

REQUIREMENTS AND DESIRABILITY  
OF A  
CONVERTIBLE LEBANESE CURRENCY

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A CONVERTIBLE LEBANESE CURRENCY

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## PREFACE

The subject of currency convertibility has been assuming an increasingly important role in the general field of international finance since the end of the Second World War. With the beginning of the postwar era, the International Monetary Fund representing a new institutional arrangement in international finance was put to test. Having renounced the "automatic" system of rigidly maintained exchange rates and its antithesis, the individualistic system of inconvertible paper currencies, the world set out to test the appropriateness of the new synthesis which proclaims currency convertibility at stable exchange rates as objective, and which entails fixed but adjustable exchange rates.

For a country like Lebanon which occupies a central financial and trade position in the Middle East and in the economy of which the foreign sector occupies a place of comparative eminence, a discussion of currency convertibility should prove, in theory at least, of greater importance than otherwise. The present dissertation is an attempt to find out whether Lebanon, having already achieved the de facto convertibility of its currency, can (and if it can, whether it should) maintain de jure convertibility or not. For the

ideas advanced here, the author makes no claim whatever to originality; they represent perhaps no more than an elaboration of current points of view on the subject. However, he hopes that in certain instances he has succeeded in giving expository force to various ideas not always clearly stated.

The author wishes to acknowledge his deep gratitude to Professor Paul J. Klat under whose supervision this study has been undertaken and whose advice, encouragement and un-failing patience proved invaluable in ironing out much of the crudities and angularities of the dissertation. None but himself, however, is responsible for the shortcomings that still remain.

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## ABSTRACT

As a member of the International Monetary Fund, Lebanon is under the obligation to maintain its currency convertible. Nevertheless, ever since it joined the Fund in 1947, it has availed itself of the transitional arrangements provided for in the Articles of Agreement, and as such, has refrained from fulfilling its obligation of formal convertibility. However, for practical purposes, the Lebanese currency is today de facto convertible, and Lebanon maintains a gold cover of over 95% of note circulation. The present dissertation inquires into the conditions which should first be satisfied if Lebanon is to maintain de jure convertibility, and considers the desirability of such course of action.

The study falls into two parts. The first consists of a theoretical presentation of the definition of currency convertibility, and of the various general conditions of convertibility. As defined in the Articles of Agreement of the Fund, currency convertibility implies the availability of a currency for conversion into another currency (or into gold) at fixed but adjustable rates of exchange for the purpose of making payments on current account. As for the conditions of convertibility, they are: balanced international

accounts; proper internal financial situation; suitable world payments situation; and, finally, adequate international liquidity.

The second part of the study is essentially an investigation into whether Lebanon can and should maintain de jure convertibility. Because of the particulars of the Lebanese economy, currency convertibility should include, for Lebanon, freedom of exchange operations for all purposes, current and capital. As such convertibility would present three possible advantages for Lebanon: it would safeguard the country against any financial expansion which is not warranted in view of the country's international liquidity and foreign exchange earnings; it would contribute toward the stabilization and growth of capital movements into the country; and, finally, it would contribute toward the stabilization and growth of various service items in the country's balance of payments.

It is believed that Lebanon currently satisfies all four general conditions listed above; however, two specific conditions, made necessary by the peculiarities of Lebanon's situation, remain still unsatisfied. These are the need to declare a new and more realistic par value of the Lebanese pound and the need for an adequate and effective monetary policy. Accordingly, and in view of the advantages which the establishment and subsequent maintenance of de jure converti-

bility are expected to produce, necessary steps should be taken in order to remove these two obstacles which still obstruct Lebanon's advance on the road to convertibility.

