question to borrow or lend abroad on long-term (or, perhaps, repay or accept repayment of old loans), on the average of the next few years. A set of rates of exchange which can be established without undue strain on either side and without large movements of gold (on a balance of transactions) will satisfy our condition of equilibrium."[23]

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21. An attempt was made by Stackelberg to revive purchasing power parity theory and free it from its most objectionable tenets, and specially by introducing capital movements into the argument. He maintains that "the rate of exchange will settle at that point at which the movement of liquid and investment capital reach equilibrium." Vide H. Stackelberg, "The Theory of Exchange Rates Under Perfect Competition" International Economic Papers, No.1 (London: Macmillan, 1951).

22. The shift from a theory of exchange rate equilibrium exphasizing the effect of prices to one emphasizing the effect of income and employment was in accord with the general trend of economic thinking during the thirties. Purchasing power parity theory rests on the implicit assumption that there is considerable flexibility in prices. But owing to the increased rigidities in wage levels and to the increased emphasis placed on internal stability, this assumption became more unrealistic . However, in its attempt to go beyond supply and demand to the forces which give rise to trade, this theory is probably superior to the balance of payments theory, but its choice of the price level as a single determinant of exchange rates is not very realistic. The theory of exchanges should rather be integrated more completely with the theory of international trade.

23. J.M. Keynes, "The Future of the Foreign Exchanges", Lloyds' Bank Monthly Review, October 1953, p.528 quoted by A.I. Bloomfield, loc. cit., p.296

In dealing with such problems as exchange rate adjustment, the application of commercial policy measures and of exchange regulations, Keynes's definition of the equilibrium rate of exchange was adopted throughout the present paper, though not to the exclusion of price and terms of trade criteria. Indeed, the paucity of balance of payments statistics in the Arab Middle East makes it necessary to rely on criteria which, theoretically, may not be the most relevant or most satisfactory.

B. Criteria for the Practical Determination of the Equilibrium Rate

While it is possible from the foregoing discussion to define the equilibrium rate of exchange, the practical problem of determining that rate remains unsolved. This problem, however, does not lend itself to a theoretical solution. The equilibrium rate must be arrived at and constantly modified by a process of trial and error which takes the following factors into consideration:

1) The volume of international liquid reserves available in the country is very important in determining the equilibrium rate and specially the short-run rate. In fact, the volume of international liquid reserves available could be used as a guide for adjusting the exchange rate provided that a study of seasonal and cyclical movements in the balance of payments is made.

2) The degree of fluctuation in the balance of payments on current account also determines the equilibrium rate. If such fluctuations can be covered by the transfer of international liquidity, they need not result in an adjustment of the short-run equilibrium rate of exchange.

3) Whether the foreign exchange market is free or controlled affects the equilibrium rate of exchange. In a controlled market any rate of exchange could be made an equilibrium rate by manipulating international payments in order to realize a balance on current account. An equilibrium rate could also be enforced by restricting trade rather than payments. In other words, the government could make a rate of exchange an equilibrium rate by either restricting trade and/or by restricting payments so that the total demand for the national currency equals its total supply seeking foreign exchange at the desired rate .

4) The flexibility of prices, wages, and costs also affect the equilibrium rate of exchange. A disturbance in the balance of payments brings into play an adjustment mechanism of which changes in the exchange rates are only one aspect. Greater fluctuations in the exchange rate will naturally be called for to restore equilibrium if the whole burden of adjustment falls on the exchange rate. And the greater the ease with which other means of adjustment

are made to operate, the smaller will the fluctuations in the exchange rates be.

5) The flow of long-term capital has also to be taken into consideration in determining the equilibrium rate of exchange. This entails a study of the flow of foreign capital in or out of the country, the forms in which it is held in the country, the regularity of this flow, and the effect of capital movement on the other items of the balance of payments.[24]

The determination of the long-run and short-run equilibrium rates of exchange of a group of countries is necessary for the successful functioning of a regional multilateral payments union. Such a union can deal with the latter type of exchange rate equilibrium, reducing its fluctuations and minimizing its adverse effects on domestic stability. But a currency which in the long-run is either overvalued or undervalued will create balance of payments problems which lie beyond the scope of a payments agreement.[25] Among such problems may be mentioned the tendency for a member country to run a persistent deficit or surplus and the consequent deflationary or inflationary problems it creates for the other members of the payments union.

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24. Vide, J.P. Younge, "Exchange Rate Determination", American Economic Review, September 1947, pp.589-95.

25. Such complications will be discussed in connection with the description of a payments agreement for the Arab Middle East presented in Chapter V below.

C. The Need to Stabilize the Exchange Rate

The need to minimize the degree of short-run fluctuations in the exchange rates is specially felt in the Arab countries for the following reasons:

1) International trade constitutes a large proportion of the economic activity of Arab countries. A disturbance in the rest of the world sector will therefore have considerable repurcussions on the whole economy.[26]

2) Fluctuations in the exchange rates imply considerable fluctuations in a country's terms of trade and probably in its gain from trade.

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26. The statement is often made by some economists that trade constitutes a large proportion of the economic activity of underdeveloped countries. This thesis was at first unguardedly reiterated in the present paper. An attempt to verify it empirically, however, proved that the thesis is somewhat too ambitious. As can be seen from Appendix I, there is no necessary relationship between the degree of development of a country and the relative importance of foreign trade in it.

This may be illustrated with the help of the following simplified diagram

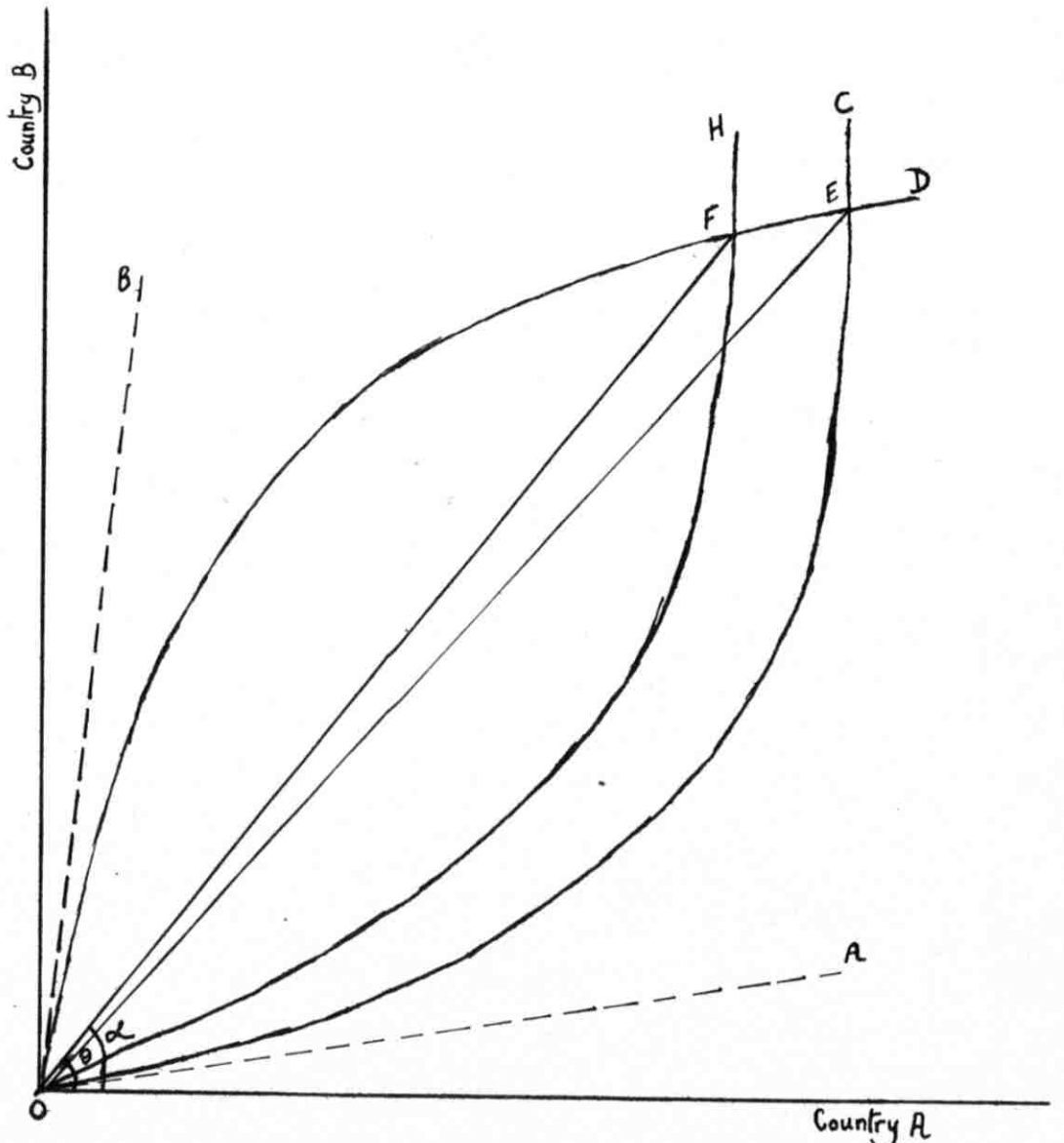

Figure 1

Assume that countries A and B have only commodities X and Y to exchange and that they produce under conditions of constant cost represented by the straight lines OA and OB. OC and OD are the offer curves of

of countries A and B respectively . Equilibrium is attained at E where the rate of exchange of Y for X is equal to tangent θ. Suppose that the currency of country A appreciates in value. In the absence of perfect price flexibility, the offer curve of country A must shift to the right such as OH. The terms of trade consequently move in favor of country A. (Since $\angle\theta > \angle\alpha$ tan.θ > tan. α) But due to the contraction in the volume of trade country A need not gain by the improvement in its terms of trade.

Fluctuations in the terms of trade may in turn result in disequilibrium in the balance of payments and in temporary and wasteful dislocation of trade .

3) Fluctuating exchanges are a disturbing factor in resource allocation. To illustrate, a fall in the exchange rates makes imports less desirable than import competing goods and thus creates a tendency for the reallocation of resources from import industries to import competing industries. But if the fluctuation in the excahnge rate is only seasonal or cyclical, forces working for the reallocation of resources in a reverse tendency will soon exert an opposite pressure.

The foregoing discussion will indicate the importance of exchange rates for a country whose foreign trade constitutes a large proportion of its economic activity. Alternative exchange rate policies and measures are, therefore, likely to be vital issues to a large sector

of the business population. Furthermore, it seems that a stable or preferably an appreciating currency has become a source of national pride in the Arab Middle East. The misconception seems to hold fast in Arab public opinion that a policy which results in an appreciating currency is *per se* a superior policy. Consequently, any scheme which deals with matters of exchange policy touches on delicate political issues. The policy which it proposes must therefore be generally acceptable.

III. The Case for Stable Exchanges

A. Fixed VS. Flexible Exchange Rate; Historical Set-up

Taken out of its specific historical context the controversy over fixed versus fluctuating exchange rates deteriorates into a mere array of the advantages and disadvantages of alternative exchange rate policies. The controversy is very old. In fact, the issues it poses were debated during every period of major economic disturbance in modern Europe and were clarified during the period following the Napoleonic wars. It was during this period, and in the face of falling prices, that some economists started to advocate an internally stabilized and, if necessary, an inconvertible paper currency. Thus in 1817 Attwood recommended " 'an inconvertible paper currency issued by the government and its quantity regulated through open market purchases and sales of its own securities... Regulation of the amount of the

currency should be intrusted to a legislative commission and should be carried out not by laws of maximum and minimum but by judicious legislative operations upon the issue of bank notes or other national paper' ".[27]

It is interesting to note that Attwood is here recommending a system with stated rules and a more liberal dose of "judicious legislative operations".[28] He was among the first to show skepticism in the automatic functioning of the gold standard. However, the current trend of thinking in this respect, which included Ricardo, Malthus and James Mill was one of adherence to the gold standard. It was asserted that "attempts to stabilize the value of money beyond what metallic money would do of itself.... were impracticable and were straining after unattainable perfection."[29]

The main issue was thus whether a fixed exchange standard (such as the gold standard) or the inconvertible paper exchange standard was the superior system in

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27. Jacob Viner, Studies in the Theory of International Trade, (London: Harper, 1937) p.213.

28. It is interesting to note the agreement between Attwood, writing in the early 19th century, and such contemporary writers as Mints and Simons. "Our problems," writes Simons in his 'Rule versus Authorities in Monetary Policy", "is that of defining an adequate monetary system based on simple rules and on finding the way toward such a system . We cannot seek merely to return to some arrangement of the past... Such a system is attainable through economic reconstruction, only by years of careful planning and wise legislation."

29. J. Viner, op. cit. p.214 .

maintaining domestic economic stability. This issue was left unsettled, because the adherents to the gold standard denied the existence of any conflict between external and internal stability by assuming a system of highly flexible prices and a high degree of mobility of resources.[30]

The above issues again became the subject of a heated controversy after World War I. In the Tract on Monetary Reform Keynes called attention to the conflict between internal and external stability. He advocated a flexible system of exchanges stabilized in the short-run by a wider spread in the value of gold and by central banking operations to buy and sell "forward exchange at reasonable premiums or discounts on the spot quotation."[31]

In the Treatise on Money Keynes again maintained that changes in the exchange rates are preferable to correct a foreign balance (B) over foreign lending (L) provided that (B) rather than (L) is in disequilibrium. Otherwise, variations in bank rates will be more effective. It is also preferable to vary the exchange rates in cases of temporary disequilibrium, because they act quickly and directly provided that adverse expectations do not defeat such a policy.[32]

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30. Lloyd Mints, Monetary Policy for a Competitive Economy, (New York, McGraw-Hill, 1950), p.90 .

31. A.I. Bloomfield, loc. cit., p.298 .

32. J.M. Keynes, A Treatise on Money, (London: Macmillan, 1930), pp. 359-61.

In the General Theory Keynes stood for a stable general level of employment and fluctuating exchange rates in order to maintain equilibrium with the rest of the world. However, the General Theory was only indirectly concerned with problems of an open economy. It remained for other economists to use the tools employed there to clarify this problem.[33] On the whole the impact of the theory of employment was to shift emphasis from the problem of price stability to that of income stability. This necessarily widens the area of economic policy from the purely monetary field to all aspects of fiscal and other stabilization policies.

The divergence of opinion on this matter and the atmosphere of discussion it created "tended to gravitate towards an intermediate system under which exchange rates would be held stable in the short-run" but adjustable over the long run.[34]

B. Case for Stable Exchanges

Stable exchanges are maintained by the transfer of

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33. Of the economists who contributed most to the clarification of this issue may be mention Ragnar Nurkse in the League of Nations' International Currency Experience and in the "Conditions of International Monetary Equilibrium", Fritz Machlup in the International Trade and the National Income Multiplier, James Meade, Abba P. Lerner, Lloyd Metzler, J.J. Polak, and Joan Robinson.

34. A.I. Bloomfield, loc. cit., p.301 .

means of payment between a country and the rest of the world or by restrictions on trade and payments. Fluctuating exchanges, on the other hand, obviate the need for such transfers by immediately changing the prices of imports and exports. Thus both systems have the same aim, namely, to achieve equilibrium in the balance of payments. But while fluctuating exchanges act directly and may be adequate to correct a persistent disequilibrium stable exchanges are more roundabout and can, in the absence of price flexibility, correct only seasonal or cyclical disequilibria.

The case for a system of short-run stable exchanges rests on a few advantages which such a system has over a system of freely fluctuating exchanges. First, fluctuating exchanges introduce a further risk element into the prices of internationally traded commodities. The prices of such commodities have therefore to be sufficiently high to cover the risk premium, and if exchange rates fluctuate considerably, the risk premium may be high enough to act as a deterrent to international trading activity. This is specially important in the case of the staple commodities such as livestock and cereals in which trade operates at a narrow margin of profit.

The presence of a well organized exchange market will make possible forward transactions in exchange and thus keep the risk to a minimum.[35] But with the exception

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35. Frank Taussig, Principles of Economics, Vol. I, (New York: Macmillan, 1943, 4th edition), p. 420.

of Beirut, the exchange markets in the Arab countries are not developed and lack the necessary organization which would enable them to deal in forward exchanges. This fact is recognized by the Syrian exchange stabilization authorities:

> "The Syrian authorities have attempted to create an exchange market in Syria and to encourage banking and financial activities in order that Syrians will not have to resort to foreign exchange markets to effect transactions in foreign exchange. The weakness of the Syrian exchange market is ascribed to two main causes:
>
> 1. The nearness of Beirut, which has become an international money market for foreign exchange and gold, and
> 2. The lack of financial facilities and of specialized institutions in the Syrian exchange market capable of absorbing and financing foreign exchange transactions."[36]

Secondly, it is often maintained that the movement of capital is facilitated under a system of stable exchanges and hampered under a system of fluctuating exchanges. Fluctuating exchanges introduce a further risk for capital movements and check the transfer of purchasing power by allowing greater variations in the prices of imports and exports. It is however doubtful whether much weight could be attached to the above argument for a system of stable exchange rates. Under

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36. Syria-Ministry of Finance, First Annual Report on the Operations of the Exchange Office for 1952, Damascus, April 1953. (In Arabic. The parts quoted were translated by the author).

present world conditions, political and economic instability are more potent deterrents to international investments than a system of freely fluctuating exchanges. Moreover, capital movements which result from discrepancies in the balance of payments are not necessarily desirable. They may represent capital flight due to uncertainty and speculation and may result in considerable instability of the balance of payments. Besides, it is not necessary that countries which are poor in capital resources should be the ones which develop deficits in their balance of payments and thus receive capital. The reverse could equally be true. To the extent that fluctuating exchanges will check such capital movements, they have desirable effects. Yet it is doubtful whether a system of fluctuating exchanges is at all efficient in checking capital flight. On the other hand, fluctuating exchanges may check such desirable short-term lending which is made to take advantage of higher discount rates or to obviate the necessity for adjustment under circumstances not representing fundamental disequilibrium.[37]

Thirdly, it has often been asserted that a system of fluctuating exchange rates will prevent or greatly reduce the transmission of economic fluctuations among countries while a system of stable exchange rates insures

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37. Lloyd Mints, op. cit., pp.100-1

external stability at the cost of internal stability. "Few nations, if any, will nowadays endure a severe deflation or inflation just for the sake of a stable exchange parity. It is only as a result, and not at the expense, of domestic economic stability that we may hope for some stability in international currency relations as well."[38]

While it is greatly correct that a system of fluctuating exchanges insures greater domestic stability, it will be a case of misplaced emphasis to draw the distinction between the two systems on this basis, specially with respect to countries where international trade accounts for a large proportion of economic activity, such as the Arab countries. Fluctuating exchanges will also entail considerable domestic instability via fluctuations in the terms of trade.

It will probably be labouring an obvious point to emphasize the fact that a system of stable exchange rates is not an end in itself.[39] The term equilibrium has unfortunately acquired some moral value and is no more a strictly neutral term. Exchange stability may rule under

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38. Ragnar Nurkse, "Domestic and International Equilibrium," The New Economics, (London: Dobson, 1949) p. 281.

39. The fact should be noted that stability does not imply the rigidity of exchange rates. Stability means that once correctly valued, the value of a currency will not be changed except to correct a fundamental and persistent disequilibrium.

conditions of stagnation as well as under conditions of prosperity. It is the conditions which lurk behind any exchange stability that are significant. The question of exchange stabilization is, therefore, whether stability is attained at the cost of specialization and the efficient allocation of resources or by fostering specialization.

The case for exchange stability in the Arab Middle East rests, not so much on the fact that it eliminates risks which impede commodity and capital movements, as it does on the fact that it is a necessary condition for regional economic integration and specially a payments agreement. A payments agreement functions according to an assumed stable pattern of exchange rates. But if actual conditions are such that exchange rates are so unstable as to make the payments agreement untenable, the arrangement will become unacceptable to some members and thus exposed to the danger of liquidation.