## TABLE OF CONTENTS

	Page
PREFACE .....	iv
ABSTRACT .....	vi
LIST OF TABLES .....	xi
 CHAPTER	
I. MONETARY CONVERTIBILITY - A DEFINITION .....	1
The International Gold Standard .....	2
The Inconvertible Paper Standard .....	19
The International Monetary Fund .....	28
 II. CONDITIONS OF CONVERTIBILITY .....	 46
Balanced International Accounts .....	46
Proper Internal Financial Situation .....	56
The World Payment Situation .....	70
Adequate International Liquidity .....	85

CHAPTER		Page
III.	THE SALIENT FEATURES OF THE LEBANESE ECONOMY .....	118
	Basic Features of the Economy .....	118
	The Foreign Sector .....	127 —
	Currency and Banking .....	153
	Public Finances and Development Policy .....	164
	Conclusion .....	170
IV.	THE ADVANTAGES OF CONVERTIBILITY .....	173 /
V.	CONCLUSION AND RECOMMENDATIONS .....	209
	BIBLIOGRAPHY .....	236

## LIST OF TABLES

Table	Page
1. Charges on Fund Holdings of a Member's Currency in Excess of the Member's Quota .....	105
2. National Income of Lebanon by Sectors of the Economy (1950) .....	121
3. Balance of Payments of Lebanon (1951-1954) .....	131
4. Balance of Payments of Lebanon by Trade, Services, and Capital Accounts (1951-1954).....	132
5. Official Gold and Foreign Exchange Holdings of Lebanon .....	143
6. Note Circulation and Note Cover (1948-1955) .....	157
7. Ordinary Budget of the Government of Lebanon .....	165
8. Movements in Reserve Fund (1946-1954) ....	166
9. Wholesale Prices and Cost of Living Indices in Lebanon (1948-1954) .....	170

## CHAPTER I

### MONETARY CONVERTIBILITY - A DEFINITION

Before beginning the analysis of the technical meaning which the term monetary convertibility has come to acquire today, it is appropriate to explain, in general terms, the content and significance of monetary convertibility. Generally, monetary convertibility signifies the ability to convert a currency into a means of international payment which is acceptable in any country or currency area. "Convertibility involves the right in fact to obtain, directly or indirectly, gold or a currency of unrestricted use in exchange for holdings of the convertible currency."<sup>1</sup> Thus the essence of monetary convertibility is the right to exchange a currency into a means of international payment which is readily transferable and acceptable. This right may not be completely unlimited; it may be restricted to all or part of payments for current transactions, or it may be restricted to certain definite countries or currency areas. It may also be extended to some holders of a currency but not to others. Thus, convertibility may be of various types depending on the extent to which the freedom of exchange transactions is

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1. International Monetary Fund, Annual Report, Washington, D.C., 1949, p. 28.

unrestricted. "Full convertibility would occur when any holder, regardless of how he came into possession of a currency and regardless of how he plans to use the foreign currency, may convert into the foreign currency without interference."<sup>1</sup>

Since convertibility, broadly speaking, is at the basis of any arrangement of payments for international transactions, a discussion of the different forms which it had taken in the past, and of the form which it has taken today, calls for a description of the various international monetary systems that were practised in the past as well as of the one existing now. This entails a discussion of the international gold standard, of the paper standard adopted in the nineteen thirties, and lastly, of the International Monetary Fund.

### The International Gold Standard

The international gold standard as an international financial system was adopted in the second half of the nineteenth century.<sup>2</sup> It is an arrangement whereby convertibility of currencies and stability in exchange rates are maintained. "The only intelligible meaning to be assigned to the phrase 'the international gold standard' is the simultaneous presence, in

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1. Willard L. Thorp, Trade, Aid, or What?, (Baltimore: The Johns Hopkins Press, 1954), p. 132.
  2. T.E. Gregory, The Gold Standard and Its Future, (New York: E.P. Dutton & Co., Inc., 1935), p.1.



a group of countries, of arrangements by which, in each of them, gold is convertible at a fixed rate into the local currency and the local currency into gold, and by which gold movements from any one of these areas to any of the others are freely permitted by all of them."<sup>1</sup> If these are in general the characteristics of the gold standard, how, in fact, did it function to maintain the convertibility of currencies and the stability in their external value?