Chapter III

Trade and Payments in the Arab Middle East

The present chapter includes a study of trade and payments in the Arab countries and of the impact of the international financial mechanism on the Arab economies. A brief description of Arab trade will be followed in Section II of the present chapter by a discussion of the payments problems arising out of trade and capital movements. Finally, measures introduced to deal with such problems will be discussed in Section III. Emphasis will be placed on exchange control and exchange stabilization in the different Arab countries.

I. International Trade Activities in the Arab World

The impact of the international financial mechanism on the different countries of the world is usually of greatest consequence in those countries where international trading activities account for a considerable proportion of their total economic activity. The effect of external forces is further intensified if a country accounts for a small proportion of total international trade. The Arab Middle East belongs to both groups of countries. Exports from the region are not only an important source of income to them but are also probably the major source of fluctuation in their economies, but

also their share in the total volume of world trade is so small that they can exert but little influence on the prices of the internationally traded goods which they produce.[1]

While the paucity of balance of payments statistics and of national income data in the Arab Middle East prevents a detailed comparison of international trade activities with overall economic activity, a study of trade statistics, including the fluctuations in trade activities and prices, the commodity and geographic composition of trade, and the terms of trade is very illuminating.

Composition of Trade: Probably the main characteristic of the international trading activities of the Arab countries is that their exports consist mainly of a few primary products. This fact could be seen most clearly from a study of the export figures of Egypt between the years 1939 and 1952 presented in Table 2 below.

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1. The main exports of the Arab countries are petroleum, cotton, textiles, and cereals. With the exception of petroleum, their total production of the remaining products is so small compared to total world production that they cannot, by their own action, produce any appreciable effect on world prices. The unsuccessful attempt made by the Egyptian government in 1951-1952 to support the prices of Egyptian cotton- which is even a somewhat differentiated product- is a case in point. With regard to petroleum, however, the price policy is not in the hands of the Arab governments.

Table 2

Value of Cotton and Other Exports from Egypt in £ E 1,000

1939 - 1952

Year	Value of Cotton Exports	Value of Total Exports	Percentage of the Value of Cotton Exports to Total Exports
1939	24,330	34,081	71.4
1945	32,173	41,630	77.3
1946	46,218	63,681	72.6
1947	69,335	85,978	80.6
1948	113,327	140,741	80.4
1949	106,089	135,875	78.1
1950	149,756	172,959	86.6
1951	164,101	200,640	81.8
1952	126,413	142,852	88.5

Source: National Bank of Egypt, Economic Bulletin, Vol. VI, No. 3, 1953, p.319.

It will be seen from Table 2 above that cotton exports constituted over 80 per cent of the total value of commodity exports between 1945 and 1952. Furthermore, this percentage showed an upward trend between 1939 and 1952. In 1939 it stood at about 71.4 per cent of total exports, then rose to a level of 86.6 per cent in 1950 and to 88.5 per cent in 1952.

In Iraq and Saudi Arabia petroleum constitutes the main export commodity. Thus in 1937-1938 petroleum and products accounted for over 65 per cent of the total

exports of Iraq. Barley and dates accounted for about 6 per cent of the value of exports each. In 1949 petroleum accounted for about 51 per cent of total exports, barley for about 20 per cent and dates for about 12 percent.[2]

The exports of Syria and Lebanon show greater diversity than the exports of the remaining Arab countries. The largest group of commodity exports from Lebanon are agricultural and animal products which accounted for about one third of the total value of commodity exports in 1952, and textiles which accounted for a little over one fourth the value of exports. However, the whole visible exports of Lebanon account for a small proportion in the balance of payments.

The exports of Syria show a somewhat similar though less diversified composition than those of Lebanon. Agricultural and animal products accounted for a little over one fifth the total value of exports in 1951, and textiles and apparel accounted for about 7 per cent of the value of exports. Table 3 presents figures on the composition of exports from Syria and Lebanon.

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2. Economic Cooperation Administration, The Sterling Area-An American Analysis, (London 1951), p.404.

Table 3

The Composition of Exports from

Lebanon and Syria

	Lebanon 1952		Syria 1951	
	Exports in LL.1000	Percentage of Total Exports	Exports in LS.1000	Percentage of Total Exports
1. Agricultural and Animal Products	26,251	33.9	58,705	21.2
2. Textiles and Apparel	21,266	27.5	19,351	6.9
3. Metals and Products	6,999	9.0	2,163	0.8
4. Instruments and Electrical Machinery	3,585	4.6	756	0.3
5. Minerals and Products	2,094	2.7	513	0.2
6. Transportation Equipment	949	1.2	38	-
Total Exports	77,430		277,134	

Source: Lebanon, Ministry of National Economy, Bulletin Statistique Trimestriel, 1952-1953 and Syria, Ministry of National Economy, Statistical Abstract of Syria 1951-1952.

Table 3 above indicates greater diversity in the composition of Lebanese exports than in the Syrian exports. Thus while items 3-6 above constituted about 17.5 per cent of the visible exports of Lebanon, the corresponding exports

of Syria accounted for a little over one per cent of total exports. This diversity in Lebanese exports will probably become even greater in comparison to Syrian exports if the exports of the two countries are categorized further to show the commodities exported rather than groups of commodities.

However, while the exports from the Arab Middle East consist mainly of a few primary products and specially petroleum and agricultural products, imports to the area are more diversified and consist mostly of manufactured goods including textiles, metal products and machinery. Table 4 presents the main imports into Lebanon and Syria. The figures are given in Syrian and Lebanese pounds at their official rates of exchange.

Table 4

The Composition of Imports into Lebanon and Syria

	Lebanon 1952		Syria 1951	
	Imports in LL.1000	Percentage of Total Imports	Imports in LS.1000	Percentage of Total Imports
1. Agricultural and Animal Products	95,287	30.9	38,729	12.8
2. Textiles and Apparel	47,058	15.3	64,950	21.4
3. Metals and Products	21,283	6.9	22,553	7.4
4. Instruments and Electrical Machinery	26,286	8.5	52,511	17.3
5. Minerals and Products	25,638	8.3	36,219	12.0
6. Transportation Equipment	13,022	4.2	13,144	4.3
Total Imports	308,480		279,596	

Source: Same as Table 3 above

Table 4 shows that agricultural and animal products accounted for one third and one eigth of the imports of Lebanon and Syria respectively. The imports of industrial products included under items 3-6 accounted for about one third of the total imports of Lebanon and about 40 per cent of the imports of Syria.

Imports by Egypt showed a similar though less diversified composition in 1952. The import of agricultural products accounted for a little over one fourth the value of total imports, fertilizers and chemicals accounted for about 9 per cent, minerals for about 8 per cent, and motor cars for about 4 per cent.[3]

The largest imports into Iraq in 1948 were textiles and apparel which accounted for about 21 per cent of total imports, iron and steel which accounted for about 11 per cent, machinery which accounted for about 12 per cent, transportation equipment accounting for about 5 per cent, and sugar accounting for about 7 per cent.[4]

To summarize, the exports from the Arab countries are mostly restricted to a few primary products such as petroleum, cotton, cereals, and dates. On the other hand, imports into the area are more diversified and consist mostly of manufactured products. The problems which this pattern of trade poses for a regional payments union and

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3. National Bank of Egypt, Economic Bulletin, Vol. VI, No.1, 1953, p.35.

4. Economic Cooperation Administration, The Sterling Area-An American Analysis, (London,1951), p.404.

for exchange stabilization will be discussed presently.

Of major importance in this respect is the fact that exports tend to be subject to seasonal fluctuations varying with the agricultural cycle of the main commodities exported. Exports are likely to be concentrated during the months following the harvest and to fall to a low level during the remaining seasons. This seasonal cycle can be seen very clearly from a study of cotton exports from Egypt. The sowing period for cotton in Egypt extends from early February to mid-March. The growing period extends from mid-August to mid-October.[5] Chart 1 presents a three monthly moving average of the quantities of cotton exported from Egypt. In order to eliminate the changes in the quantities exported from year to year, these export figures are expressed as percentages of the yearly exports.

It is evident from Chart 1 that, allowing for some irregularities, cotton exports from Egypt are subject to regular seasonal fluctuations which follow very closely the agricultural cycle of cotton production. Thus, with the exception of 1950, exports reached their lowest level during the last months of the growing season, namely July and August and attained the highest level during the period extending from December to February .

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5. National Bank of Egypt, Economic Bulletin, Vol. VI, No.2, 1953.

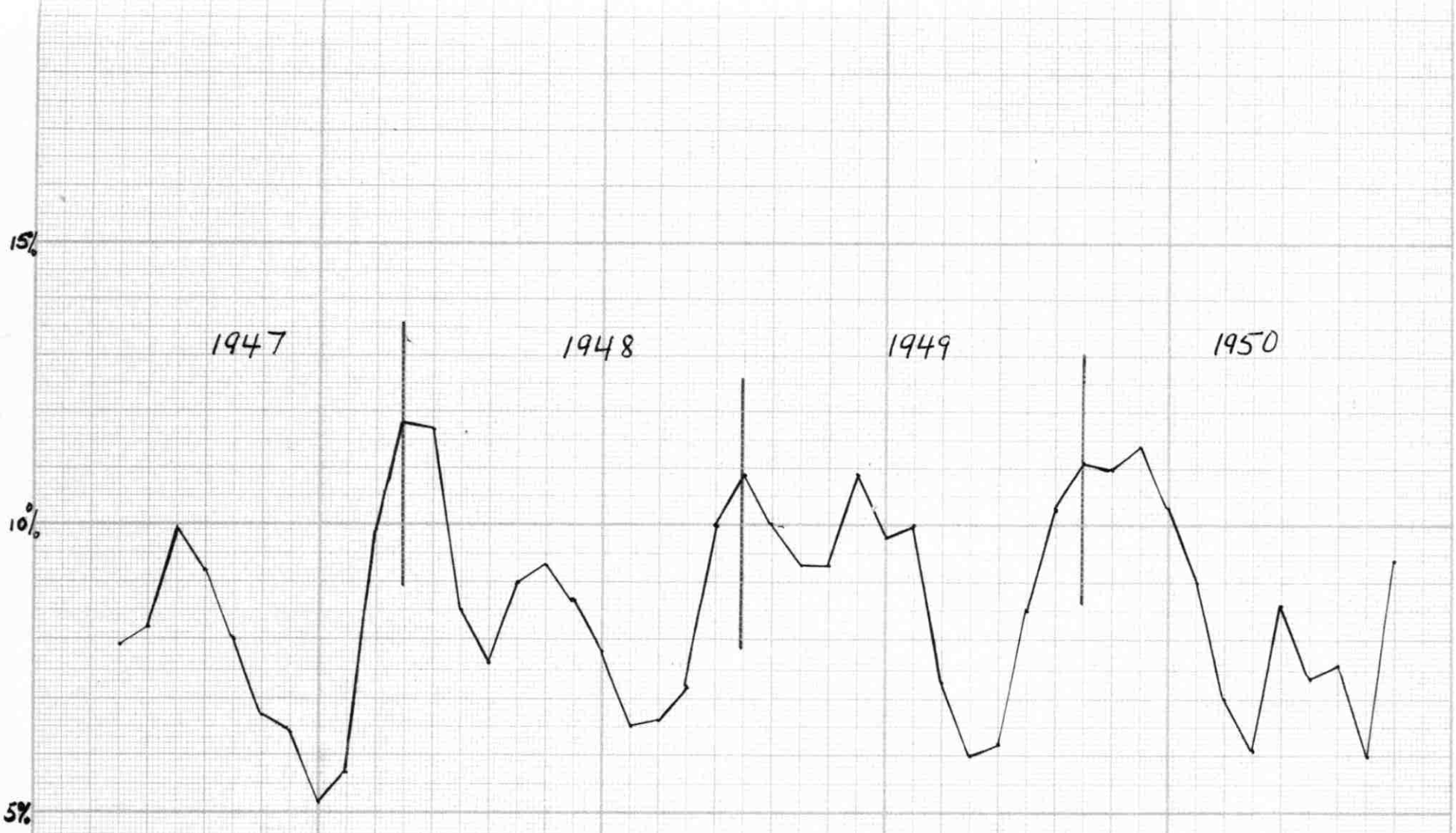

Chart 1. Three Monthly Moving Averages of the Quantities of Cotton Exported from Egypt Expressed as Percentages of Yearly Exports, 1947 - 1950 (Republique D'Egypte, Annuaire Statistique, 1949-1950 et 1950-1951, Le Caire, 1953)

Chart 2 presents three monthly moving averages of the value of cotton exported from Egypt expressed as percentages of yearly exports for the years 1949-1952. It will be seen that the seasonal cycle of the value of cotton exports is more pronounced than the seasonal fluctuations of the quantities exported.[6] This disparity between quantity figures and value figures is attributable to two main reasons. First, since cotton exports which constitute about 80 per cent of the total exports are subject to this seasonal cycle, the demand for and consequently the value of the Egyptian pound in terms of other currencies will be subject to similar fluctuations.[7] A period of heavy cotton exports, for example, results in a rising exchange rate for the Egyptian pound and therefore rising prices for cotton in terms of the local currency. The reverse is equally true for periods of low cotton exports. Secondly, the price of cotton and the quantities exported are closely related. High cotton prices call forth larger exports and low prices result in a decrease in exports. With both

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6. The irregularity in the quantities of cotton exports during the latter half of 1950 is due to the boom in cotton prices following the outbreak of the Korean War.

7. Since imports are less diversified, they are subject to a much lesser degree of seasonal fluctuations. This will create a disparity between the demand for and the supply of Egyptian pounds in the foreign exchange market during the various seasons.

Chart 2. Three Monthly Moving Averages of the Value of Cotton Exported from Egypt Expressed as Percentages of Yearly Exports, 1949 - 1952 (National Bank of Egypt, Economic Bulletin, Vols. IV-VI, 1951-1953)

quantities and prices thus moving in the same direction, the value of exports will show greater fluctuations than either the quantities exported or their prices.

The need to maintain equilibrium in the balance of payments against seasonal fluctuations is felt by some Arab countries, specially Egypt and Syria. In Egypt, the Egyptian Cotton Commission was established in order to provide the Egyptian cotton market with additional capital and storage facilities, while in Syria stabilization against seasonal fluctuations is made the function of the Syrian Exchange Bureau, which was established in 1952.

A further implication of this pattern of trade on international payments for the Arab countries is that fluctuations in the prices of one of the main export commodities will have a great effect on both the terms of trade and national income. Undoubtedly, the more diversified a country's exports and imports are the smaller will the effect of variations in one commodity be on over-all economic activity. In the extreme case, if the prices and composition of imports were assumed constant and exports consisted of one commodity only, then the relationship between the terms of trade and the price of that commodity will be direct and proportional.

Table 5 below shows the relationship between the terms of trade and cotton prices in Egypt for the years 1950-1952.[8] The price terms of trade is here computed by dividing the price index of exports by the price index

8. The prices are those of Karnak "good" cotton which accounts for about a half of the total value of cotton exports from Egypt. See N.B.E., Economic Bulletin.

of imports. The gain from trade index is computed by multiplying the price terms of trade by an average of the quantity import and export indices, thus:

$$\text{Gain from Trade Index} = \frac{e_{p1}}{ip_1} \times \frac{eq_1 + iq_1}{2}$$

where (e) stands for exports, (i) for imports, (p_1) for the price index during the year, and (q_1) for the quantity index during the year.[9]

Table 5

Cotton Prices and Terms of Trade in Egypt

1950 - 1952

Year	Price Indices		Quantum Indices		Price Indices of Karnak "good" Cotton	Price Terms of Trade	Gain from Trade
	Imports	Exports	Imports	Exports			
1950	100	100	100	100	100	100	100
1951	114	158	100	74	117	139	121
1952	136	120	75	68	45	88	63

Source: National Bank of Egypt, Economic Bulletin, Vol.VI No.1 pp.37 and 71.

Though conclusions based on estimates obtained for three years only are mostly unwarranted, it is nevertheless interesting to note the close relationship between the

9. See Jacob Viner, Studies in the Theory of International Trade, (New York: Harper, 1937) p.563.

price of cotton and both the terms of trade and the gain from trade between 1950 and 1952.[10] Between 1950 and 1951 the price of cotton increased by about 17 per cent and the gain from trade increased by about 21 per cent. Cotton prices in 1952 fell to 45 per cent the level of 1950 prices and the gain from trade fell to 63 per cent the level of 1950. The reasons for this disparity is that other prices did not fall as sharply as did cotton prices.

Fluctuations in the prices of cereals and petroleum are probably as important for the economies of the other Arab countries as are fluctuations in the prices of cotton for Egypt. The prices of petroleum probably do not fluctuate as violently as the prices of cotton and some other agricultural products. The stabilization of the prices and production of such commodities would therefore be very effective in stabilizing payments, the exchange rates, and incomes. But because the Arab countries are small producers compared to total world production, they cannot by their single action stabilize the prices of their main exports. Table 6 below presents the production figures of a few important commodities produced by the

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10. In a way, the column on the gain from trade is somewhat misleading. It gives the impression that the relationship between the terms of trade and the gain from trade can be readily established and that the latter lends itself to easy calculation. Admittedly, the issue is still a controversial one; but for the purposes of the present paper this controversy could be avoided by adopting the formula used above.

Arab countries as compared to total world production.

Table 6

Production of a Few Products by Arab countries as Compared to Total World Production in 1950

(1,000 tons)

Product	World Production	Production by Arab Countries	Percentage of total World Production
Wheat	143,000	2,500	1.7
Maize	131,000	1,400	1.0
Barley	46,000	1,300	2.8
Rice	150,000	1,500	1.0
Cotton	5,400	440	8.0
Crude Petroleum	486,000	56,000	12.0
Crude Petroleum 1951	550,000	80,000	15.0

The petroleum figures include Bahrein, Kuweit, Qatar, Saudi Arabia, Iraq and Egypt. All other figures are exclusive of Saudi Arabia and Yemen and include only the remaining Arab League countries.

Source: United Nations Statistical Office, Statistical Yearbook, 1952. For Lebanon the figures are from National Income of Lebanon, Monograph No.1, the Agricultural Sector. The figures on Syria are taken from the Statistical Abstract of Syria, 1951-1952. For Jordan and Iraq the figures were taken from Economic Research Institute Reports on Agricultural Credit.

It is seen from Table 6 above that in the production of cereals Arab countries account for such a small proportion of total world production that they cannot produce any appreciable effect on world prices. On the other hand, though Arab countries have a greater degree of control over the prices of cotton and petroleum, it is doubtful whether their share of total world production is large enough to make the exercise of this control at all practicable. Furthermore, the control which Arab governments can exercise on the production of agricultural produce is greatly restricted by the fact that agricultural production is subject to considerable uncertainty on account of climate conditions and that it does not respond readily to changes in prices and demand conditions.[11]

Direction of Trade: An attempt was made in the preceding section to discuss some of the problems which arise out of the composition of trade. In the present section some of the problems arising out of the direction, or geographical composition, of trade will be discussed. Tables 7, 8, and 9 and 10 present trade figures obtained for Syria, Lebanon, Egypt, and Iraq classified by countries of origin and destination.

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11. T.W. Schultz, Agriculture in an Unstable Economy, (New York: McGraw-Hill, 1945), passim.

Table 7

Syria's Exports and Imports Classified by Countries of Origin and Destination (L.S. 1,000)

1951

	Exports	Percentage of Total Exports	Imports	Percentage of Total Imports
Arab League Countries	107,794	38.9	54,690	18.0
France	50,353	18.2	31,727	10.4
U.S.A.	37,362	13.5	55,514	18.3
United Kingdom	19,522	7.0	38,945	12.8
Italy	14,493	5.2	21,225	7.0
Turkey	3,498	1.3	16,097	5.3
Western Europe	2,799	1.0	16,922	5.6
Total	277,134		303,951	

Source: Syria, Ministry of National Economy, Statistical Abstract of Syria, 1951-1952, Damascus, 1953.

Table 8

Lebanon's Exports and Imports Classified by Countries of Origin and Destination (in 1,000 LL.) 1952

	Exports	Percentage of Total Exports	Imports	Percentage of Total Imports
Arab League Countries	37,283	48.2	90,529	29.3
U.S.A.	6,907	8.9	48,009	15.6
United Kingdom	4,279	5.5	30,663	9.9
France	3,666	4.8	26,708	8.7
Italy	3,361	4.3	12,497	4.1
Holland	117	-	5,267	1.7
Total	77,430		308,480	

Source: Lebanon, Ministry of National Economy, Bulletin Statistique Trimestriel, 1952-1953.

Table 9

Egypt's Exports and Imports Classified by Countries of Origin and Destination

(£E 1,000) 1951

	Exports	Percentage of Total Exports	Imports	Percentage of Total Imports
Arab League Countries	4,789	2.4	9,270	3.3
United Kingdom	38,571	19.2	41,927	15.0
India	29,883	14.9	5,424	1.9
France	19,725	9.8	20,282	7.3
U.S.A.	19,507	9.7	65,146	23 .3
Italy	16,161	8.1	15,665	5.6
Japan	14,670	7.3	1,208	0.4
Czechoslovakia	9,524	4.7	2,101	0.8
Germany	8,710	4.3	9,798	3.5
Total	200,639		279,596	

Source: Ministère des Finances et de L'économie, Annuaire Statistique 1949-1950 et 1950-1951, 42ème et 43ème années, Le Caire, 1953, pp.852-3

Table 10

Iraq's Imports and Exports Classified by Countries of Origin and Destination

(I.D. 1,000) 1952

	Exports	Percentage of Total Exports	Imports	Percentage of Total Imports
Arab League Countries	2,726	15	2,630	4
United Kingdom	6,737	36	23,163	37
Europe	2,248	12	10,917	16
India	1,224	7	2,440	4
U.S.A.	491	3	11,330	18
Total	18,776		61,872	

The Arab League figures include Egypt, Syria, Lebanon, and Jordan only. The figures on Europe include Belgium, Czechoslovakia , Germany , Italy and Netherlands only.

Source: UNRWA, Quarterly Bulletin of Economic Development, No.9, 3rd quarter, 1953, Statistical Appendix, p.23.

On the basis of the above tables and on information obtained for other Arab countries, it is possible to classify these countries into three groups with reference to the geographic pattern of their trade. The first group includes such countries as Syria and Lebanon which have very strong trade relations with other Arab countries. The trade of these countries with the United States and Western Europe is also very large though it ranks second to their regional Arab trade.

Table 7 shows that about 40 per cent of the Syrian exports went to other Arab countries while only about 20 per cent of its imports came from other Arab countries. Syrian exports to other Arab countries exceeded its imports therefrom by a little over L.S. 60 million.

Table 8 shows that imports from all other Arab countries constituted about 30 per cent of total Lebanese imports while exports to other Arab countries constituted about a half of Lebanon's exports on commodity account. In this respect, the U.S.A. ranked second, the United Kingdom ranked third, and France ranked fourth. It should be noted, however, that until March 14, 1950, Syria and Lebanon constituted one customs union and that their trade with Arab countries as given in Tables 7 and 8 is largely trade between them.

The second group includes those countries in which inter-Arab trade constitutes only a small proportion of

their over-all trade. This group, which includes Egypt and Libya, has the closest trade relations with other areas, specially the United States, the Sterling area and Western Europe. Table 9 thus shows that Egyptian trade with the other Arab countries accounted for a little over 2 per cent of the total exports and over 3 per cent of the total imports. On the other hand, Egyptian trade with the United States accounted for about 23 per cent of the total imports and 10 per cent of the exports; trade with the United Kingdom accounted for about 19 per cent of the exports and 15 per cent of the imports; trade with India accounted for about 15 per cent of the exports and 2 per cent of the imports; and trade with three O.E.E.C. countries (France, Italy, and Germany) accounted for about 22 per cent of the exports and 16 per cent of the imports.

Finally, countries such as Iraq, Jordan, and Saudi Arabia may be classified as a third group. Their trade relations are closest with non-Arab countries, primarily the United States and England, but unlike Egypt, inter-Arab trade constitutes an important proportion of their over-all international trade activities. Thus Table 10 shows that in 1952 about 36 per cent of the exports of Iraq went to the United Kingdom, about 12 per cent went to a few European countries, 7 per cent to India, and about 3 per cent to the United States. On the other

hand, Jordan, Syria, Egypt, and Lebanon imported about 15 per cent of the total exports of Iraq.[12] Of the total imports of Iraq about 37 per cent came from the United Kingdom, 16 per cent from a few European countries, and 18 per cent from the United States. Imports from a few Arab Middle Eastern countries accounted for about 4 per cent of the total imports.[13]

The foregoing discussion indicates that the importance of inter-Arab trade varies considerably from one Arab country to the other. The need for a regional payments union will also vary.

II. Balance of Trade and Payments Problems:

From a study of international trade figures and of the available balance of payments statistics, the following observations are made with reference to international payments in the various Arab countries:

1) Commodity imports tend to exceed exports from the various Arab countries. Table 10 below presents import and export figures for Syria and Lebanon during the period 1938-1951 inclusive. Since the value of imports are converted into Syrian or Lebanese pounds

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12. Figures for 1949 were obtained and they show a similar pattern. See Economic Cooperation Administration, The Sterling Area-An American Analysis, (London,1951), p.417.

13. Import figures for Jordan in 1950 were obtained. They indicate that the largest proportion of Jordan's imports come from the United Kingdom and that all other Arab countries together rank second in this respect.

at their official rates which are lower than their market rates while the value of exports is given at the market rates of exchange, the excess of imports over exports is deflated. This correction will strengthen rather than detract from the validity of the arguments presented here.

Table 11

Value of Goods Imported and Exported from Syria and Lebanon 1938-1951

	Value of Imports into Syria and Lebanon in LS. 1,000 Million	Value of Exports from Syria and Lebanon in LS. 1,000 Million	Excess of Imports over Exports in LS. 1,000 Million
1938	71	39	32
1939	76	37	39
1940	57	19	38
1941	41	11	30
1942	107	24	83
1943	110	32	78
1944	94	46	48
1945	131	44	87
1946	267	86	181
1947	263	84	279
1948	483	79	404
1949	516	111	405
1.1.50 to 13.3.50	117	38	79

	Syria LS. Million	Lebanon LL. Million	Syria LS. Million	Lebanon LL. Million	Syria LS. Million	Lebanon LL. Million
13.3.50 to 31.12.50	198	245	208	67	-10	178
1951	304	321	277	98	27	223
1952		308		77	[illegible]	231

As from March 14, 1950 the Customs Union between Syria and Lebanon was terminated.

Source: Lebanon, Ministry of National Economy, Bulletin Statistique Trimestriel, Vols. I-III, Syria, Ministry of National Economy, Statistical Abstract of Syria, 1951-1953.

It is evident from Table 11 that between 1938 and March 13, 1950 the combined import surplus for Syria and Lebanon amounted on the average to about 75 per cent of the total imports. In other words, exports covered only one fourth of the total value of imports. Trade figures secured for the period subsequent to the termination of the customs union between the two countries show that while the ratio of exports to imports does not change in the case of Lebanon, the corresponding ratio for Syria is about equal to one.

Similarly, Egyptian trade figures for the years 1945 to 1951 inclusive show a persistent import surplus averaging about 25 per cent of the total imports.[14] The trade figures of Iraq for the three years 1947 to 1949 also show a deficit amounting to about 46 million dinars, or a little over one third the total value of imports during the same period.[15]

This aspect of Arab trade, namely, the tendency for the various countries to develop a persistent import surplus on account of their commodity trade is ascribed to two main causes. First, Arab countries are susceptible to over-expansionist policies which result in a persistent disequilibrium in the balance of payments.[16] Secondly,

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14. National Bank of Egypt, Economic Bulletin, Vol.VI, 1953. Trade with the Sudan is excluded.

15. Economic Cooperation Administration, The Sterling Area - An American Analysis, (London, 1951),p.417.

16. This problem was discussed in chapter II above.

it seems that whenever balance of payments problems impose on the government a restrictive trade policy, the imports of services are more readily restricted than the imports of tangible goods.

The presence of a large import deficit on commodity trade account is necessarily covered by an export surplus of invisible trade, or by a net capital influx, or by accommodating transactions. However, since the deficit described above is persistent, it is unlikely that the adjustment in the balance of payments is brought about with the help of accommodating transactions. It will therefore be admitted that the deficit on commodity trade transactions reflects the magnitude of long-term capital inflow and the export surplus arising from invisible trade. Thus in Lebanon the yearly deficit on visible trade account exceeds LL. 300 million which, in the absence of additional restrictions on trade and payments, indicate the presence of a corresponding surplus on invisible trade and the capital accounts.

2) The United States is the most important source of imports for many Arab countries but is not the most important export market for the same countries. This is true of Syria, Lebanon and Egypt. It seems that despite the fact that sizeable dollar payments are made to a few Arab countries on account of petroleum exports, the Arab Middle East as a whole does suffer from a problem of dollar shortage. An indication of the nature of this problem

can be seem from Table 12 below which presents figures on the distribution of foreign exchange resources and gold in Egypt.

Table 12

Spot Assets of Foreign Exchange and Gold of All Egyptian Banks (in £ E million) 1951 - 1953

	29.12.1951	27.12.952	28.3.953	29.8.953
Sterling No.1 a/C	23.9	6.3	18.1	21.4
Sterling No.2 a/C	196.2	173.7	164.0	164.0
Gold	60.6	60.6	60.6	60.6
U.S. and Canadian Dollars	37.4	20.8	19.3	11.6
Other Currencies	12.3	10.9	10.7	12.0
Total	330.4	272.3	272.7	269.6

Source: National Bank of Egypt, Economic Bulletin, Vol.VI, 1953.

It is evident that the ratio of dollar assets to total foreign exchange and gold assets available at all Egyptian banks was falling between 1951 and 1953 and reached a low level of 4 per cent at the end of August 1953. Should such a low percentage of dollar resources be compared with the trade figures, it will reveal that while in 1951 total

imports from the United States amounted to about £E 65 million, exports to the same country amounted to about £E 20 million. In other words, while trade with the United States amounted to about 20 per cent of total Egyptian trade in 1951 and the trade deficit with the same country amounted to a little over on half the total trade deficit, dollar resources which amount to about 5 per cent of the total foreign exchange resources seem to be small. This deficit, however, was partially covered by an export surplus to other dollar area countries - mainly Japan -[17] and partially by dollar acquisitions from other countries and by the liquidation of a part of the dollar resources. Imports from the American monetary area were sufficiently curtailed in 1952 to reduce the deficit to a mere £E 2.7 million.[18] Nevertheless, dollar reserves declined by about £E 16.6 million of which about £E 11 million were utilized in the settlement of multilateral deficits chiefly with Switzerland, the United Kingdom, and Canada.[19]

It is however probable that aside from capital inflow the problem of dollar shortage is common to all the countries of the Arab Middle East. The gap in dollar

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17. The total proceeds of exports to other dollar area countries amounted to £E 14.2 million in 1951. Of these £E 12.2 million came from Japan. The payments for imports amounted to £E 10.7 million of which £E 4.3 million were made to Japan. See National Bank of Egypt, Economic Bulletin, Vol. VI, No.2, 1953, p.102.

18. Ibid., pp.104-106

19. Ibid., p.103

acquisitions on current account is in some countries covered mostly by capital inflow, but is in most Arab countries covered by the imposition of restrictions on trade with the American monetary area and the liquidation of dollar reserves accumulated during the World War and during the recent boom following the Korean War.

The problem of dollar shortage has profound implications for any regional payments agreement in the Arab Middle East, especially as the intensity of the problem and the degree of exchange control practised in the area differ widely from country to country. Pending a fuller discussion of the problem in chapter V below, some of its implications on a payments union may be mentioned here in passing. The first is that regulations concerning payments and specially dollar payments will tend to gravitate to a uniform pattern for all countries concerned. This will involve considerable changes in the monetary and exchange control systems. Secondly, restrictions on trade with members of the payments union must be modified in order to prevent, among other things, the carrying out of three cornered transactions which are detrimental to the financial position of some members of the payments union. The necessity thus to tighten trade regulations will be contradictory to the basic objective of a payments union. Thirdly, it involves

for some countries the substitution of foreign exchange earnings from a soft currency area for earnings from hard currency areas. Fourthly, as it is very unlikely that the intensity of the dollar shortage will be uniform for all countries concerned, any plan for pooling dollar resources, even if initially accepted, will not be very stable.

3) A large proportion of the foreign exchange reserves of the Arab countries accrue directly to the governments on account of petroleum exports. Thus the direct payments made by oil companies to the governments of oil producing countries in the Arab Middle East in 1952 amounted to about $ 440 million. Furthermore, this source of income has been increasing sharply since the last fifteen years. It increased from about $ 11 million in 1940, to about $ 27 million in 1946, to $ 60 million in 1948, to $ 150 million in 1950, $ 240 million in 1951, and then to $ 440 million in 1952.[20]

It should however be noted that this revenue is not evenly distributed over the whole region. It accrues almost exclusively to three countries only, namely, Iraq, Kuweit, and Saudi Arabia. Thus in 1952 these countries together received about 95 per cent of the total royalties while Egypt, Bahrein and Qatar received the remaining 5 per cent.

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20. U.N.O., Review of Economic Conditions in the Middle East, 1951-52, Department of Economic Affairs (New York: March, 1953), p.59. The figures on petroleum include Bahrein, Egypt, Iraq, Kuweit, Qatar and Saudi Arabia.

In addition to the royalties paid to the various governments, the petroleum companies spend large sums on wages, services and supplies thus providing Arab countries with a further source of foreign exchange. In 1949 such expenses amounted to about 6.4 million dinars (about $19 million) dinars in Iraq, $ 20 million in Saudi Arabia, $ 19 million in Kuweit and Bahrein, and about £E 1 million in Egypt. In Syria it was estimated that the local expenditure and direct payments by the oil companies amounted to about LS. 55 million (about $ 15 million) of which LS. 17 million (about $ 4.5 million) was met from the proceeds of petroleum sale for local consumption.[21]

From the foregoing discussion two conclusions become eminently clear. The first is that the petroleum industry, which is an export industry, is probably the most important source of foreign exchange in the Arab countries. The major part of this revenue accrues directly to the governments. Secondly, this revenue is very unevenly distributed over the whole region.

III. Exchange Control and Exchange Stabilization in the Arab Middle East

Broadly defined, the term exchange control signifies "every form of intervention on the part of the

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21. loc. cit.

monetary authorities... aiming at interfering with the tendencies affecting exchange rates."[22] Such a broad definition of exchange control is, however, too wide to be useful. It will in fact comprise all types of exchange control irrespective of their purpose, their severity, or the degree of their interference in the price mechanism.

It is therefore found necessary in analyzing the measures of exchange control and exchange stabilization practised in the Arab countries to distinguish between the different systems of exchange control, taking into consideration the severity of the measures, their purpose, and their departure from a liberal system. Accordingly five types of exchange control are distinguised below :

1) Controls restricted to mild interference in the exchange market and directed to the elimination of speculative activity in exchanges and at ironing out sharp variations in exchange rates. This type of control was practised by the British monetary authorities after the establishment of the British Exchange Equalization Account in 1932 and is now practised by such countries as Switzerland and the United States. The system of exchange regulations now operating in Lebanon conforms most closely to this type of control.

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22. Paul Einzing, Exchange Control, (London, Macmillan, 1934), pp. 9-10.

2) The second type of control is that which aims at protecting the currency against loss of value arising out of capital flight. This type of control involves the restriction of capital movements and sometimes the monopolization of foreign exchange resources in the hands of the government. However, because capital flight can be brought about in many ways, of which the transfer of purchasing power is only one, measures of this type of control would normally lead to stricter control over trade and international transactions.

Exchange control measures practised in Syria at present are a mixture of the first and second types of exchange control. The monetary authorities aim at protecting the Syrian currency against loss of value arising from capital flight but do not exercise any monopoly power over the foreign exchange resources of the country. The Syrian monetary authorities work on the assumption that the main cause for capital flight from Syria is the fact that the Syrian currency is subject to a considerable degree of seasonal fluctuations. Stabilization against such fluctuations will therefore greatly reduce capital flight.

3) The third type of exchange control exists when the government fixes prices for foreign currencies and prohibits all dealings outside of such prices. This usually entails the monopoly of foreign exchange resources or strict supervision of transactions which involve the

use of foreign exchange. In its broad outlines this type of control is practised in Iraq, Jordan, and Egypt.

4) The fourth type of exchange control is similar to the third in outward form, but differs from it in the appropriate policy required to adjust equilibrium. If adjustments can be brought about by the imposition of restrictions on capital movements, this type of control may be classified as the third type. But if adjustment requires the imposition of restrictions on credit, adjustment of costs of production, and changes in the level of economic activity, these methods may be classified as the fourth measure of exchange control. This type of exchange control is probably not practised by the Arab countries.

The distinction between the above two methods of exchange control lies in the underlying conditions which bring about disequilibrium in the balance of payments. If such conditions can be remedied by a change in the regulations affecting capital movements and exchange rates, then the system of control is less severe than under conditions which require either a readjustment of costs or changes in the level of economic activity.

5) The culminating phase of exchange control is attained when it is used as a weapon of commercial policy or even as a tool for the excercise of political control. This type of control does not differ from the rest in the severity of the measures applied, but rather in the purpose for which exchange control is resorted to.

A good example to this system of exchange control is found in the system of multiple exchange rates devised by Germany during the thirties and used to discriminate against certain countries.[23] This type of exchange control is now very uncommon and is not used in the Arab world.

It is possible in the light of the foregoing classification to describe more clearly the systems of exchange control and exchange stabilization practised by a few Arab countries. Unavoidably, however, the following analysis cannot be systematic.

Syria and Lebanon: Exchange control was introduced into Syria and Lebanon in 1939, when a Bureau of Foreign Exchange was established and placed under the direct control of the High Commissioner for Syria and Lebanon.[24] In 1944 the Bureau was handed over to the Syrian and Lebanese governments and was entrusted by them to the Banque de Syrie et du Liban. This parallel development of the system of exchange control in Syria and Lebanon was terminated when, in February 1948, the Lebanese government signed the monetary agreement with France while the Syrian government later signed a separate agreement.

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23. Howard Ellis, Exchange Control in Central Europe (Cambridge: Harvard University Press, 1941), pp.3-6

24. Order 336/LR, March 3, 1939.

In Syria Legislative decrees No.91 and 92 were immediately promulgated, on February 10, 1948. It was stipulated that the administration of the Foreign Exchange Bureau will be left with the Banque de Syrie et du Liban and that a Committee for Foreign Exchange Control be created and attached to the Ministry of Finance. On the 10th of October 1949, the Foreign Exchange Fund was established and endowed with the main function of dealing in gold and foreign exchange for government purposes.[25]

This multiplicity of institutions without any clear definition of their functions resulted in some confusion and in considerable inefficiency. Consequently, the need was felt for a complete overhauling of the system of exchange control. To this need the government responded by issuing Legislative Decree No. 208, which was promulgated on April 21, 1952. The provisions of this law will be discussed presently.

Exchange control in Syria passed through the following stages. Between December 3, 1939 and August 12, 1948 there was almost complete control over foreign exchange transactions. In other words, exporters were required to sell their foreign exchange acquisitions to the exchange control authorities at the official rate,

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25. Legislative Decree No. 55, 10 October 1949.

while importers were required to obtain import licenses which entitled them to a certain amount of foreign exchange at a specified rate. This made it possible for the government to practise a system of multiple exchange rates and thus to discriminate against some imports and exports, a power which was often grossly abused.[26]

The period extending from the 12th of August 1948 to the 26th of September 1949 witnessed a considrable liberalization of foreign exchange transactions. Control was in general discontinued over the largest proportion of trade, but was maintained over a few currencies only and over a few imports and exports. At first exporters were required to sell at the official rate 20 per cent of their foreign exchange acquisitions to the authorities. Subsequently, this ratio was reduced to 10 per cent.