A qualifying statement must first be mentioned before an attempt is made at a discussion of the actual working of the gold standard. The following account of the actual working of the said standard is an abstract description of major trends, and, since it lacks laboured detail concerning the exact complexity of events, it may even distort some of the facts. It is essentially general in nature, and this generality represents its major weakness, for "at no time have all countries been prepared to accept to a like extent all the responsibilities which devolve from an international monetary system".<sup>2</sup> A brief account of the way in which the international gold standard operated before the First World War is now given.

The gold standard applicable before 1914 came nearest to what may be called the pure or authentic gold standard. Under

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1. Ibid., pp. 7-8.

2. League of Nations, Second Interim Report of the Gold Delegation of the Financial Committee, (Geneva: League of Nations, 1931), p. 9.

this system, gold coins circulated equally with bank-notes and gold formed the basis upon which the whole credit and banking structure rested, thus determining the volume of the note issue; as the monetary stock of gold changed, the note issue could as well be changed by a multiple, depending upon the ratio which law or custom maintained between monetary gold and the volume of currency. Thus, gold movements which affected the stock of monetary gold reserves of a country had direct influences upon the total amount of money in that country. Moreover, under the authentic gold standard as it functioned before 1914, notes were freely converted into gold at a fixed price and gold movements among countries were unrestricted. The rate of exchange between any two currencies was determined by the gold contents of a unit of each currency, which contents remained unchanged for all practical purposes. Thus, the rate of exchange between any two currencies which were on the gold standard was fixed, or, could only vary between narrow limits set by the cost incurred in moving gold between the centers concerned. A hypothetical example will render this more clear.

Suppose that one sterling pound is declared by the British monetary authorities to be worth eight grains of gold of a specific fineness and that one dollar is declared by the United States monetary authorities to be worth two grains of gold of the same fineness. The exchange rate between the pound sterling and the U.S. dollar as expressed by their gold

contents in this case would be £ 1 = US \$4. Suppose, further, that for some reason or another, demand for sterling increased relatively to that for dollars. The gold standard would prevent an appreciation of the pound sterling vis-a-vis the dollar which might have otherwise been the result of the assumed increase in the demand for sterling. This appreciation in the value of sterling is prevented by the movement of gold from New York to London. An American importer who is in need of sterling has the choice of either directly buying sterling in New York for payment in London or else, buying gold in New York, sending it to London and there converting it into sterling. It is exactly because he has the choice between these two alternatives that the price of sterling vis-a-vis the dollar would not rise by more than what it costs to send the gold contents of one sterling pound from New York to London to be converted there into sterling. This maximum limit within which the value of sterling vis-a-vis the dollar may rise under the gold standard is called the gold export point. When the rate of exchange is at the gold export point, the two possibilities open for an American importer to secure sterling are equally expensive; hence, he is presumably indifferent to them. And importers who cannot secure sterling directly against their dollars will in fact settle their obligations quoted in sterling by sending gold to London.

The reverse is also true, i.e., in case of a fall in the demand for sterling relative to that for dollars. The par value of sterling to dollar (£ 1 = US \$4) would not fall

by more than what it costs to send the gold contents of four US dollars from London to New York to be converted there into dollars. This minimum to which the value of sterling to dollar may fall is called the gold import point. Those American exporters who cannot sell their sterling at this rate, will prefer to repatriate their earnings by importing gold from London to New York.

This is a hypothetical example showing how, under the gold standard, convertibility of currencies and stability of their exchange rates are maintained - exchange rates being allowed to vary around a given par value set by the gold contents of the currencies concerned, and only within relatively narrow limits set by the gold export and gold import points. However, as it can be seen from the hypothetical example given above, there are two conditions which must be fulfilled if currency convertibility and stability of exchange rates are to be maintained:

first, the monetary authorities of the countries concerned should always stand ready to buy and sell gold against local currency at a fixed and previously declared price; this is the convertibility of a currency into gold; and

second, gold should be allowed to move freely among countries.