The period extending from the 27th of September 1949 to the 2nd of May 1950 was one of full freedom in all foreign exchange dealings which were made on account of normal trade transactions. The export of foreign exchange and Syrian currency was strictly prohibited. But close upon the termination of the Customs Union with Lebanon, additional restrictions on foreign exchange transactions were imposed. It was made necessary that the value of a few commodities exported to such currency

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26. Syria, Ministry of Finance, First Annual Report on the Operations of the Exchange Office for 1952 (Damascus, April 1953), p.8 .

areas as the dollar, the sterling and the Swiss franc should be repatriated within a period not exceeding six months from the date of export. Yet the exporter was given full freedom to dispose of this foreign exchange in the open market.[27]

Complete reorganization of the system of exchange control in Syria was attempted by the government in April 1952, when it promulgated Legislative Decree No.208. This law created the Bureau of Foreign Exchange and abolished all other institutions dealing in the regulation of foreign exchange. The Bureau was invested with the following functions:

1) To stabilize the foreign exchange rate of the Syrian pound against all fluctuations deemed detrimental to the international financial position of Syria;

2) To act as intermediary for the government in all public transactions in gold and foreign exchange;

3) To hold the official reserves of gold and foreign exchange; and

4) To administer on behalf of the government all clearing, payments, and capital movement agreements concluded between Syria and foreign countries.[28]

Aside from these organizational changes in the system of exchange control the law introduced little

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27. Ibid., pp. 10-11

28. Ibid., p. 13

changes into the actual measures of exchange regulation. In fact, the government had noted that because the Syrian currency was subject to seasonal fluctuations and the Syrian exchange market lacked the banking institutions and facilities which are capable of absorbing the foreign exchange during the seasons of heavy exports, the Syrian exporter was not repatriating completely the value of his exports. Indeed, the pull which the Beirut money market excercised on the Syrian trader greatly hampered, so it seemed to the government, the development of an organized money market in Syria. This resulted in some capital flight from Syria and in considerable evasion of exchange control regulations. The objectives desired from the establishment of the Bureau of Foreign Exchange are therefore three-fold:

1) To strengthen the Syrian money market by increasing the facilities available for financing the foreign exchange resources accruing to residents;

2) To stabilize the Syrian pound mainly against seasonal fluctuations, specially as such fluctuations tend to produce some capital flight from the Syrian money market to the nearby Beirut market; and

3) To consolidate and make effective the regulations instituting a free money market in Syria with the hope that such a market will provide foreign investors with sufficient security to make them invest their capital in Syria.

It is rather contradictory that paternalism in state economic policy should be made the mainspring of a liberal money market. In its attempt to develop the national economy the Syrian government overlooked the simple fact that a free money market is the result of suitable political, economic and social conditions and cannot be simply legislated into existence. The following paragraph, taken from the First Annual Report of The Bureau of Foreign Exchange illustrates this implicit indecision between paternalism and the desire to create a liberal money market:

> "In as much as the law reserves for the banks and for the exchange dealers all transactions in foreign exchange, it also imposes upon them honesty in performing that which is entrusted to them. Such institutions should administer the exchange regulations faithfully and treat their customers with consideration; consequently, they should prepare schedules of the commission, expenses, and interest rates which they charge for their services as financial intermediaries and must submit such schedules to the Bureau of Foreign Exchange for approval." [29]

Lebanon: Foreign exchange regulations enacted by the Lebanese government since February 1948 did not differ materially from the regulations introduced by the Syrian government. But while both governments aimed at the creation of a free foreign exchange market, conditions in Lebanon were far more favourable for the

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29. Ibid., p.15 .

attainment of that end. In the first place, Lebanon enjoyed a greater degree of political stability than did Syria. Arab exporters and importers, therefore, deemed it more secure to hold their liquid funds in Lebanon rather than in their own countries. Furthermore, financial institutions in Lebanon were more organized than their counterpart in the remaining Arab countries and thus afforded traders with greater facilities than they could get elsewhere in the region. Secondly, the general economic policy which the Lebanese government followed was more consistently liberal than the policy adopted by the Syrian government. In fact, in Lebanon more than in any other Arab country, foreign exchange transactions were thoroughly, though gradually, freed of all restrictions.[30] Thirdly, the phenomenal development of the petroleum industry in the Arab Middle East, coupled with the fact that the standard of education in Lebanon is higher than in any other neighboring Arab country made of Beirut a most suitable locality for the various foreign companies which had interests in the Arab Middle East. Fourthly, Lebanon is, culturally, a center of diverse educational, religious and social organizations emanating from all over the world. It is furthermore a refuge for people who are compelled to

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30. Of special importance in this connection are Decree No. 13532 of November 5, 1948 authorizing the creation of a free money market in Lebanon and Decrees No. 7393 of January 26, 1952 and No. 8300 of May 17, 1952 which made capital movements in and out of Lebanon free of all restrictions.

leave their countries, either on account of political creed or of religious belief. Moreover, as a tourist country, Lebanon attracts people from different parts of the world and specially from the Middle East. Whatever its merits or demerits are, the welter of ideas which this social structure creates prevents the development of extreme nationalism in economic policy. Fifthly, Lebanon relies heavily on imports and particularly on food imports. While in itself this may not be very important, yet it has considerable psychological implications on the formulation of the economic policy of the country. The difference between Lebanon and Syria in this respect is somewhat akin to the difference between England and France during the 19th century. With a more specialized economy which relied heavily on foreign markets for the supply of food and raw materials, England acquired a more cosmopolitan outlook which greatly helped the development of a liberal trade system.[31]

However, a monetary and financial center such as Beirut faces two different types of problems each of

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31. Of course it is not claimed that this is the most important factor affecting commercial policy in 19th century Europe. Such factors as the unequal rate of industrialization and the spread of nationalism were probably more potent forces in shapping the economic policies of the various European countries. Otherwise, the fact that the protectionist movement associated with the name of Friedrick List gathered greatest support in Germany finds no satisfactory explanation.

which affects exchange stability in a peculiar manner. The distinction must be drawn between international acceptance business on the one hand and international deposit banking on the other. The former tends to be roughly self-liquidating whereby a close identity is established between external credits and external debits. If a Syrian merchant, for instance, has a three month bill of exchange accepted by a Lebanese bank, he will increase the supply of Lebanese pounds forthcoming on the exchange market. But three months later, the merchant has to buy back Lebanese pounds up to the value of the bill plus interest and commission charges. Such payments in and out tend to offset each other, except when fluctuations in the volume of business done produce a discrepancy in the two flows. Even then, slight variations in bank rates and some tightening or loosening of credit conditions will be adequate in ironing out fluctuations of this nature. Deposit banking, on the other hand, poses completely different problems. There is no tendency for the external credits and debits to be self liquidating, and as such deposits are affected by political and psychological factors and are freely withdrawable at the will of the depositor, it becomes rather difficult to pair off the purchases and sale of the Lebanese currency. Consequently, to the extent that Beirut becomes an international or regional depo— sit center, exchange stabilization becomes more difficult,

specially during periods when the movement of funds is accentuated. It will become necessary for the monetary authorities to insist upon greater liquidity by the banks and to acquire gold and foreign exchange without a corresponding increase in the credit structure.[32]

Iraq: As from November 1941, all foreign exchange transactions other than those made with the Sterling area were subjected to strict control by the Foreign Exchange Committee, which was then created to administer the system of control. It was stipulated that:

1) No person may buy, sell, borrow, lend, grant, or be granted any foreign exchange or conclude any transaction except through a bank authorized accordingly by the Minister of Finance;

2) No person is allowed to sell or buy from a non-resident of the sterling area any shares or securities before securing a written authorization from the Foreign Exchange Committee;

3) The proceeds of all exports of goods outside of the sterling area should be repatriated within a period not to exceed six months from the date the export license is secured; and

4) All exports or imports of banknotes, postal orders, gold, securities or foreign exchange were

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32. N.F. Hall, The Exchange Equalization Account (London, Macmillan, 1953), pp.85-91.

strictly prohibited unless the Foreign Exchange Committee or the Minister of Finance authorizes such transactions.[33] This provision was extended in 1942 to include bills of exchange, promissory notes, and titles to ownership.[34]

Few amendments to the 1941 law were introduced before 1947. Whatever amendments were made prior to that date were introduced to enforce the control regulations and to render evasions more difficult. In 1947, however, all exchange regulations were made applicable to the sterling area as well.[35] But the multiplicity of amendments and regulations made it desirable to recast the system of exchange control into one law. This law, which incorporated the various regulations and amendments pertaining to exchange control was promulgated on May 9, 1950. It contained only one major change, namely, the powers of the Foreign Exchange Committee were entrusted to the National Bank of Iraq.[36]

It will thus be noted that Iraq has introduced measures of exchange control which, in their severity, surpass those introduced in either Syria or Lebanon

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33. Decree No. 71, November 24, 1941, Official Gazette, No. 1972.
34. Decree No. 14, February 18, 1942, Official Gazette No. 1997.
35. Decree No. 33, July 22, 1947, Official Gazette No. 2496.
36. Decree No. 18, May 9, 1950, Official Gazette No. 2829.

and that while the latter countries have attempted to revert to a more liberal system of payments, Iraq has consolidated its system of control. The reasons for this difference between the three countries are not hard to seek. In the first place, they may be ascribed to the phenomenal expansion of the petroleum industry in Iraq which increased the direct payments made by the petroleum companies to Iraq from about $ 8 million in 1940 to about $ 110 million in 1952.[37] In addition, the expenditure by the oil companies in Iraq showed an almost proportional rate of increase from about 0.5 million dinars in 1938 to about 6.5 million dinars in 1949.[38] To cushion the effects of this sharp increase in exports on the stability of the Iraqi dinar and financial system, the government had to maintain a strict system of exchange control. In the second place, as a member of the sterling area, Iraq is enjoined to maintain such restrictions on its trade and payments as are in accord with the over-all payments position of the whole sterling area.

Egypt: Exchange stabilization in Egypt depends to a large extent on the fluctuation of cotton prices

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37. U.N.O., Review of Economic Conditions in the Middle East, 1951-52, Dept. of Economic Affairs (New York, March 1953), p.59.

38. Economic Cooperation Administration, The Sterling Area - An American Analysis (London, 1951), p.417.

in terms of the Egyptian pound. It will have already been noted from Section I above that the value of cotton exports constitute a little over 80 per cent of total exports from Egypt and that such exports show considerable seasonal fluctuations. However, to understand the problem of exchange stabilization in Egypt one must probe a little further into the conditions of cotton production inthe country.

Egyptian agriculture relies heavily on a highly developed system of irrigation which enables the government, if it so desired, to exercise almost full control over the area of land put under cotton cultivation. In fact, had Egypt been a large world producer of cotton, stabilization of cotton prices at this level would have been most effective. But Egypt does not produce a sufficiently large proportion of the world supply of cotton to make its command over cotton prices at all remunerative.[39] The government has therefore attempted to stabilize the Egyptian pound at a different level. The Egyptian Cotton Commission was established in 1951 and financed out of the issuance of Treasury bills and the floatation of a government cotton loan. It was

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39. In 1952 the Egyptian government did try to fix the area of land put under cotton cultivation to one third the total area of cultivated land. But the main purpose behind this measure was mostly to encourage other lines of production and thus introduce greater diversity in exports and not to support cotton prices.

hoped that the Commission will succeed in performing two main functions. First, since Egyptian cotton is a somewhat differentiated product, the Commission may succeed in supporting cotton prices. Secondly, by providing additional finances and facilities for the holding of cotton stocks, the Commission will help to reduce the seasonal fluctuations in cotton exports and eventually reduce the resulting fluctuations in the external value of the Egyptian pound.

In addition to such measures which purport to stabilize the external value of the Egyptian pound by stabilizing the prices of the main export commodity, the Egyptian government resorts to a strict system of exchange control. It has also endeavoured, more than any other Arab country, to create a network of bilateral trade and payments agreements with other countries.

The first important measure of exchange control was introduced in September 1939 whereby all foreign exchange transactions which were not made for the normal requirements of trade or for personal expenses accepted to the authorities were strictly prohibited. Furthermore, all dealings in foreign exchange were to be channeled through banks duly authorized by the government. To these measures of exchange control, sterling was at first exempted.[40]

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40. Decree No. 109, September 28, 1939, Official Gazette, No. 106.

The promulgation of the above law was inevitably followed by other measures designed to consolidate and render effective its successful application. As of June 1940 exporters were required to submit all export documents to an accredited bank and were put under obligation to repatriate the value of their exports in foreign exchange within a period not exceeding six months from the date of export.[41] In September 1941 all transactions in dollars were prohibited except by permission of the Minister of Finance. Egyptians were further requested to submit to the Ministry of Finance information on the amounts of dollar holdings they own either in Egypt or abroad.[42] A month later transactions in sterling were subjected to the law governing all foreign exchange transactions. The importation and exportation of Egyptian banknotes was also prohibited except by written permission of the Minister of Finance.

The climax in the Egyptian exchange control system was attained in 1945, when a law was passed stipulating that "Any person residing in Egypt, whether an individual or moral person, must pay to the Ministry of Finance, at the official rate of exchange, all what he

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41. Military Proclamation No. 53, June 15, 1940, Official Gazette No. 75.

42. Military Proclamation No.182, September 7, 1941 Official Gazette No.119.

obtains whatsoever, in the form of revenue in foreign currency, whether for his account or for account of any other person."[43] By monopolizing the foreign exchange acquisitions of Egypt, the government hoped to control more completely all international payments in and out of the country.

A limited system of multiple exchange rates was then put into operation by the government whereby importers were sold foreign exchange at rates varying with a schedule of import priorities and subject to a license obtained from the Ministry of Finance.

Subsequently, exchange regulations were considerably relaxed. An area was defined within which payments and receipts for current transactions were made freely transferable. In October 1949, the Egyptian government introduced an important innovation into the system of exchange control. It "devised the system of the export pound accounts through which the Egyptian pound could be freely transferable within an Egyptian transferable account area. The purpose of the new system was to enable essential goods and in particular goods of hard currency origin (which were relatively cheap) to be imported into Egypt either directly or indirectly through intermediate countries which accepted payment

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43. Military Proclamation No. 555, January 11, 1945, Official Gazette No. 5, Article 1.

in Egyptian export pounds."[44]

The use of the export pound, at first restricted to a few countries not including the hard currency areas and the countries with which Egypt had a payments agreement, was later widened to comprise also 75 per cent of the value of exports to the United States, Canada, the American monetary area, and the Scheduled territories.[45]

Very recently, however, (February 1953), the Egyptian government introduced the import entitlement account, which in effect amounted to the introduction of a partially free market for certain currencies. The law creating the import entitlement account stipulated that the proceeds of exports to hard currency areas and to the sterling area should be repatriated and deposited at an accredited bank. The exporter is entitled to utilize this foreign exchange either by importing certain goods specified in the import account list and for which import permits could be obtained from the Ministy, or by selling it to other importers. In case the exporter did not make use of this privilege, it would lapse within a period of six months. This measure, which gave the exporter an entitlement premium on sterling, dollars and other hard currencies was intended to

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44. National Bank of Egypt, Economic Bulletin, Vol.VI No.3, 1953, p.192.

45. Ibid., p. 193.

give a fillip to cotton exports.

It is thus clear that despite efforts to liberalize payments, Egypt still maintains a strict and rather complicated system of exchange control. In explaining this development two facts stand out. The first is that the heavy reliance on a very unstable export commodity requires the application of direct measures of adjustment whenever disequilibrium in the balance of payments develops. Secondly, a large proportion of the foreign exchange reserves of Egypt are in the form of blocked sterling balances (Sterling No. 2 account), which are not available for use as a buffer against seasonal and cyclical fluctuations in the balance of payments. Blocked sterling balances in fact constitute about 60 per cent of the total foreign exchange and gold reserves held by all Egyptian banks.[46] Under such conditions the government must rely more heavily on measures of exchange control in order to pair off the demand for and the supply of the Egyptian pound at stable exchange rates.

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46. National Bank of Egypt, Economic Bulletin, Vols. IV-VI, 1951-1953, sections on "Foreign Exchange".

Chapter IV

The Requirements for a Regional Payments Union in the Arab Middle East

An attempt will be made in the present chapter to study economic conditions in the Arab Middle East with a view to determine the extent to which such conditions are conducive to the establishment of a regional payments union.

The present chapter falls into three sections. In Section I the requirements for the establishment of a regional payments union are discussed, taking into consideration the type and degree of regional integration contemplated, the objectives - both immediate and ultimate - for which the payments union is to be established, and the functions which the payments union will perform.

In the light of the foregoing analysis, prevailing economic conditions in the Arab Middle East will be examined in Section II to determine whether the institution of a multilateral payments union between the Arab countries is at all practicable. In Section III, the need for and importance of a payments union to the Arab countries will be discussed. An attempt will also be made to state clearly the objectives desired from the establishment of such a regional payments union.

I. Requirements for a Regional Payments Union

The fact that a group of countries will contemplate the formation of a payments union only when they have payments problems among themselves is often overlooked in the Arab Middle East. Yet it is a mere platitude that no country will accept the additional responsibilities incumbent on its membership in a payments union unless it does have payments problems which can be dealt with more effectively on a regional basis. It is therefore obvious that the need for the establishment of a payments union will not be felt among countries which have small trade relations between them and where the prospects for the expansion of trade are only slight.

The criterion most relevant in this respect is not of course the absolute value of trade between the payments union countries, but rather the relative importance of trade between them compared to the overall value of their trade relations with the rest of the world. To illustrate, Egyptian trade with the remaining countries of the Arab Middle East is considerable, if measured in value figures. But it constitutes about 3 per cent only of the overall foreign trade activities of Egypt. It is therefore unlikely that Egypt will feel the need to join a regional payments union which involves only a small percentage of its total trade activities.

Aside from political considerations, the foregoing requirement is extremely important for a payments union. For unless trade among the members of a payments union is very large compared to their total trade with the rest of the world; or the prospects for the immediate expansion of trade are considerable, the need for a payments union will not arise.

It is further required for a country to join in a regional payments union that it have balance of payments difficulties with the remaining countries. In other words, every country which joins the payments union should either be a net creditor to some countries and a net debtor to others such that "multilaterization" of net claims leaves it in a state of greater equilibrium with the whole region,[1] or should be subject to seasonal and cyclical fluctuations in its net current payments with the region. A country which is a net debtor or net creditor to all other members of the payments union or one which incurs persistent deficits or persistent surpluses with the remaining countries has problems which a payments union cannot deal with very effectively. On the other hand, if the net current payments between a group of countries are small or can be covered by net

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1. This implies the assumption of non-convertibility of a few currencies used. Otherwise, if balances are settled with the use of freely convertible currencies, payments are automatically multilateral and a payments union will not serve any purpose with respect to this function.

transfers of available international reserves, the need for a payments union between these countries does not arise. A payments union is a device which is resorted to in order to provide additional means to deal with disequilibrium in the balance of payments. Needless to say, it is only resorted to whenever such a disequilibrium exists.

The disequilibrium between a group of countries, however, must not be of such a magnitude as to render ineffective a payments agreement between them. The disequilibrium must be just sufficiently large to make the need for a payments union felt, but not so large that the payments union is paralyzed by the attainment of the maximum limits of credit extended to some members.

The third requirement for the establishment of a regional payments union is that all member countries be in overall equilibrium with respect of their trade relations with the rest of the world. If members of a payments union show persistent deficits or persistent surpluses in their balance of payments, variations in the degree of softness or in the convertibility of their currencies will necessarily develop. This will undermine an already existing payments union, or otherwise will be a major obstacle in the establishment of such a union.

Likewise, persistent disequilibrium in the balance of payments of a member country is detrimental to a

payments union from another viewpoint, namely its effects on trade restrictions and exchange control. This can be seen clearly from an analysis of the balance of payments adjustment mechanism. Thus suppose that country A, which is a member of a payments union, develops a deficit in its balance of payments. Let SS in figure 1 be the number of units of currency A supplied in the foreign exchange market and DD be the number of units of currency A demanded in the exchange market. Equilibrium is attained at OQ units demanded and supplied and at a rate of R_0 for one unit of currency A. An increase in the demand for imports, hence in the supply of currency A will result in a shift in the SS curve to S'S'. This deficit in payments will be prevented if the exchange rate is allowed to drop to R_1. But if the exchange rate is maintained stable at R_0, the deficit may be covered by the transfer of international liquid reserves from country A to the rest of the world.

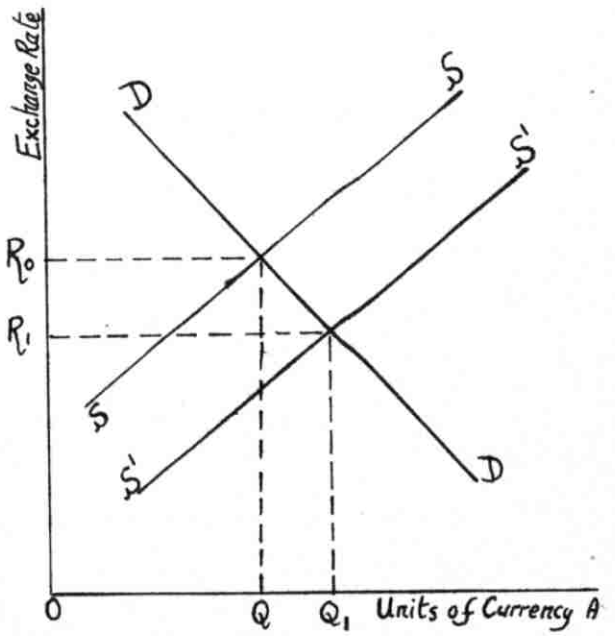

Figure 1

The transfer of international liquid reserves, however, brings into play an automatic adjustment mechanism which tends to restore equilibrium in the balance of payments. The loss of reserves will have repurcussions on the banking system and hence on prices and the level of economic activity. The fall in prices will give an impetus to exports (thus shifting the DD curve to the right) while the fall in the level of economic activity will tend to reduce imports (thus shifting the S'S' curve to the left) until the two curves intersect at R_0 again. This in fact means that in the absence of destabilizing speculative movements, a deficit in the balance of payments will produce a sufficient deflationary effect on prices and on the level of economic activity until equilibrium is again attained at the going exchange rate.[2] The degree of deflation necessary depends mainly on the income elasticity of demand for imports and on price flexibility. If the value of these two is low, then a considerable degree of deflation may be required to bring about equilibrium in the balance of payments.

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2. This is what amounts to the classical view of the international adjustment mechanism. Though the theory is not dependent on the assumption of price flexibility, it does presuppose a considerable degree of price flexibility to make it useful in policy recommendations. But it does leave out of account destabilizing speculative movements which may either prevent the attainment of equilibrium, or equilibrium may require such a long time as to make a policy based on such a theory rather impractical.

Alternatively, the exchange rate of currency A, if allowed to drop to R_1, will automatically bring about equilibrium in the balance of payments. This implies some deterioration in the terms of trade of country A. The fall in the terms of trade is greater the lower the price elasticities of demand for imports and supply of exports are. This mechanism may also be subject to destabilizing speculative movements and may produce considerable deflationary effects on prices and incomes.

Consequently, a country (in the absence of destabilizing speculation) cannot be in a state of persistent disequilibrium if automatic adjustment forces are allowed to function irrespective of the degree of inflation or deflation which they dictate. It is only when countries counteract the working of such forces by the imposition of direct restrictions on trade and payments that they can remain in a state of persistent disequilibrium with the rest of the world. Such countries will find themselves under increasing pressure to tighten their restrictions on trade and payments, and this will not only amount to a repudiation of the purpose and rationale of a payments union, but will also jeopardize the balance of payments position of other member

countries.[3]

To summarize, members of a payments union have to attain a state of overall equilibrium in their balance of payments. Disequilibrium will normally create a tendency for changes in the restrictions on trade and payments and may result in considerable differences in the degree of softness of the currencies of the various member countries. Both conditions are detrimental to a payments union.

It is extremely important that the members of a prospective payments union arrive at an agreement upon such matters as a) program for military expenditure, the) general lines of monetary and fiscal policy, exchange rate policy and the degree of freedom of capital and labour movement.

Agreement on a program of military expenditure is important for the success of a payments union in two respects. First, military considerations are usually

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3. In fact this problem gives rise to numerous complications which will be discussed in chapter V below. To mention only a few of such problems here, a country which incurs a deficit in its balance of payments will substitute imports via the other members of the payments union for direct imports from abroad. Other members of the payments union may also be compelled to impose restrictions on their trade with the deficit country, or if the latter is predominant, they may be compelled to impose restrictions on their trade with other countries. Lastly, the other members of the union will probably have to hold the maximum credit margin allowed to the deficit country, which may have an undesirably soft currency.

given top priority in policy making. It is therefore advisable that countries planning a greater degree of economic integration among themselves be fully aware of these military realities in order to plan the payments union accordingly. Countries are not generally prone to subject their military affairs to a decision in which they have only one vote among many votes, unless they have agreed in advance to follow certain lines of policy. It may of course be argued that countries desiring to have a payments union may not agree to commit themselves on a certain line of policy in military affairs. And even when they do commit themselves, the provisions of a payments union will be violated whenever military requirements are considered urgent. The question of sovereignty is certainly a delicate issue and it becomes much more delicate when military matters are at issue. This objection, however, forestalls a further requirement for the establishment of a payments union, namely the acceptance of a modified and more liberal conception of sovereignty by the members. This problem will be further discussed at the end of the present section.

Secondly, both in their magnitude and timing, military expenditures have considerable repurcussions on economic activity. Their implications on the successful

functioning of a payments union become clearer among such countries as the Arab countries, where a considerable proportion of military expenditure goes to direct purchases of military supplies from abroad and where the administrative machinery necessary to put inflationary forces under control is probably lacking.

Furthermore, it is necessary that prior to the establishment of a payments union, agreement be reached among the members upon the general lines of monetary and fiscal policy. The necessity for such an agreement arises from the fact that the problems which a payments union is set up to deal with are greatly conditioned by the internal economic conditions of the various member countries. If country A, for example, introduces inflationary measures, its earnings of foreign exchange will tend to fall while its demand for foreign exchange will tend to rise. This gap in its balance of payments will be partly covered by drawing upon the credit margin which country A has in the union thus spreading the inflationary gap to other members of the union. It will also endanger their foreign exchange position and probably compel them to impose restrictions on their trade and payments with non-union countries.

Quite often, it is necessary for a member country to apply measures of monetary and fiscal policy in order to remain within the lines of a payments union. Thus

a country may sometimes fail to correct a disequilibrium in its balance of payments by the application of such automatic adjustment mechanisms as the transfer of international liquid reserves or fluctuations in the exchange rate of their currency.[4] The only alternatives left for that country are either to introduce measures of monetary and fiscal policy in order to bring about the correction in the balance of payments or to impose direct restrictions on trade and payments. Countries are generally prone to follow the latter alternative, specially when the former involves deflationary measures. But increased restrictions on trade and payments amount to a repudiatation of the provisions of the payments union.

The foregoing requirements in fact transcend the purely monetary and fiscal aspects of economic activity to the more general aspects of economic life. This will include all legislation which bears either directly or indirectly on the functioning of a payments union. Among other things it will include taxation laws, minimum wages laws, company laws and specially those relating to foreign-owned concerns, exchange rate policy, commercial policy and protective tariffs. However, full uniformity on these matters among the various members of a payments union cannot be attained short of unifying legislation on economic matters. Yet it is a rather uncommon state of affairs for a state to relinquish

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4. See the discussion on pages 101-105 in the present chapter.

its sovereignty over the economic aspects of life to a regional super-national body and retain jurisdiction over other aspects of life. And aside from the difficulty of drawing the line between that which pertains to economic life and that which does not, such a "division of labour" is neither sound nor necessary for a payments union.

What is necessary, however, is that the members of a payments union agree on the general lines of economic policy and further agree to set up a body endowed with merely advisory powers and entrusted with the function of keeping the legislation of the various member countries in line with the overall requirements of a payments union.

None of the foregoing requirements will in fact be met, and the idea of a payments union among a group of countries will never materialize unless such countries have no fundamental differences among them, either in their economic structure or in their political outlook. The idea of a payments union itself must be understood, its benefits realized and appreciated, and its responsibilities willingly accepted.

A payments union implies the modification of the concept of sovereignty in so far as every country which desires to join the union must agree to exercise only qualfified sovereignty over certain aspects of its economic life. Yet this modification is more apparent than real. A country which willingly agrees to accept the

responsibilities incumbent on its membership in an organization, in view of the advantages accruing to it therefrom, does not waive any of its sovereign powers, if the term sovereignty is liberally interpreted. Yet this same issue has given rise to considerable misunderstanding in the Arab Middle East and specially in the discussion of the customs union issue between Syria and Lebanon. Sovereignty and economic integration seem to be indirectly related in the minds of the people in the region. This misunderstanding may be ascribed to two causes. The first is that sovereignty is often conceived of as an absolute desideratum to be sought as an end in itself and not as a means to the achievement of a greater end. Every state exercises full and unqualified sovereignty over all aspects of its life. Although such a crude conception of sovereignty was probably never accepted in international law, it finds widespread acceptance in the Arab Middle East. The second reason for this misconception is that Arab countries are suspicious lest a measure of greater economic integration among them unavoidably lead into further economic and political integration until their individual sovereign entitities are submerged in a wider political entity. Steps for greater economic integration in the Middle East are regarded as disguised political measures. It is therefore necessary in proposing a payments union to make clear both the purpose and the objectives of such a meaaure.

II. Is a Payments Union Possible in the Arab Middle East

The foregoing discussion casts some light on the requirements for the establishment of a payments union, with special reference to the Arab Middle East. It remains to be seen, however, whether existing economic conditions in the region (outlined in chapter III above) make possible the establishment of such a union and whether the union, if established, will serve any purpose which the Arab countries cannot attain more satisfactorily either with the help of another form of plan or individually.

It will be noted that the first and basic requirement for the establishment of a payments union discussed above was the fact that countries planning a payments union must have considerable trade relations among them, or their trade must be subject to immediate expansion once payments restrictions are relaxed.

The analysis of the foreign trade figures of Arab countries on the basis of these criteria shows that of all the Arab countries Syria, Lebanon, Jordan, Iraq and probably Saudi Arabia satisfy this requirement. Thus in 1951 Syrian trade with the remaining countries of the Arab League constituted about 40 per cent of total commodity exports and about 20 per cent of the total imports. Lebanese trade in 1952 constituted about 50 per cent of the commodity exports and about 30 per cent

of the commodity imports.[5] The figures for Iraq and Jordan reveal that their external trade relations are closest with non-Arab countries though their inter-Arab trade constitutes an important proportion of their over-all international trade activities. Thus in 1948, about 43 per cent of the imports of Iraq came from the United Kingdom, 11 per cent from the rest of the Sterling Area and 14 per cent from non-Sterling O.E.E.C. countries. Imports from other Arab Middle East countries accounted for about 5 per cent of the total imports. The exports of Iraq in 1949 were as follows: about 25 per cent to France, about 14 percent to the United Kingdom, 9 per cent to India, and 12 per cent to Syria, Lebanon and Jordan.[6]

On the other hand, the geographic pattern of Egyptian trade does not satisfy this basic condition for the establishment of an Arab payments union; for Egyptian trade with the remaining Arab countries constitutes about 2 to 3 per cent only of the total international trade activities of the country. The same conditions apply to both Libya and Yemen, both of which have small and sometimes negligible trade relations with the rest of the Arab world. It does not therefore seem advisable - on the basis of the present criterion - for an Arab

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5. Import figures are converted into Syrian and Lebanese pounds at the official rates of exchange.

6. See chapter III above.

payments union to include Egypt, Libya, or Yemen. The direction of trade in these countries is such that the need for a payments union with the remaining Arab countries does not arise.

A further requirement for the establishment of a payments union was that countries contemplating such a measure should not be already in a state of equilibrium among themselves. On the other hand, the degree of disequilibrium between these countries must not be of such a magnitude as to render a payments union ineffective and should not be larger than their disequilibrium with the rest of the world. Otherwise, there will be little justification (aside from political considerations) for these countries to join in a payments union to the exclusion of other countries.

Unfortunately, the lack of balance of payments statistics makes it difficult to test the above criterion empirically for the Arab Middle East. In fact, even where available, balance of payments statistics in the Arab countries lack the necessary continuity, accuracy, and detail which make them useful in testing the above criterion. Yet one fact stands out; namely, that a few Arab countries exercise a considerable degree of exchange control on their transactions with the rest of the world including other Arab countries. This entails a considerable degree of non transferability of some Arab

currencies and the necessity for some sort of an agreement whereby purchases from and sales to the country exercising exchange control are paired off.[7]

Indeed, the existence and severity of measures of exchange control and import restrictions exercised by a country provides a clue to the degree of overall disequilibrium which that country has in its balance of payments.[8] A further clue to the existence of disequilibrium in the balance of payments is also provided by the instability (whether seasonal or cyclical) of the exchange rate of that country's currency.[9] These two conditions, however, create such variations in the degree of transferability of currencies and in the degree of their stability and softness as to render the establishment of a payments union between these countries a highly improbable fact.

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7. Of course this provision need not be a strict bilateral clearing agreement whereby the value of exports is equated to the value of imports. It could be a bilateral payments agreement which makes provision for a certain credit margin.

8. This statement will not be correct if restrictions on payments are taken as given. Then changes in the degree of control on imports will be the relevant criterion here.

9. It has been noted that both in Syria and Egypt the Egyptian and Syrian pounds are subject to a considerable degree of seasonal fluctuations in their value owing mainly to fluctuations in the quantities of exports and to the inability of the financial institutions in these countries to absorb the foreign exchange resources at stable exchange rates.

The foregoing difficulty is of particular importance for any prospective payments union in the Arab Middle East, specially with reference to the position of Lebanon in such a union. Among the Arab countries Lebanon imposes by far the least degree of restrictions on its payments with the rest of the world. The Lebanese currency has attained a very high degree of transferability and stability. These conditions are due to such factors as the ability of Lebanon to draw a constant flow of capital resources from abroad, the development of a free money market in Beirut, the availability of financial institutions which are able to absorb large quantities of foreign exchange, the absence of a seasonal pattern in Lebanese exports such as that experienced in neighbouring countries which rely mainly on agricultural exports, and the consistenly liberal policy pursued by the Lebanese government with respect to foreign capital and foreign interests. Yet the fact that Lebanon relies very heavily on capital inflow to attain overall equilibrium in its balance of payments renders more precarious its position with respect to the stability of the monetary system and to the transferability of the Lebanese pound. Indeed not a small part of capital inflow into Lebanon is due to the confidence on the part of foreign investors that such capital can be drawn out of the country at any time and with a low probability of loss of value arising

from fluctuations in the exchange rates. Such a state of the mind on the part of investors will persist so long as confidence in the stability and full transferability of the Lebanese pound is maintained, but may nevertheless produce a sharp reversal if these confidence imparting conditions are only slightly changed. Lebanon is therefore apt to be extremely cautious about such engagements as a regional payments union which involves currencies of a much lesser degree of transferability than the Lebanese pound. Such suspicion on the part of some Lebanese economists is highly justified, for a payments union produces a tendency to reduce to a uniform level the degree of stability and transferability of the various currencies involved. The outcome is very likely to be that Lebanon might have to forego a certain degree of transferability in its currency. But such an outcome may be very unstable, for it may result in a reversal in the direction of capital movements thus either reducing capital inflow or even producing capital outflow. Once started, this process may prove to be self aggravating and might entail some radical reshaping of the economic and monetary system in the country.

The problem of exchange control and exchange stability must therefore be solved satisfactorily by the different countries prior to the establishment of a payments union among them. The problem may be tackled individually whereby every country attempts to attain full transferability and stability of its currency

before it joins a payments union. Or the problem may be tackled collectively whereby countries desiring to form a payments union agree on a preliminary plan to cooperate on the attainment of greater stability and transferability in their currencies. The plan may range from the agreement on uniform policies to be adopted by the monetary authorities in the various countries, to the setting up of an organization composed of representatives from central banks and governments to carry through an agreed upon stabilization policy, and finally to the establishment of a joint exchange stabilization fund.

However, a payments union may include some provisions which accord a specail treatment to countries adversely affected by the operation of the union. An example to this possible approach is afforded by the special treatment of sterling balances in the European Payments Union. Because of the fact that sterling, more than any other currency, is widely used by third countries as a means of settlement, and countries have traditionally held sterling as part of their reserves, and accumulated holdings of sterling were due to many countries (both European and non-European) the United Kingdom during the negotiations on European economic cooperation at first rejected a proposal for a European Payments Union which made sterling balances over a certain limit convertible into gold and dollars. The Union seemed to impair the value of sterling as an international

currency and to throw on the United Kingdom the onerous burden of having to redeem sterling balances from European countries which may have acquired such balance from trade with any country which deals with sterling. Finally a compromise was arrived at whereby sterling was given special treatment in the European Payments Union.[10] Broadly, this preferential treatment accorded to sterling consisted of allowing member countries to hold sterling rather than E.P.U. credits. Per contra these countries were also allowed to convert any sterling balances which they hold into E.P.U. credits provided that they are in a net deficit position with respect to the E.P.U. The European Cooperation Administration then agreed "to indemnify the United Kingdom for any actual losses of gold that might result from such multilateral use of sterling balances."[11] Similarly, special treatment could be given to the Lebanese pound or to any currency which may be adversely affected in a prospective payments union in the Arab Middle East.

Yet the degree of understanding and political harmony which must prevail among the Arab countries must be very large in order that the principle of

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10. Albert O. Hirschman, "The European Payments Union, Negotiations and the Issues" The Review of Economics and Statistics, February 1951, p.1

11. Vide Chapter V

preferential treatment be accepted and applied whenever the need arises .

Finally, Arab countries must agree upon such matters as the general lines of monetary and fiscal policies, a program for military expenditure, exchange stabilization, protective measures, and economic policy in general. The problem of agreement upon these matters is primarily a political problem; one of overcoming certain obstacles and forces of discord in the Arab Middle East. Of these obstacles only five will be discussed below.

The first is that the Arabs still lack an agreed upon conception of national existence. This manifests itself in the diversity of views among various groups in the area on the territotial definition of their nation. On the one hand there are groups who would include all Arab speaking countries in the same national entity. On the other hand, there are groups who insist on a narrower regional definition of national existence. The latter groups include the Syrian Nationalist Party, the various Lebanese national groups, and almost all Egyptian parties. Superimposed on these movements, however, are such groups as the Islamic Brotherhood, which works for some sort of a theocratic pan-Islamic world and the Communist parties in the various Arab countries.

It is interesting to note, however, that a more narrow conception of national existence is met with in those countries in the Arab Middle East which are farthest from a nomadic pattern of life. Thus the different variants of Lebanese nationalism, the Syrian National Party, and Egyptian nationalism are centered in the two countries in the Arab World which are farthest from a nomadic pattern of life. On the other hand, Arab nationalism finds its main support in Syria, Jordan, and Iraq, where nomadism is more prevalent .

2) The second centrifugal force in the Arab Middle East is the predominant importance of landowners in some Arab countries. The interests and the problems of landowners are inherently local in nature. Of course landowners may intellectually or emotionally believe in a wider conception of nationalism; and they may even join parties and blocs which have the attainment of Arab unity as their basic aim. But when it comes to their interests, these landowners are indifferent to greater regional integration.[12]

3) A third centrifugal force in the Arab Middle East

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12. Probably a distinction should be drawn here between large landowners who usually grow cash crops with a world market and small farmers who rely more heavily on such products as vegetables and fruits which have a local market. The latter group are usually not indifferent to regional integration with neighbouring Arab countries, for if they stand to gain by such a step, they will support it. And if they stand to lose, they will be against it. To illustrate, recently, the farmers around Damascus (who probably rely mainly on fruits and vegetables) submitted strong complaints to

is to be found in the inherited animosity between some ruling families. Unfortunately, beduin type feuds have been carried over from the past and given national status.