It was seen above that gold moved from one center to another as a result of relative changes in the demand for one currency to that for the other; in the absence of gold movements

such changes would cause exchange rate fluctuations which are beyond the gold points. However, the importance of such gold movements is not only that they maintain the stability of exchange rates; they are also a first and short-run corrective of disequilibrium in the balances of payments of the countries concerned, such disequilibrium being nothing more than a register of the relative changes in the demand for the currencies. And here lies, in fact, the principal function of the international gold standard: it is an arrangement whereby international financial obligations are settled and whereby disequilibria in the balances of payments of different countries are corrected.

The hypothetical example shows that when demand for a country's currency relative to that for another country's currency increases, the country whose currency is now in greater demand would tend to witness an inflow of gold. This inflow of gold satisfies the increased demand for the country's currency and hence accounts for the surplus in its balance of payments. Therefore, when a country's balance of payments is in a surplus position it tends to receive gold, other things remaining constant; and it tends to lose gold if its balance of payments registers a deficit, also assuming that other things remain constant. Thus, gold movements constitute a first corrective for balance of payments disturbances. However, by themselves they are not enough; for a country cannot continue to lose gold indefinitely without impairing the very foundations of the gold

standard. Therefore, some force should be introduced to correct disequilibrating balance of payments movements and hence to prevent further gold losses. This is in fact provided for under the gold standard in a way considered to be almost "automatic". The process of adjustment may be explained by using a hypothetical example again.

Suppose that due to crop failure a country's exports fell below its imports and that the excess of imports over exports was paid for with gold. The outflow of gold would reduce the cash reserves of the deficit country (since gold is the basis of the whole credit and monetary system) which reduction would in turn tend to raise the rediscount rate (and hence to reduce the prices of fixed-income-yielding securities) and to restrict credit. The increase in the rediscount rate (and consequently in other market rates) would tend to attract short-term funds from abroad and to discourage domestic short-term funds from being invested abroad. Moreover, with their prices now depressed, it is expected that more securities would be sold to foreigners, i.e., exported; (this is the speculative movement of foreign funds and not the movement of funds seeking higher rates of interest). All these factors would act to increase the demand for the deficit country's currency and the supply of foreign currencies. But such factors are essentially of a short-run nature.

In the long run, the tendency to restrict credit would reduce prices and consequently incomes. With lower incomes and

prices, exports would be encouraged (since they are now relatively more competitive) and imports discouraged (because they become relatively more expensive). Thus, the disequilibrium in the balance of payments would be corrected.

Opposite developments would take place in the surplus country receiving gold. Interest rates would tend to fall, securities to appreciate and prices and incomes to rise. There would develop a tendency to increase the outflow of short-term funds (both for profit and speculative motives) and to discourage exports and encourage imports, which may ultimately wipe away all the original surplus.

To sum up, under the gold standard balance of payments equilibrium is restored in the short run by movements of gold and/or movements of short-term funds, and in the long run by changes in relative price and income levels. "An adjusted or equilibrated position of the balance of payments comes about when the relative position of prices and money incomes in the two countries becomes such that no metal need move from one to the other and, in the absence of disturbing causes, free gold movements will force this adjusted or equilibrated condition to come about ..... The international gold standard creates, not a common price level but an integrated price and income structure....."<sup>1</sup>

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1. Gregory, op.cit., pp. 13-14. (The underlined words are italicized in the original text.)



However, in order that this adjustment takes place, certain conditions must be satisfied, certain "rules of the game" must be adhered to. These may be summarized as follows:

first, every country should stand ready to import and export gold at fixed prices;

second, gold movements among countries must proceed unrestricted;

third, gold importing countries should inflate and follow an expansionary financial policy, while gold exporting countries must deflate and follow a restrictive financial policy; and

fourth, goods must not be prevented from moving in the wake of gold, nor must capital movements between countries be unduly restricted.

As it was mentioned above, the account given of the functioning of the pure gold standard before 1914 lacks in detail, and hence may be found to distort the facts in certain instances. Generally, however, the picture is fairly representative of the actual functioning of the international gold standard before 1914. The gold standard functioned relatively smoothly under the leadership of London as "the undisputed financial capital of the world".<sup>1</sup> A very brief account of the evolution of events between 1914 and the collapse

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1. G. Crowther, An Outline of Money, (London: Thomas Nelson and Sons Ltd., 1949), p. 303.



of the gold standard in the thirties, alongwith the basic changes introduced to the system during the said period is now given.

The outbreak of the First World War resulted in the abandonment of the gold standard by belligerents, then accounting for the major portion of international trade.<sup>1</sup> The reasons for the abandonment of the gold standard during the war are primarily the following:

first, belligerents were forced to suspend the internal convertibility of notes into gold and to prohibit the export of gold in order to mobilize their gold stocks for the important task of war financing; and

second, the task of financing the war necessitated resort to inflationary financing measures. Thus, even if the gold standard could be maintained on the grounds of military or political strategy mentioned above, it had to be discarded for purely economic considerations: inflationary price rises coincident to war financing would have led to a continuous loss of gold, for under such conditions adjustments in price and income levels necessary for maintaining the gold standard would not have been permitted.

When the war ended, it was believed that countries should again return to the gold standard, since the cause for

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2. In 1917 the United States became a belligerent and prohibited the export of gold.

its abandonment no more obtained. Moreover, the inflation caused by war (and, as some believed, by the abandonment of the gold standard itself), from which inflation countries suffered to different extents, was a further reason for the restoration of the gold standard. It was believed that however serious the disadvantages of the gold standard, it had the then all-important advantage of preventing further extreme inflations as was the case in Germany for example.

However, the movement toward the restoration of the gold standard had to await till 1925, when in April of that year England restored the convertibility of sterling at the prewar parity of £1 = \$4.86 2/3. The last major country to restore the gold standard was France, where legal recognition was given in June 1928 to the de facto return to the gold standard achieved in December 1926. "De facto stabilization had been achieved in December, 1926, with the franc at about one-fifth of the old gold parity, and the new monetary law confirming the position and establishing a gold bullion standard was passed in June, 1928."<sup>1</sup> By the middle of 1929, the only important countries which were not on the gold standard, excluding the U.S.S.R., were China, Mexico and Spain.<sup>2</sup>

However, though the gold standard was restored, it was not exactly the same as the one existent before the war. It

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1. R.G. Hawtrey, The Gold Standard in Theory and Practice, (4th ed.; London: Longmans, Green & Co., 1939), p. 134.

2. Crowther, op.cit., p. 313.

may be recalled that the pre-war gold standard was termed the pure or authentic gold standard, under which gold coins circulated equally with notes. But under the restored gold standard circulation of gold coins was in most cases suspended. Instead gold was bought and sold only in bars of specific weight and fineness. Monetary authorities, however, were "under legal obligation to buy and sell gold in exchange for currency at a fixed price and in unlimited amounts (sometimes with a minimum amount fixed but never a maximum)".<sup>1</sup> Such an arrangement is called the gold bullion standard since under it local currency is convertible into gold bullion and not into gold coin. Moreover, some countries, for the most small and with relatively little gold reserves, resorted to still another form of gold standard, the gold exchange standard. Under this system a currency is convertible neither into gold coin nor into gold bullion but rather into another currency which is convertible into gold. Both the gold bullion standard and the gold exchange standard were established to effect an economy in the use of gold.