A fourth element of dicord in the Arab world is to be found in the problem of religious minorities. Such minorities, whether they are Shi'ites in Iraq, Syria and Lebanon, or Druzes in Syria and Lebanon or Christians (mainly in Lebanon) are suspicious lest any step towards greater regional integration should lead to Sunni domination again, which Ottoman fanaticism has rendered completely unpopular.[13]

Lastly, the absence of strong groups and classes which stand to benefit by regional integration deprives any such movement of an important driving force. For ultimately, it is not assertions of brotherhood and love

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the government objecting to the free movement of agricultural products between Jordan and Syria. No such complaints came from the farmers of northern Syria due partly to the fact that the distances to be covered by the imported products are greater, but mainly due to the fact that in northern Syria the main crops are cereals and cotton which have a world market only negligibly affected by exports from Jordan.

13. The solution which these minorities propose differ from one group to another. The Lebanese Phalanges, for example, which represents the views of a part of the Maronites in Lebanon will not accept integration at any cost. The Syrian Nationalist Party, which probably represents the views of a sector of the Christians of Lebanon has faith that conditions are now changed and that political integration into the secular state of Greater Syria will be the best solution.

that bring about political and economic integration, but rather manufacturers and farmers seeking wider markets, organized labour seeking most remunerative employment outlets, and merchants whose interests extend over the whole region.[14]

This extended discussion of some of the obstacles which impede regional economic integration in the Arab Middle East is necessary for an understanding of the difficulties in establishing an Arab Payments Union. But these forces are of course counteracted by opposite forces which lead to political and social harmony. Of these latter forces a few will be mentioned here. The presence of a common threat to the group; namely, the

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14. It must be admitted that this argument cuts both ways. It certainly is to the interest of the manufacturer and farmer to widen their markets, but in the same breath it is to their interest to restrict competition. Organized labour may indeed press for greater employment opportunities, but they will also press for protecting the labour market from the cheap labour coming from outside. A merchant may strongly desire to free himself from all restrictions so that he can expand into neighbouring countries, but he will certainly resent the fact that a merchant from a neighbouring country might also expand. The benefits which will make a businessman desire a greater degree of regional economic integration are long-run benefits, while the benefits which make him desire restrictions are short-run benefits. All told, the typical businessman in the Arab world is probably one who would rather snap at a short-run benefit and forego what seems to be the less certain long-run benefit. Entrepreneurship in the sense that the term is known in the West is still very uncommon in the Arab Middle East. Furthermore, political instability in the Arab Middle East strengthens this short-sightedness in policy on the part of the businessmen and makes long-range planning on their part very unsafe.

creation of Israel is probably the most potent unifying factor in the Arab Middle East today. This common challenge to the national existence of various Arab countries must call forth a response the main lines of which are still not clear. Yet it will be begging the question to assert that the creation of Israel presents Arab countries with a common threat unless there are other factors which bring these countries together. Of these factors, the fact that Arab countries have a common language and that for the past few centuries they have been subject to similar historical movements are particularly important.

But indeed it will be most difficult to judge at the present time the relative importance of these forces. The present discussion is therefore inevitably somewhat inconclusive.

III. The Need for A Regional Payments Union in the Arab Middle East

The need for a multilateral payments union in the Arab Middle East arises from the problem of the inconvertibility of currencies. Full convertibility of the currencies used will itself serve as a means to "multilaterize" trade, because a net deficit or surplus between two countries could then be freely transferred for the settlement of an opposite balance with a third country, or could be carried forward in time for the

settlement of future claims. Thus while convertibility enables countries to transfer their accumulated balances and to purchase in the cheapest market,[15] its absence compels them to pair off their demand for other currencies with the supply of these currencies by means of import restrictions or clearing arrangements.

A regional payments union amounts to the attainment of regional transferability in the balances among the countries of the union. Yet a payments agreement has another aspect. Unlike a clearing arrangement, a payments agreement does not require that net balances between countries should be settled as soon as they are incurred. A payments agreement makes provisions for the holding of these balances up to a certain level and for a maximum time duration determined in advance. Payments agreements thus provide member countries with additional international liquidity which they can utilize to correct an unbalance in their payments without the need to resort to the imposition of additional restrictions on either trade or payments. This is particularly important for the Arab Middle East in two respects. The first is that countries which rely heavily on the export of agricultural products are subject to a greater degree of fluctuations in their

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15. This advantage could be partly nullified by the imposition of restrictions on trade; thus while currencies may be freely transferable, trade may be subject to such import restrictions as licenses and quotas which will weaken the price mechanism in trade.

balance of payments. This is due to the existence of seasonal fluctuations in their exports and to the fact that the prices of agricultural products are subject to a greater degree of fluctuations than the prices of other types of commodities.[16] In addition, the quantities of agricultural products produced are subject to further fluctuations due mainly to changes in weather conditions. Such countries are therefore in need of large sums of international liquid reserves to cover these fluctuations. Secondly, while the need for large international liquid reserves is great, the ability to hold adequate reserves is greatly limited. Generally, the living standards in the Arab Middle East are considerably low, and consequently the level of savings is low. Furthermore, the desire for a rapid rate of economic growth and the priority given to the importation of military supplies exerts such a pressure on the balance of payments which leaves little place for the accumulation of international liquid reserves.

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16. The statement that the prices of agricultural products are likely to fluctuate more violently than the prices of manufactures is here made on purely theoretical grounds. It may be explained by the fact that in agriculture the change in employment and output due to changes in prices is likely to be very small or even negative. In manufacturing industries, however, output could be more readily adjusted to changes in prices. This difference may be ascribed to the fact that a larger proportion of the costs of production in agriculture are fixed than is the case in manufacturing industries.

This points out to one of the main advantages of a payments union, namely, that it reduces the necessity for the imposition of restrictions on trade and may even make possible the relaxation of such restrictions. A payments union will therefore make it possible for a group of countries to widen the markets for their products. With reference to the Arab countries, however, this will fit in with their desire for a more rapid rate of economic development, specially as the limited size of their markets is probably one of the major obstacles to the economic development of the area.[17]

Yet the point should be made clear that in this respect a payments union is only a permissive device. If effective, it permits the relaxation of trade restrictions between a group of countries without making it necessary for the whole region to increase their restrictions on trade with outside countries. A payments union does not itself create a wider market, but it only provides member countries with greater means for the creation of such a market. The benefits which can be derived from a payments union could therefore be considerably forfeited if member countries either believe that market limitations are not an important obstacle

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17. This limitation arises both from the small number of people in each of the Arab countries (with the exception of Egypt) and from the low standards of living of the majority of these populations. A payments union deals with the former cause for the limitation on the size of the market. It may remotely and in the very long-run affect the latter also.

to their economic development; or, submitting to pressure from vested interests, they decide not to undertake the short-run readjustments consequent upon the widening of their markets for the sake of benefits realizeable only in the very long-run.

This discussion leads to some interesting conclusions on the position of various economic groups with respect to regional economic integration in the Arab Middle East. It is of course difficult, without resorting to some oversimplification of the situation, to define clearly the views of such groups concerning an agreement which may result in a relaxation of trade restrictions among Arab countries.

In Syria manufacturers, who are aware of the fact that Lebanese industries are on the whole more efficient than Syrian industries, are generally against such an agreement. The pressure which this group exerts on current politics is probably larger than their relative importance in the economy due mainly to the fact that they are better organized than other groups.

Merchants may be divided into two groups, namely, those whose trade relations are local or at most extend over a few neighbouring countries (including dealers in cereals and livestock) and those whose main business is in the export and import trade. On the whole, the former group of merchants are interested in a greater degree of

regional economic integration and could become a potent pressure group if properly organized. The second class of merchants (those who deal in the export-import trade) are attempting to consolidate their position in Syria, specially after the proclamation of Legislative Decree No. 151 which greatly restricted the activity of foreign businessmen in Syria. Though not explicity stated, the main purpose behind the law was to strengthen the competitive position of the Syrian businessman vis-à-vis the more experienced Lebanese businessman.

Finally, landowners and labour are probably indifferent to regional economic integration. Landowners derive the largest proportion of their incomes from agricultural products which have a world market and which are mostly exported outside of the area. They will therefore not benefit from the institution of a regional payments union. On the other hand, labourers are probably completely unaware of the problem.[18]

The situation in Lebanon is probably somewhat different. In the first place, Lebanese merchants are

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18. The foregoing discussion probably casts some light on recent political developments in Syria. The People's Party represents mostly the merchants, and the National Party represents mainly the landowners. On the whole, these two groups favour the adoption of more liberal trade policies and specially with respect to other Arab countries. On the other hand, the industrialists are not represented in any party but constitute a very influential pressure group. In fact, during Shishekly's regime they had the upper hand in economic policy and were responsible for various restrictive measures.

probably more experienced than merchants in other Arab countries. Secondly, the policy which the Lebanese government has followed with respect to the protection of local industries did not deprive these industries of the stimulating effect of foreign competition. Lebanese industries are therefore in a better position to compete with industries in the region. Thirdly, Lebanon has developed a world money market which exerts a considerable pull on financial transactions made in the area. Fourthly, Lebanon, probably more than any other Arab country, is a recipient of foreign capital and foreign technical skills. Fifthly, Lebanese agricultural products are mainly of the type most suited for regional consumption. Fruits, olive oil, and vegetables are either not in great demand in foreign countries, or the difficulty and cost of transportation restricts their consumption to the area.

It seems then that a widening of markets is likely to be in the interest of a larger number of groups in Lebanon than is the case in Syria. The main problem is, however, that the advantages which Lebanon enjoys over neighbouring Arab countries are rather precarious. Conditions may very radically change if, by joining a regional payments union, Lebanon has to impose restrictions on payments. An inflow of capital may very well be turned into capital outflow if the transferability

of the Lebanese pound is restricted. This may necessitate the imposition of additional restrictions on payments, and the free money market will cease to function. Lebanon may therefore be interested in regional trade agreements with provisions to ease payments and not in commitments such as a payments union will impose. This has to be taken into consideration in the discussion of an Arab payments union. [19]

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19. It will be noted that the discussion here was restricted to Syria and Lebanon only. It is recognized that the present paper is incomplete without a similar discussion for other Arab countries, but the author's ignorance of conditions in these countries made such a discussion impossible.

Chapter V

A Multilateral Payments Union in the Arab Middle East

An attempt is made in the present chapter to discuss some of the problems arising out of the organization and operation of a payments union in the Arab Middle East. This chapter falls into five sections. In section I the establishment, organization, and operation of the European Payments Union are discussed with a view to clarifying some of the basic problems that are likely to be faced by any payments union. Section II includes a discussion of the organization and administrative setup of a prospective Arab payments union. Section III is reserved for a discussion of the offsetting mechanism in the payments union. In Section IV, such problems as the settlement of balances and the adjustment for disequilibria in the balance of payments of member countries are dealt with; and finally the problem of financing the payments union is discussed in Section V.

I. The European Payments Union

It may be useful to digress into a brief discussion on the problems raised both in the creation and operation of the European payments union. While the experience of West European countries during the post-War period in the establishment of various trade and payments

organizations may not be completely relevant to the Arab Middle East, yet it is very valuable for an understanding of the problems which a payments union is likely to face.

The European Payments Union was the outcome of the realization that the system of bilateral payments agreements which tied European trade into one network could no more function smoothly. Bilateral payments agreements among the European powers were entered into by their exiled governments during the War, when most of Western Europe was still under German domination. By September 1947, however, a network of seventy four bilateral trade agreements embracing all the fifteen West European countries was already in operation.[1] These agreements were concluded according to a fairly uniform pattern. "The central banks, as technical agents, supplied their own currency at a fixed rate of exchange against that of their partner, up to a certain limit which was often referred to as the "swing", since it was intended

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1. The maximum number of bilateral agreements which fifteen countries can conclude among them is

$$\frac{n(n-1)}{2} \quad \text{or } 105 \text{ agreements.}$$

The European countries had, by September 1947, concluded seventy four agreements. Vide Gardner Patterson and Judd Polk, "The Emerging Pattern of Bilateralism," Quarterly Journal of Economics, November 1947, p.118

to afford room for minor fluctuations in commercial deliveries between the two countries; beyond the limits thus fixed, settlement had generally to be made in gold or convertible currency."[2]

Such agreements proved to be extremely useful in restoring trade in the early post-War years, but it became apparent before long that the limitations which they put on trade were becoming a handicap to further development. The exhaustion of the swing in most bilateral agreements soon hindered their functioning and the need for a multilateral system became acutely felt.[3]

Acting upon these considerations the Benelux countries presented in the summer of 1947 an ambitious scheme for a multilateral payments agreement. The plan was discussed in a conference which met in London in late 1947, but it was immediately deadlocked owing to the attitude of Great Britain, which was reluctant, right after the conspicuous failure of the convertibility experiment to engage in a similar scheme. The objections of Great Britain to this plan may be summarized as follows:

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2. Brian Tew, International Monetary Cooperation, 1945-52 (London: Hutchinsons University Library, 1952), p.97.

3. R. Triffin, "Institutional Developments in the Intra-European Monetary System", from Money, Trade and Economic Growth (New York: Macmillan, 1951), p.36.

First, since sterling was widely accepted by third countries as a means of settlement and held by many countries as part of their monetary reserves, the plan seemed to endanger the position of sterling in this respect by subjecting sterling balances over a certain limit to redemption in gold or convertible currencies. Secondly, the fact that sterling is widely used in international financial transactions makes European countries acquire sterling balances from their trade not only with Great Britain but also with any other country which uses sterling, and specially the sterling area. A European multilateral payments union would therefore throw on Great Britain the onerous duty of having to redeem the sterling balances arising from the trade of other countries. Thirdly, the problem of blocked balances was not dealt with in the plan for multilateral trade; and fourthly, the failure of the recent convertibility experiment made Great Britain adopt a rather non-committal attitude with respect to similar schemes.

Consequently, the Benelux countries, joined by France and Italy and later by the Bizone of Germany, attested their signature to the more modest Agreement on Multilateral Monetary Cooperation. In this agreement two means of offsetting operations were distinguished.

The first, called "first category compensations" consisted of a circuit offsetting mechanism, whereby country (A), for example, will agree to cancel a claim against country(B) if a claim against it is cancelled by country (C). Or country (A) will reduce its indebtedness to country (B) if it acquires an equivalent credit against country (C) and not by increased indebtedness to (C) . The other means of offsetting, known as "second category compensation", consisted in the pooling of all debits and credits. In the First Agreement on Multilateral Monetary Cooperation the latter means of offsetting was made optional and required the unanimous approval of all member countries.[4] This agreement was later widened to include six permanent members who were bound only by "first category compensations" and eight occasional members who were not bound except by their specific consent. In October 1948 the Intra-European Payments Union was created and with the encouragment of ECA funds (known as conditional aid,) it comprised all Western European countries.

It was soon realized, however, that circuit offsetting was not a very effective multilateral payments system. Thus out of a total of $ 1,640 million of deficits and surpluses incurred among Western European countries between October 1948 and June 1949, only $ 42 million (or 2.6 per cent) were settled, and out of $ 1,231

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4. Ibid., pp. 37-38.

million incurred over the second half of 1949 only $ 28 million (or 2.3 per cent) were settled.[5]

The negotiation of a new agreement was therefore found to be necessary though it proved to be hard. Finally agreement was reached on the basis of a French plan whereby 25 per cent of the drawing rights were made fully transferable amd the remaining 75 per cent of both the drawing rights and conditional aid remained subject only to "first category compensations". Yet this partial "multilaterization" of payments was rendered ineffective by the provision that circuit offsetting was to be used before the application of the transferable portion.[6]

The increasing monetary and economic stability in European countries and the progress in production and trade rendered more acceptable the idea of establishing a full multilateral payments union in Western Europe. A tentative plan was submitted in early 1950 proposing the establishment of such an organization and agreement over the European Payments Union was reached on July 7, 1950 - one week after the expirtation of the second Intra-European Payments Scheme.[7] The main obstacle to the establishment of

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5. Loc. cit.
6. Ibid. pp. 38-43
7. Ibid. pp.43-44 and Albert Hirschman, "The European Payments Union, Negotiations and the Issues", The Review of Economics and Statistics, February 1951, p.49.

E.P.U. was the sterling problem. Finally the problem was solved by a compromise which had the following aspects:

1. "Britain agreed to "establish a net balance with E.P.U. for all the transactions of the sterling area with the other O.E.E.C. countries and would settle this balance through the E.P.U. in accordance with the general procedure for settlements."

2. "With respect to the use of sterling as a monetary reserve, it was agreed that, instead of holding E.P.U. credits, creditors could make arrangements to hold in the form of sterling that part of their surplus which would correspond to their surplus in sterling."

3. "With respect to the existing sterling balances of the Continental members of the E.P.U. it was decided that these balances could be used only if the holders were in a net deficit position with respect to the E.P.U., but could then be used irrespective of whether the holders were in a deficit position vis-à-vis the sterling area. E.C.A. agreed to indemnify the United Kingdom for any actual losses of gold that might result from such multilateral use of sterling balances."[8]

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8. Albert Hirschman, "The European Payments Union, Negotiations and the Issues", The Review of Economics and Statistics, February 1951, p.52

E.P.U. consists of two parts. The first is a multilateral offsetting mechanism designed to break through bilateralism in payments by making credits accumulated for one country freely transferable. This transferability makes it impossible to define credits and debits in terms of a country's currency and it becomes necessary to use a common unit of account, at least for book-keeping purposes. The second part of E.P.U. is a settlement mechanism. This was not made as a clearing arrangement which requires 100 per cent settlement in gold or convertible currency; neither was it made so soft as to encourage countries to run deficits and thus invite inflation. E.P.U. extends drawing rights to members in accordance with a schedule of quotas agreed upon in advance. Members have to extend to the union credit equivalent to their quotas. The Union pays 2 per cent interest on credit extended by member countries and charges 2 to 2½ per cent on the amounts borrowed from the Union.

Drawing on the quotas is allowed provided that settlement is made in gold or dollars according to the following schedule:

Deficit as a Percentage of Member's Quota	Settlement in Gold or in US. Dollars
0 - 20%	0
20 - 40%	20%
40 - 60%	40%
60 - 80%	60%
80 -100%	80%
In excess of quota	100%

With respect to the settlement of credits extended to the Union, the following schedule was approved:[9]

Surplus as a Percentage of Members Quota	Settlement by EPU in Gold or U.S. Dollars
0 - 20%	0
20 -100%	50%
In excess of quota	not specified

To insure that E.P.U. funds will not be depleted by a more rapid rate of gold and dollar payments than receipts, E.C.A. granted E.P.U. an initial fund of $ 600 million. The grant was to be used "on terms and conditions specified by the administrator and designed to promote multilateral Intra-European trade, to facilitate the transferability of European currencies, and progressively to eliminate the existing systems of bilateral trade among participating countries and between them and other countries."[10]

In studying the European Payments Union four points have a close bearing on any payments union and must be emphasized. First, a payments union does not provide means for development or reconstruction projects. Drawing rights extended by the union to member

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9. Brian Tew, International Monetary Cooperation, 1945-52, (London: Hutchinson's University Library, 1952), p. 110.

10. Albert Hirschman, "The European Payments Union, Negotiations and the Issues," The Review of Economics and Statistics, February 1951, pp.50-1.

countries should only be used to even out fluctuations in payments and not to support a development program no matter how desirable the latter may be. Yet the practical enforcement of this provision is likely to prove extremely difficult, for the funds which a payments union provides need not be directly used except for the purposes specified by the union. But a member country could pursue such a policy with respect to military and development expenditure that will give rise to an excess demand for union funds. To all intents and purposes such a course amounts to the channelling of union funds into uses for which they were not designed.

Secondly, a payments union must include specific provisions for the liberalization of trade to go side by side with the liberalization of payments. In the E.P.U. it was stipulated that up to 60 per cent of the restrictions on trade will be gradually relaxed.[11]

Thirdly, a full multilateral payments union will only be accepted if member countries have already attained a reasonable degree of economic stability both internally and externally. Countries which experience a high degree of fluctuations in the level of economic activity and where the balance of payments and

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11. Brian Tew, op. cit., p. 119

exchange rates are subject to violent disturbances are generally ill suited for a multilateral payments union.