In 1929 the great depression set on and, in May 1931, the financial crisis began in Austria when the insolvency of the Austrian Credit Anstalt was disclosed. "The depression had crushed the industrial concerns in Austria and neighboring countries to which that bank had made advances, and it (the Credit Anstalt) was compelled to stop payment... The ominous parallel

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1. Ibid., p. 280.

with the far greater credit structure of Germany sent a terrible spasm of panic through the financial centers of the world. Advances to German banks and industrialists began to be called in on a colossal scale.... On the 13th July the crisis culminated in the failure of the Dramstadter Bank and the temporary closing of all German banks.<sup>1</sup> It was due to the trade depression which began in 1929 with its accompanying fall in prices that the Credit Anstalt was rendered insolvent; and the fear of the same thing happening in Germany led to the withdrawal of advances which forced Germany to suspend payment. Consequently, in both Austria and Germany exchange restrictions were imposed, and the gold standard was suspended, though no official declaration to the effect was made.

The German financial crisis aroused some fears with regard to the international strength of London as a financial market, since London was both a creditor and a debtor on a large scale, and since the blocking up of foreign capital in Germany would impair London's liquidity. Such fears were expressed in the enormous withdrawals of foreign capital funds from London beginning with the second half of July, 1931. In face of such heavy withdrawals, the Bank of England was relieved on September 21, 1931 from the obligation to sell gold. Hence the suspension of the gold standard by England.

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1. Hawtrey, op.cit., pp. 155-156. (Parenthesis added by the author.)

The movement off the gold standard was by now fairly established. England was followed by the Scandinavian countries, Greece, Portugal, South Africa and Japan; Australia, New Zealand and most South American countries had already abandoned it. Most central and eastern European countries introduced strict and onerous exchange controls, though officially their currencies were kept at gold parity. Even the United States suspended the gold standard in April, 1933.<sup>1</sup> The few countries still maintaining the gold standard, among which France was the most important, suffered much from the depreciation of other countries' currencies which had abandoned the gold standard; and by September, 1936, they too had to abandon it. As such, the inter-war gold standard lasted for little more than a decade. What were the reasons for which the gold standard was discarded as an international financial system? Perhaps the best account of these reasons would be a presentation of the relevant changes (whether economic or otherwise) which developed during and after the War and which impeded the efficient working of the gold standard.

The first point to be mentioned in this respect is the inflationary measures with which countries were faced upon the termination of the War. The extent to which inflationary forces had developed in various countries differed greatly and hence, the restoration of the smooth working of the gold

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1. The immediate cause for this was the American banking crisis which reached its height in February, 1933.

standard was presented with the difficult task of reintegrating the various economies; the necessary readjustments proved to be of much greater amplitude than those of the pre-war era. Moreover, prices and costs were less amenable to change than previously; this, however, is the second point to be mentioned here.

The economic structures of the various countries became more rigid and less amenable to change than was the case in the pre-war era. Trade unions became more effective in preventing a downward readjustment of wages. Moreover, the movement toward cartellization, monopolization and price control in general increased, so that on the whole economies did not lend themselves with ease to changes required by the smooth functioning of the gold standard.

The third point to be discussed is the changed nature of capital movements. Political disturbances did much to destroy the atmosphere of confidence in the future necessary for long-run investment. Moreover, the lack of confidence in the strength of currencies (due to a heightened awareness of inflationary possibilities) also contributed to the state of uncertainty regarding the future. Thus, long-term investment was discouraged and there was created, as a result, an abundance of liquid funds. The movement of such funds from one center to another was more volatile than before (because of the fear element) and responded more to speculative and fear factors than to inducements of interest rates. Thus, the bank rate was

less effective than before in directing the movement of short-term funds in a way conducive to adjustment. Moreover, "capital movements..... play a more important part in international balances now than formerly, and are more subject than commodity trade or service transactions to abrupt and substantial shifts in amount and direction".<sup>1</sup> This introduces a further disturbing factor to the situation.