Fourthly, it has become eminently clear from the working of the E.P.U. that first category compensations (or circuit offsetting) is not a very effective device for multilateral payments. It could probably serve on a temporary basis during a transition period, but cannot take the place of a full multilateral payments system.

II. Organization and Administration

In planning an Arab payments union the following matters should be taken into consideration:

1. The union should attempt the least possible interference in the domestic economic policies of the various member countries; and, whether in exchange rate policy or in advising on fiscal and monetary policy, the union should attempt to give maximum scope to the interests of individual members.

2. The union, both in its organization and methods, "must be capable of application irrespective of the type and principle of government and of the economic policy existing in the prospective member States." This is of particular importance for the Arab Middle East where differences in political organization and economic structure are considerable.

3. "Management of the union must be genuinely international, without preponderant power of veto or enforcement lying with any country or group. And the rights and privileges of smaller countries must be safeguarded."

4. The union must be so designed as to operate both for the individual advantage of each participating country and for the general advantage of all.

5. The form of organization must be acceptable to all countries concerned. Yet the union should neither be of a purely technical nature nor be completely controlled by political interests.[12]

6. The union must be easily, though not too easily terminable. Any country which decides to leave the union must be given reasonable chance to do so. Withdrawal may be allowed provided that a country submits a notice in advance declaring its desire to withdraw from the union. The time which must elapse between the submitting of the notice and actual withdrawal must be sufficiently long to allow member countries to adjust their payments and policies to the changed conditions. Furthermore, any member country which desires to withdraw must settle in full all its

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12. Arthur Smithies, "European Unification and the Dollar Problem", Quarterly Journal of Economics, May 1950, pp. 173-74.

deficits to the union. The union will also be required to settle all deficits which it has incurred with a country desiring to withdraw.

7. The union should not be invested with economic development functions. Development policies and their requirements are much wider in scope than the regularization of payments arising out of trade. The administrative set up that will relegate a wider objective to an organization with a narrower objective is not very sound.

The above conditions are probably best fulfilled with the help of a central administrative body. Such an institution may be planned according to either oneof two possible alternative forms.

General rules for the operation of the union should be formulated and an organization, primarily of a technical character, will be set up to ensure that these rules are properly carried out. Under this form of organization discretionary power will be reduced to the lowest possible minimum. For the Arab Middle East, however, this type of institution does not seem to be very practical. Member countries will in fact insist upon an organization which allows them a greater degree of power in such matters as exchange rate policy, fiscal and monetary policy, commercial policy, and exchange control.

The alternative form of organization will be one which admits of a greater degree of discretionary power by the member countries. In its extreme form this type of organization will be based completely on discretionary action arrived at by bargaining among the member countries. While this form of organization is not very practical, a combination of discretionary power with some rules seems to be inevitable for any payments union. The plan proposed for the Arab Middle East should be based upon such a compromise of "rule versus authority", though a more liberal dose of the former will probably result in a more effective institution.

The foregoing argument has one important implication; namely, that a payments union should have representatives from the various governments and treasuries as well as representatives from non-governmental organizations. The management of a prospective Arab payments union, for example, may be composed of the following groups:

1. It will include representatives from the different governments. The governments of the various countries may be given equal representation, or unequal representation may be allowed, and the number of votes for each country determined in accordance with an agreed upon principle.

2. The payments union may include representatives from the various central banking institutions of the member countries. Every central bank in the Arab Middle East (or any institution which performs some of the functions of a central bank and which is recognized as such) will be given a certain number of votes in the payments union and will be called upon to send representatives to the central administration of the union.

3. Likewise the payments union may include persons representing the views of commercial, agricultural and industrial interests in the member countries. The various chambers of commerce, industry and agriculture may therefore be called upon to send representatives to the central administration of the union. A precedent to this provision may be found in the Statutes of the Bank for International Settlements whereby the Bank administration includes "seven persons representative of finance, industry or commerce, appointed one each by the Governors of the central banks... and being of the same nationality as the governors who appoint them."[13]

4. Finally, the union may also include in its representation persons who are chosen for their professional standing and competence.

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13. Statutes of the Bank for International Settlements, Article 28, from Paul Einzig, The Bank for International Settlements (London: Macmillan, 1950), p.172.

By combining the above groups among its representation the union will probably ensure that while political considerations are not left completely out of account they are not allowed to dominate most of the decisions of the union. Furthermore, by bringing together into one organization the representatives of financial, commercial, industrial and agricultural interests, the union will advance one of its long-run aims; namely, to bring about a greater degree of regional economic integration.

Yet the problem which should be settled is that member governments which will negotiate the payments union may not agree to a form of organization in which non-governmental interests are so strongly represented. Governments may in fact desire to create an inter-governmental organization. Most probably, this will be accompanied by the desire to have a greater degree of discretionary power in the payments union.

III. The Clearing Mechanism

A payments union should include specific provisions governing the methods regarding both the offsetting of payments balances among member countries and the settlement of debits and credits incurred.

Generally three methods have been used to deal with the first problem; namely, the offsetting of balances arising out of trade. These methods are bilateral

clearing, the circuit offsetting mechanism devised by the Intra-European Payments Scheme, and the multilateral pooling of claims such as the one resorted to in the Eruopean Payments Union and the plan proposed by Lord Keynes for an International Clearing Union. These three methods can be explained with the help of the following hypothetical examples.

Illustration I

Import - Export Matrix

Exports / Imports	A	B	C	D	E	Total Exports
A	-	640	30	340	300	1310
B	950	-	600	620	610	2780
C	130	690	-	710	170	1700
D	690	890	960	-	670	3210
E	190	680	290	900	-	2060
Total Imports	1960	2900	1880	2570	1750	11060

In illustration I the trade between countries A,B,C,D, and E is given in matrix form.(Exports in rows and imports in columns) Exports from country A to the remaining countries have a total value of 1310

of which 640 are exports to country B, 30 to C, 340 to D and 300 to E. The imports of country A amount to 1960 of which 950 are imports from B, 130 from C, 690 from D and 190 from E. Country A has a net deficit of 650 with all the remaining countries, etc. with a system of bilateral offsetting whereby only the net deficit or net surplus between two countries will have to be settled in gold or convertible currencies, the trade matrix between these countries will result in the following net balances.

Illustration II

Net Balances with Bilateral Offsetting

	A	B	C	D	E	Total Surplus
	-	-	-	-	110	110
	310	-				310
	100	90	-			190
	350	270	250	-		870
	-	70	120	230	-	420
Total Deficit	760	430	370	230	110	1900

It will be seen from Illustration II that with a bilateral offsetting mechanism, 9160 are offset while net balances amounting to 1900 remain to be settled by the transfer of international liquid reserves. A bilateral system of clearing, however, acquires a great many of the advantages of a multilateral system if deficits and surpluses can be financed by convertible currencies or gold. But the amounts of such liquid reserves needed for bilateral clearing may be very large, specially if the degree of disequilibrium among these countries is considerable. Further clearing can be effected by resorting to a circuit offsetting mechanism (first category compensations) which is a combination of bilateral clearing and a limited multilateral system. This mechanism consists in the clearing of balances between a group of countries without the resort to a pooling device. It can be shown with the help of the following illustrations:

Illustration III

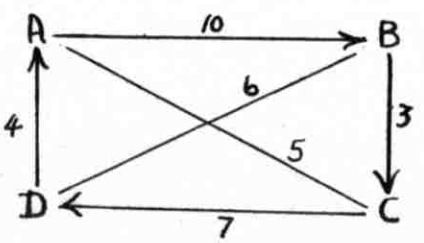
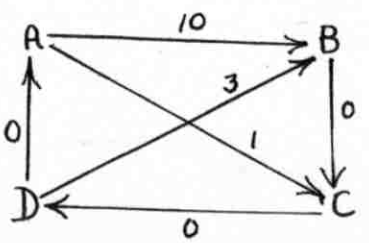


Illustration IV



Country A has a surplus of 10 with country B and 5 with country C and has a deficit of 4 with country D. Country B has a surplus of 3 with C and deficits of

10 and 6 with A and D respectively, etc. In this illustration there are three possible circuit clearing operations; namely A-B-C-D-A, A-C-D-A, and D-B-C-D. The ones chosen will depend on the purpose of the clearing; namely, whether it is to minimize total net balances or to clear away critical balances. It will be seen from Illustration III above that maximum clearing can be attained by offsetting A-C-D-A and then D-B-C-D leaving total net balances of 14 which cannot be offset (Illustration IV). The application of the circuit offsetting mechanism to the hypothetical figures given in Illustration I will result in the following net balances:

Illustration V

Net Balances Remaining After Circuit Offsetting

	A	B	C	D	E	Total Surplus
A	-				0	0
B	200	-				200
C	100	0	-			100
D	350	250	160	-	-	760
E		70	120	120	-	310
Total Deficit	650	320	280	120	0	1370

It will be noted from Illustration V that maximum offsetting via the circuit mechanism will leave 1370 for settlement in contrast to 1900 left with only bilateral settlement. The need for international liquid reserves to be used in the settlement of net claims is thereby considerably reduced. Yet it can be reduced even further if these balances are pooled on the basis of a full multilateral system as shown in Illustration VI.

Illustration VI

Net Balances Remaining After Multilateral Offsetting

	A	B	C	D	E	Total Surplus
A	-					0
B		-				0
C			-			0
D				-		640
E					-	310
Total Deficits	650	120	180	0	0	950

In Illustration VI above, multilateral clearing reduces the total amount of net balances which have to be settled from 1900 under the bilateral clearing mechanism to 950. A multilateral payments union therefore reduces further the amounts of international liquid reserves needed to effect the necessary settlement. In comparison to any other means of clearing it implies considerable savings in foreign exchange reserves which have to be maintained by a group of countries. Furthermore, the remaining net balances need not be subjected to immediate settlement but could be carried forward in time and settled by the possible development of opposite claims. This is in fact what distinguishes a multilateral payments union from a multilateral clearing union. The latter provides that net balances arising from multilateral offsetting be settled immediately while the former allows for the holding of such balances up to a limit and over a certain period of time agreed upon in advance.[14]

Generally there are two broad variants of a multilateral payments system. The simplest is the creation of a clearing office to which all debits and credits are reported. Member countries are required to extend to the union a certain credit margin which

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14. The Bank for International Settlements was probably the nearest approximation to a multilateral clearing union. The Bank served only as a clearing house for claims (and specially reparations) among its members.

can be used by any other member country on a multilateral basis. Every country is also extended a credit margin which it can utilize against any other country. A different variant of the same plan will be to create a fund which will hold the currencies of the different member countries. It will then issue to the deficit countries such currencies as they need in accordance with a quota system. The fund transactions may either be carried out in terms of one currency or in terms of an international currency, such as the unitas in the White Plan.[15]

A comparison of Illustrations V and VI points out to some of the important problems raised by both circuit and multilateral offsetting. It will be noted from Illustration V that one country (country A) will come out with zero surplus and another country will come out with zero deficit. This characteristic of circuit offsetting is general and not particular to the present illustration.[16] On the other hand, multilateral offsetting may result in zero surplus or zero deficit for all countries but one. Thus in Illustration VI

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15. The International Monetary Fund is an example of the fund type of multilateral payments union. The other type of union is to be found in the European Payments Union and in Keynes's International Clearing Unions.

16. Unless by coincidence one circuit offsetting operation happens to cancel out simultaneously the surpluses and deficits of two or more countries.

countries A, B and C have zero surpluses and 650 , 120 and 120 deficits respectively while countries D and E have zero deficits and 640 and 310 surpluses respectively. This, however, has an important implication for a multilateral payments union; namely, that there is a possibility (at least theoretical) that all deficits may be concentrated against one country thus spelling out considerable inflationary forces therein. To prevent a situation of this sort from developing it is necessaty to make a detailed study of the trade pattern among countries contemplating the establishment of a payments union among themselves. In order to plan for any possible concentration, it is necessary to set the credit and debit limits in such a way as to make every country able to bear the force of concentration, and to set rules for the settlement of claims whereby every country is given the right to convert a part of these credits into gold and foreign exchange.[17]

A further complication raised by a system of multilateral offsetting is that countries have to accept the obligation by all debtors for credits extended to the union rather than the obligation of a given country. The substitution of collective for individual indebtedness may nevertheless mean that creditor countries will

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17. Raymond Mikesell, "Regional Multilateral Payments Arrangements", Quarterly Journal of Economics, August 1948, p. 513.

sometimes have to accept payment in softer currencies than they would under a bilateral payments system or even under circuit offsetting. Furthermore, while a multilateral system implies an automatic pooling of balances, a bilateral system or circuit offsetting retain some discretionary powers for the member countries.

A comparison of Illustrations V and VI also indicates that the net balances which remain for settlement under a multilateral system are invariably smaller than the net balances which have to be settled under a circuit offsetting mechanism. The amounts of balances cancelled out under the two types of mechanisms depends inter alia on the degree of overall disequilibrium in the payments of the member countries, and on the magnitude of the smallest balances. This can be illustrated with the help of the following hypothetical examples.

Illustration VII

Net Balances Remaining After Bilateral Clearing

	A	B	C	D	Total Surplus
A	-	100	250	150	500
B		-	220	180	400
C			-	170	170
D				-	0
Total Deficit	0	100	470	500	1070

In Illustration VII the attainment of a zero surplus by country D and zero deficit by country A blocks any further circuit offsetting. In other words Illustration VII does not have any complete circuit which can be offset. The application of multilateral offsetting to the figures in Illustration VII gives the following results.

Illustration VIII

Net Balances Remaining After Multilateral Clearing

	A	B	C	D	Total Surpluses
A	-				500
B		-			300
C			-		0
D				-	0
Total Deficits	0	0	300	500	800

Thus of a total of 1,070 net balances which cannot be cleared either by bilateral clearing or by circuit offsetting, 370 could be cleared by a system of multilateral clearing leaving 800 for settlement.

The main lines of an offsetting mechanism for a prospective Arab Payments Union could be outlined here in the light of the foregoing discussion. It will probably be advisable for Arab countries to start with an automatic circuit offsetting mechanism for all members of the union and with an optional multilateral offsetting mechanism for member countries which at present impose few restrictions on their payments. Such an arrangement will probably be politically more acceptable since it does not admit of the pooling of balances and will give member countries which impose considerable restrictions on payments sufficient leeway to adjust their payments mechanism to accommodate a regional multilateral system. Yet this arrangement should be temporary and introduced only as a transitional phase. The experience of E.P.U. has in fact made clear the futility of circuit offsetting as a permanent arrangement.

It is however extremely important that the pattern of payments of the various Arab countries be studied in some detail in order to determine both the type of clearing mechanism most suited for the area and the type of settlement mechanism required. Such studies will consist of balance of payments studies, analysis of the composition of trade in each country, the direction of trade, and the currencies used in international

transactions by the various member countries. This will help to locate the critical balances of the various member countries and to arrive at an estimate of the maximum balances which can be cleared with the help of each mechanism.

For the above offsetting mechanism it seems that the fund type of payments union is not a very workable device and may not be a very practical proposal for the Arab Middle East. Arab countries are probably less disposed to pool a certain proportion of their reserves than they are to extend credit to a central organization. Furthermore, the fund type of payments union is a rather more complicated form of organization to administer, and the problem of choosing a location for the administrative set up for the payments union will become more difficult to solve under it than it is under the credit form of payments union.

IV. The Settlement and Adjustment Mechanism

Closely linked with the problem of offsetting deficits and surpluses is the two-fold problem of the settlement of the remaining net balances and the adjustment of the balance of payments in order to restore equilibrium.

Unlike a clearing union a payments union does not require the immediate settlement of net balances arising from trade. Members of the union are required to extend credit to the union according to a schedule

of quotas. The union then agrees to accommodate the deficits in the payments of a member country with the remaining countries up to a certain limit determined in advance and usually equivalent to the credit extended by the member country to the union.

The problem of deciding on the quotas of the member countries may prove to be a thorny one. Member countries will probably try to obtain large drawing rights but may nevertheless attempt to shirk the responsibility of having to extend to the union equivalent credit. A possible solution to this problem is indicated if member countries agree that whatever the drawing rights made available to them are, they must extend to the union equivalent credit. The quotas of the various member countries should then be arrived at in accordance with a general rule based upon some relevant criteria such as the magnitude of deficits or surpluses which a member country has with the remaining members of the union over a certain period of time, the availability of foreign exchange and gold reserves, and the overall equilibrium position of that country.

Once the schedule of quotas is decided upon a schedule for the settlement of both credits extended to the union and debits incurred with the union should also be agreed upon. Settlement in gold or convertible

currency should probably be made according to an increasing schedule of rates such as the one adopted by the European Payments Union or the one suggested by Keynes for the International Clearing Union. The Union will also settle credit balances extended to it by member countries in accordance with a similar schedule of rates. But provided that the union is not required to make settlement in gold or convertible currency at a more rapid rate than such settlement is required of member countries, the question of deciding on these two schedules may be subjected to considerable bargaining among the various member countries, Countries which expect to incur deficits with the union will probably try to institute an easy credit policy whereas countries which expect to be creditors will insist upon a strict credit policy both in the settlement of claims to the union and in the settlement of claims by the union. A suggested schedule for the settlement of claims in a payments union is presented below.

Settlement of Balances to the Union			Settlement of Balances by the Union		
Percentage of Drawing Rights (Quotas)	Percentage of Settlement in gold and Convertible Currency	Rate of Interest Charged for Debits Outstanding	Percentage of Drawing Rights (Quotas)	Percentage of Settlement in gold and Convertible Currency	Rate of Interest paid for Credits Extended to Union
First 25%	0	3 %	35%	0 %	2 %
25 - 50 %	25	4 %	35 - 70%	30 %	3 %
50 - 75 %	50	5 %	70 -100%	60 %	4 %
75 -100 %	75	6 %	over 100%	100 %	
over 100%					

The above hypothetical schedule seems to satisfy some of the basic requirements of a sound settlement mechanism for an inter Arab Payments Union. In the first place, settlement of deficits incurred by member countries with the union is required to take place at a more rapid rate than the settlement of claims outstanding against the union. This will probably ensure that the union will not have to pay out in gold and convertible currencies more than it actually receives from member countries. On the other hand, if the union accumulates international reserves, then the schedules could be adjusted in such a way as to bring into closer equality the receipts and payment of these reserves. In the second place, the above schedule provides the union with a further check on the accumulation of balances; namely, the requirement that interest on such balances be paid in accordance with a schedule of rising interest rates. Thirdly, the provision that the payment of interest by the union to the member countries will be smaller than its receipts therefrom will provide the union with a constant flow of funds which may be adequate to cover the administrative and research expenses of the organization. Such an arrangement is probably superior to the alternative plan which provides that the union be supported from regular contribu-

tions made by member countries. The union renders credit services for which it can legitimately impose a small charge to cover the cost of such services.

These provisions - namely that member countries be subjected to an increasing pressure in order to reduce their deficits with the union - are necessary in order to keep the functioning of the union within the limits specified in the quota schedule agreed upon and to give member countries sufficient leeway in order to bring about the necessary adjustments in their payments. Yet it is contrary to the prupose of a payments union to require that deficits be completely or largely settled in gold and convertible currencies as soon as they are incurred. A payments union will, in fact, cease to function when member countries, having exhausted their quotas of drawing rights, are required to settle all additional deficits by the payment of international liquid reserves.

Provisions should therefore be enacted into the payments union agreement in order to ensure that member countries introduce such corrective measures as are adequate to bring about the required adjustments. A good plan should in fact give this problem a thorough rather than a sketchy treatment. It should also contain provisions for constant research in this field in order to determine the efficiency of the various alternative

measures for the adjustment of the balance of payments of member countries on their economies, and the steps necessary for the implementation of each of these measures.

Generally, however, countries are unwilling to accept the decision of a supernational institution in such matters as exchange rate adjustment, fiscal and monetary policy, exchange control, and import restrictions. It may therefore seem advisable to endow a regional payments union with only advisory powers on such matters. The payments union may nevertheless be given the power to apply sanctions against a member country which consistently ignores the advice of the union and thereby jeopardizes its proper functioning.

Foremost among the problems of a payments union is to decide on the general rules for exchange rate adjustment. Parity rates of the various currencies should at first be defined. It is then necessary to formulate principles for the adjustment of the exchange rate of a currency wherever it is deemed to be either overvalued or undervalued. But aside from the practical difficulty of determining the equilibrium rate of exchange and the degree of overvaluation or undervaluation, a payments union must be based upon a sound understanding of exchange rate adjustment as a means for correcting disequilibrium in the balance of payments.

In fact recently some disillusionment has been voiced with respect to the efficiency of exchange rate adjustment as a means for correcting a disequilibrium in payments. It is now recognized that devaluation is a blunt and indiscriminate device which in many cases may be inferior to selective control.[18]

Devaluation tends to encourage exports and reduce imports subject to the following qualifications:

1. The export advantage presupposes that countries adversely affected will not retaliate or will retaliate by a lesser degree of devaluation.

2. The export increase tends to be wiped out by a rise in costs and prices. If a country is subject to inflationary forces, then devaluation will occasion a further rise in prices and may not result in any increase in exports.

3. If the price elasticity of demand for the exports of the devaluing country is low, then devaluation will not increase the value of exports and may actually result in a diminution of foreign exchange acquisitions.

4. Import disadvantages will wipe out the export advantages if a country relies heavily on international trade. Devaluation will result in a fall in

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18. Thomas Balogh, "Exchange Depreciation and Economic Readjustment", Review of Economics and Statistics, November 1948, p. 279.

realwages and in a deterioration in the terms of trade.[19]

The foregoing arguments indicate that the provisions governing exchange rate adjustment in a payments union are dictated by the pattern of trade of the member countries, the nature of the disequilibrium, its causes, course, and duration. Devaluation is likely to be effective as a corrective measure if disequilibrium in the balance of payments is a price disequilibrium, which results either from overvaluation or undervaluation of a currency or from a change in the price level either at home or abroad. But devaluation need not be effective if the disequilibrium in the balance of payments is a structural disequilibrium resulting from such factors as a shift in demand for a major export product or changes in the conditions of supply for a product.[20] Thus let X be the overall balance in the payments of country (1) and x_2, x_3, ... x_n be its surplus or deficits with countries 2, 3, ... n. then

$$X \equiv x_2 + x_3 + x_4 ..... + x_n$$

Where $X \neq 0$

Let the currency of country (1) be sufficiently depreciated to bring the balance of payments into

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19. Kenneth Kurihara, Monetary Theory and Public Policy (London: Allen and Unwin, 1951) pp. 309-10.

20. The argument is presented here in terms of devaluation only because the payments problems of a deficit country are more distinct than those of a surplus country.

equilibrium (i.e. $X \equiv 0$). This will affect the balances of countries 2 ..... n yet not in the same proportions as to eliminate the deficits in each. "Depreciation is a new disturbance which does not neutralize the effects of a shift of demand or supply for country (1)". If the effects of depreciation on countries 2 .....n are $y_2, y_3 \ldots\ldots + y_n$ then.

$$(x_2 - y_2) + (x_3 - y_3) \ldots\ldots (x_n - y_n) \equiv 0$$

but $(x_2 - y_2) \neq 0$ and $(x_n - y_n) \neq 0$, etc.

On the basis of the foregoing discussion the following conclusions could be drawn with respect to an exchange rate adjustment mechanism for an Arab Payments Unions:

1. It may be advisable that the union be given minimum powers with regard to the exchange rate policies of the various member countries.

2. The importance of research to determine the efficiency of exchange rate policy on balance of payments equilibrium of the various member countries should be stressed.

3. The union should include measures to deal not only with countries which incur a surplus. The burden of adjustment should in fact fall on both creditor and debtor countries and not on the latter only,

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21. The above analysis was taken from J.J. Polak's "Exchange Depreciation and International Monetary Stability", Review of Economics and Statistics, No. 3, Vol. XXIX, August1947, pp. 173 - 77 .

specially as creditor countries are put under no pressure to effect these adjustments.

4. Exchange rate adjustment is primarily a non discriminatory adjustment mechanism and should therefore not be applied wherever a selective measure (such as restrictions on a few imports) is more effective .

A payments union should also include provisions for the application of other measures of adjustment, such as import restrictions, exchange control, fiscal and monetary policy, and expenditure on development projects. The union aims at the attainment of equilibrium in the payments among member countries and in the overall payments position of the whole group.

These two aspects of a payments mechanism which the union must deal with; namely, the attainment of equilibrium within the group and the attainment of equilibrium by the group as a whole, must be coordinated into one system. In other words, the provisions enacted into the union to deal with the problem of equilibrium among the countries of the union must be consistent with the provisions enacted to deal with the problem of the equilibrium of the whole group.

Foremost among the problems of the equilibrium of the whole group is that of the scarce currencies and particularly the dollar shortage. The existence of a scarce currency with respect to the region as a whole

makes it imperative for the group of countries to practise discriminatory exchange and trade restrictions against the scarce currency area. Otherwise, the attempt by a group of countries to attain a greater degree of convertibility in their currencies will result in a state whereby each country attempts to maintain its imports from the scarce currency area at the cost of reducing its imports from other countries. This will create a scramble for the scarce currency and will result in an aggravation of the shortage rather than in the improvement of the situation.[22]

The above provides an explanation why any group of countries which desire to establish limited convertibility among themselves have to provide for some sort of pooling of scarce currencies and for a joint policy regarding such pools. The emphasis should probably be based here on the joint policy and not on the fact of pooling, specially with respect to the Arab Middle East. For countries will consent to pool their scarce currencies provided that they are neither regular contributors to the pool nor regular recipients of scarce currencies from the pool. Cooperative action in this respect must be based on conditions whereby the demand for and the supply of scarce currencies by member countries are of

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22. Joan Robinson, "The International Currency Proposals", from S. Harris (editor), The New Economics (London: Dobson, 1949), pp. 166-67.

a cyclical rather than persistent nature. This is a rather weighty argument against the establishment of a common hard currency pool among the Arab countries; for it seems that the ability of the various Arab countries to earn hard currencies differs considerably from one country to the other. Countries with the greater ability to earn hard currencies may resent the fact that they consistently have to forego a portion of their hard currency earnings and be given softer currencies in exchange. This will induce them to withdraw from the pool (assuming they have agreed to participate) leaving only deficit countries in the union and thus depriving the pool of one of its basic purposes. It seems, therefore, that any payments plan which aims at the establishment of limited convertibility should rely on an agreed upon policy and not on a common pool.

The policy most commonly adopted with respect to a scarce currency consists of discriminatory measures applied against the scarce currency in order to bring into equality the demand for that currency with the available supply. Yet the need to resort to discriminatory measures in this case has called the attention of some economists to the effectiveness of such measures in correcting an unbalance in payments irrespective of the nature of disequilibrium. A rather strong case has in fact been made recently by Ragnar Frisch in support of

the superiority of discriminatory means of adjustment over non-discriminatory measures.[23]

Frisch criticizes the traditional non-discriminatory adjustment mechanism of the I.T.O. and I.M.F. on the grounds that they propose a one-country-approach which does not solve the problem of disequilibrium but rather shifts it to other points in the system and which results in a greater contraction of trade. This is illustrated with the help of the following simple matrices.[24]

I. Unbalanced Matrix.

(Global sum = 20)

Exporting / Importing	A	B	C	Net Surplus
A	-	5	1	
B	3	-	2	
C	8	1	-	6
Net Deficit	5	1		6

23. See R. Frisch, "On the Need for Forecasting a Multilateral Balance of Payments," American Economic Review, September 1947. Also R. Frisch, "Outline of a System of Multicompensatory Trade", Review of Economics and Statistics, November 1948.

24. Ragnar Frisch, "On the Need for Forecasting a Multilateral Balance of Payments", American Economic Review, September 1947, pp. 541-47.

In Matrix I the total volume of trade is 20 while the deficits or surpluses amount to 6. The attainment of equilibrium via non-discrimintary measures will result in the following:

II. Solution with Proportionality Condition

(Global sum = 9.39)

Exporting / Importing	A	B	C	Net Surplus
A	-	2.45	1.00	0
B	0.94	-	2.00	0
C	2.51	0.49	-	0
Net Deficit	0	0	0	0

III. Solution without Proportionality Condition

(Global sum = 14)

Exporting / Importing	A	B	C	Net Surplus
A	-	5	1	0
B	3	-	2	0
C	3	0	-	0
Net Deficit	0	0	0	0

It will be seen from Matrices II and III that application of discriminatory measures reduces trade to 14 while application of non-discriminatory measures reduces trade to 9.39. Selective measures are therefore less restrictive of trade than non-discriminatory measures.

The above case for discrimination has important implications for any payments union. It implies that, subject to certain accepted rules, a payments union will be given the power to advise the application of measures which may appear to sacrifice the interests of one member country for the advantage of the union or of a group of countries. But aside from some theoretical pitfalls in the theory,[25] the main criticism against the case for discrimination is that it presupposes a degree of political integration which is not very common. Frisch's case requires in fact an ideal degree of cooperation among nations which, if attainable, should be applied to the attainment of a more rational trade policy and not simply to the one which aims at "minimum-contraction-

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25. See S. Meier, "A Trade Matrix: A Further Comment on Professor Frisch's Paper", American Economic Review, September 1948. J.J. Polak, "Balancing International Trade: a Comment on Professor Frisch's Paper", American Economic Review, March 1948. Anthony Koo, "A Note on Professor Frisch's Trade Matrix and Discriminatory Restriction of Imports", The Review of Economics and Statistics, February 1952. Randall Hinshaw, "Professor Frisch on Discrimination and Multilateral Trade", The Review of Economics and Statistics, November 1948.

via-discrimination".[26] Indeed under such ideal conditions it will make little difference if the aim is placed a little higher.[27]

It is advisable for an Arab payments union to be given a traditional non-discriminatory adjustment mechanism. This arrangement will be politically more acceptable and much easier to manage.

V. Financing the Payments Union

It will be noted from the foregoing discussion that the need for funds to finance a prospective Arab payments union arises from four possible sources. In the first place, considerable sums may be needed for the preliminary studies and for the establishment of the organization. Secondly, funds will be needed to cover the administrative and research expenses of the union throughout its life. Thirdly, the union may need some funds in case it has to make settlement to creditor countries at a more rapid rate than such settlements are made to the union by debtor countries. Schedules for the settlement of claims by and to the union will be set in such a way as to equalize the total of international reserves received by the union with the total

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26. Randall Hinshaw, "Professor Frisch on Discrimination and Multilateral Trade", Review of Economics and Statistics, November 1948, p. 274.

27. loc. cit.

payments made by the union. An initial fund will nevertheless be needed to pair off such receipts and payments which may be subject to considerable fluctuations. Fourthly, the union may need funds to settle a claim held by a member country which decides to withdraw from the union.

For all of the above purposes the union will require a reserve fund and a constant source of income to cover current expenses. To finance the union the following measures may therefore be recommended:

1. Member countries will be called upon to deposit with the union a certain proportion of their international reserves. The quota of every member country will be determined in advance in accordance with an agreed upon principle. For example, every member country may be required to deposit with the union reserves equivalent to say 25 per cent of its drawing rights, and of the total deposits not less than one third should be paid in gold, dollars and other convertible currencies. The remaining two thirds could be paid in the national currencies of the member countries provided that every country agrees to convert its currency into gold and convertible currencies upon the request of the union.

2. The union will be allowed to charge a higher interest rate on its credits with member countries than

it will pay on its debits with creditor countries. Since all debits with the union must necessarily equal all credits, the difference in the interest charged and the interest paid will give rise to a surplus which may be used by the union to cover the administrative and research expenses of the organization.

3. In case the funds available are not sufficient to cover the current expenses of the union, member countries will be required to make regular contributions to cover the resulting deficit. Furthermore, the union must reserve the right to call upon member countries in case of any unexpected need for funds.

Chapter VI

Conclusion

While the discussion in the present paper has been mostly inconclusive, it has nevertheless been possible to arrive at some important conclusions regarding both the establishment and organization of a suggested payments union for the Arab Middle East. An attempt is made in the present chapter to summarise some of these conclusions.

1. The paper deals with regional economic integration, which takes as given the present political set up in the Arab Middle East. The payments union is "an arrangement between sovereign states aiming at the same distribution of resources in the light of the total consumer and investment demand as might take place if the several states were combined into one political and economic unit."[1] Yet a payments union deals only with one aspect of the problem of regional economic integration; namely, the organization of effective financial cooperation on a multilateral basis.

2. The advantages which will result from a regional payments union are mostly long-run advantages.

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1. See page 1 above.

In fact, a regional payments union implies some radical adjustments in the short-run and may call for a considerable redemployment of resources in the various countries. A payments union will therefore have to face considerable opposition from vested interests. Furthermore, owing to political instability in the Arab Middle East; Arab governments are prone to be susceptible to these short-run considerations. In the present paper an attempt was made to assess the relative political influence of various economic groups in Syria and Lebanon regarding their views on regional economic integration. On the whole, it was found that while the groups which stand to lose by regional economic integration are outspoken in their views on the matter and attempt to exert considerable pressure on their respective governments, the groups which stand to benefit are either indifferent or completely unaware of the issue. The reason for this difference in attitudes is that the advantages of a payments union are mostly long-run advantages in which cause and effect will not be established while the losses are short-run and immediate. The groups which stand to lose will therefore fight for what they already have with much greater vigour than those who are likely to benefit in the long-run.

3. In defining the area which an Arab payments union might comprise emphasis should be placed on voluntary adherence to the union. Neither feelings of brotherhood nor considerations of pure philanthropy on the part of a few prospective member countries should be invoked in support of a regional payments union. The area studied in the present paper comprised the countries of the Arab League, because the Arab League provides a vehicle for the agreement on fundamental political and economic problems among its member countries.

Technically, however, a payments union should include all countries which have payments problems among them, which are fully aware of the advantages of a payments union and which are ready to shoulder the responsibilities of internal short-run adjustments. Provided that the above conditions are satisfied, political accord among the member countries becomes a basic requirement for the establishment of a payments union.

4. Arab countries are subject to common conditions with respect to their payments problems. Thus military requirements and the desire to attain a rapid rate of economic development have been given a fillip by the establishment of Israel. These tendencies create an ever increasing desire for foreign exchange resources and persistent balance of payments problems.

Furthermore, most Arab countries rely on the export of a few primary products for their foreign exchange requirements. Since the exports of these commodities are subject to considerable seasonal and cyclical fluctuations, the whole balance of payments becomes subject to similar fluctuations.

Petroleum exports present a somewhat different picture. While such exports are not subject to any regular seasonal and cyclical fluctuations, the phenomenal expansion in the production of petroleum in the Arab world creates different payments problems.

5. A study of exchange control and exchange stabilization systems in the different countries of the Arab Middle East is necessary in order to determine the possibilities for regional financial cooperation. An attempt was made in the present paper to analyze the systems of exchange control in four Arab countries only; namely, Syria, Lebanon, Iraq and Egypt. Of these four countries, Lebanon imposes the least degree of restrictions on its payments with the rest of the world. It has also succeeded, owing to some factors discussed in the text of the present thesis, to create a free world money market in Beirut. On the other hand, while the Syrian exchange control system is substantially similar to that of Lebanon, conditions in Syria were not favourable to the development of a free money market of any great importance.

Iraq and Egypt, on the other hand, have introduced measures of exchange control which, in their severity, surpass those introduced in either Syria or Lebanon. The main reasons for this difference are the following:

In Iraq the sharp rise in the production and exports of oil since 1940 resulted in a rapid increase in the foreign exchange earnings of the country. Thus direct payments made by the petroleum companies to Iraq amounted to about $ 8 million in 1940. By 1952 such payments had increased to $ 110 million annually.[2] But since Iraq lacked a developed monetary and fiscal set up, the government had to resort to a strict system of exchange control in order to cushion the effects of this sharp increase in the value of exports on the stability of the Iraqi dinar and economic life.

With reference to Egypt, however, the main reasons behind the system of exchange control rest in the fact that Egypt relies heavily on the exports of a highly unstable product - cotton. The value of cotton exports are subject to violent seasonal and cyclical fluctuations, notwithstanding the fact that in addition to the country's poverty in foreign exchange reserves,

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2. U.N.O., Review of Economic Conditions in the Middle East, 1951-1952, Department of Economic Affairs, (New York, March 1953), P59.

about 60 per cent of these reserves are in the form of blocked sterling balances.[3]

A plan for financial cooperation among Arab countries will not be acceptable unless it provides a more satisfactory solution to their respective payments problems. A thorough understanding of these problems is therefore extremely important for the establishment of a regional payments union.

6. There may be a desire on the part of some Arab countries to entrust the payments union with other, but apparently related, functions such as the supervision and promotion of development projects. It is also very likely that some countries will suspect that the payments union is a vehicle for the spreading out of petroleum royalties over the whole region.

While it is true that the payments union aims at a more even distribution of resources in the region and may succeed in removing some of the obstacles to the free movement of factors of production among Arab countries, it does not follow that the pattern of capital movement within the region will be from oil producing countries to other countries. Aside from government control, capital tends to move in accordance with considerations of security and remuneration. Evidently, no necessary and direct relationship can be established

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3. National Bank of Egypt, Economic Bulletin, Vol. VI, 1953.

between the mere fact that a country is a recipient of oil royalties and the security and remuneration of investments in that country.

Yet a confusion of functions should not be allowed into the payments union by entrusting it with such other functions which do not strictly pertain to payments and exchange stabilization problems. This narrower definition of the functions of a payments union, whereby the union is entrusted with specific and closely related functions seems to be politically more acceptable and administratively more sound.

7. The importance of political harmony among the member countries of a prospective payments union cannot be overemphasized. In fact, conditions in the Arab Middle East may sometimes require the application of discriminatory or preferential measures. Such measures will not be accepted unless the member countries are agreed on basic political, economic and military problems.

8. A payments union should include specific provisions for the liberalization of trade to go side by side with the liberalization of payments. In this respect a payments union is only a permissive device unless specific provisions to liberalize trade are made a part of the agreement.

9. A full multilateral payments union will only be accepted if member countries have already attained a reasonable degree of economic stability, both internally and externally. It is therefore necessary that a period of adjustment precede the establishment of a payments union, or that a full multilateral arrangement be introduced in stages extending over a period of time which is sufficiently long to enable member countries to effect the necessary adjustments in their payments mechanism.

10. The importance of research into the field covered by a payments union should be stressed. Detailed research into the relevant problems is necessary in order to determine the type of agreement suited for the Arab countries, the problems which it will deal with, the possible effect of the union on the payments position of the Arab countries as a group, and the funds necessary for the union.

Appendix I

The following table gives the total value of external trade as a percentage of national income in a few countries selected at random. While these percentages may not be significant for any single country, they are significant for comparison purposes among countries. They indicate that there is no necessary relationship between the degree of economic development and the importance of foreign trade in a country.

Total Value
of
Exports and Imports as Percentage of
the National Income in various countries

Country	Units of Currency used	Total Value of Imports and Exports	National Income	Percentage of Column (3) to (4)
Ceylon	million rupees	3,563	4,507	79
Norway	million kroner	10,679	15,504	69
Denmark	" "	12,779	20,716	63
United Kingdom	million £	6,621	11,384	58
Australia	million £ A	1,723	3,238	53
Burma	million rupees	1,662	3,166	52
Sweden	million Kroner	18,406	36,800	50
Canada	million $ C	8,048	17,229	47
France	billion francs	3,039	9,082	33
Italy	billion lire	2,351	7,746	30
Japan	billion yen	1,228	4,564	27
Turkey	million £ T	2,005	9,706	21
Argentina	million pesos	10,248	73,000	14
U.S.A.	million $	26,094	277,554	8

Source: U.N.O., Yearbook of International Trade Statistics, 1951 and Statistical Yearbook, 1952.

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