Another factor in this connection is what may be called economic nationalism. After the war there was a growing tendency among economists to prefer the internal stability of economies to stability in the exchange rates. And since the gold standard in maintaining exchange rate stability necessarily sacrifices internal stability, such a tendency among economists consequently meant a movement away from the gold standard, in fact, a reluctant attitude to maintain the gold standard at the cost of internal stability. This tendency may be seen in what is usually referred to as the failure of the monetary authorities in the post-war era to play the "rules of the game". It is sometimes claimed that the gold standard could not function efficiently after the War mainly because its rules were not adhered to to a sufficient extent. For example, it is advanced that the United States refused to inflate sufficiently when it was receiving gold and England refused to deflate sufficiently

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1. Quincy Wright ed., Gold and Monetary Stabilization, (Chicago: The University of Chicago Press, 1932), pp. 7-8.



when it was loosing gold. This certainly weakened the prompt and efficient working of the gold standard. Furthermore, economic nationalism expressed itself in the increased burden of tariffs in the post-war period. This greatly impeded the functioning of the gold standard since the movement of goods was somewhat obstructed; and this was more so in face of the enormous reparations and war debts which had to be paid. "These payments (reparations and war debts) provided an element in the foreign exchange market which was not amenable to control by the weapons of the gold standard."<sup>1</sup> Such payments had to be made whatever the bank rate was or whatever the change in the price or income level was.

Lastly, there are two factors of purely monetary nature. The first one is the narrowing of the gold points after the war due to reductions in transport costs, thereby rendering the economy of every country more sensitive to international disequilibria than otherwise, since a smaller change in exchange rates now renders profitable the export or import of gold. To that extent, the role of gold movements in the process of adjustment had been increased. The second factor is the generalization of the gold exchange standard and the consequent complication of the functioning of the gold standard due to the distortion of the effects of reserve movements:

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1. Crowther, op.cit., p. 318.



"Thus, if a Central Bank keeps its foreign assets in the form of a sight deposit in a foreign commercial bank in a gold centre and sells its claims on that bank to a trader who has obligations to meet in that market, conditions will be created tending to compel it to curtail credit at home. But no reciprocal conditions will be created in the country in which the commercial bank is situated. The commercial bank may find that the only change in its position is a substitution of a domestic for a foreign depositor.

The effects of such operations are again different if the transfer is made by the country holding foreign assets to any country other than that in which those assets are held. In such circumstances, if both parties hold assets in the same country and the transfer is made between their respective accounts, there is reciprocity of effect between them and no effect on the country in which those deposits are held. If the transfer is made by the conversion of those assets into gold and the shipment of that gold to the country to which payment is due, there is a triple influence which may bear no relationship to the actual balance of payments between the country in which the deposit is held and any other." (1)

#### The Inconvertible Paper Standard

The second arrangement for the settlement of international financial obligations to be discussed here may be called the inconvertible paper standard. Such an arrangement replaced the gold standard in those countries which the developments of the early thirties had forced to abandon the gold standard. It will be discussed here only in so far as it functioned as a mechanism through which international financial obligations were effected, i.e., through which currencies of the various countries and currency areas were rendered convertible.

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1. League of Nations, Report of the Gold Delegation of the Financial Committee, (Geneva: League of Nations, 1932), pp. 13-14.

In this respect the most essential characteristic of the inconvertible paper standard is the inconvertibility of a country's currency into metallic money, more specifically, into gold. The monetary authorities of a country under the paper standard relieve themselves of the obligation to convert that country's currency into gold. The internal value of such a currency is thus an effect of public confidence in it. Its value in relation to other currencies, however, is left to be decided upon by conditions of supply and demand in the foreign exchange market.

Since under the paper standard, currencies are no more convertible into gold, and since, as it was shown above, convertibility of a currency into gold is an essential prerequisite for stability in its external value, therefore, under the paper standard exchange rates are free to oscillate to whatever extent the conditions of supply and demand may require. "When currencies are not convertible into gold at fixed mint prices, fluctuations in foreign exchange rates are not confined within the narrow limits of the gold points; they may be very wide."<sup>1</sup> Such changes in the rates of exchange provide the necessary corrective to restore equilibrium once it has been disrupted. An example, perhaps, may clarify this point.

Suppose that a country's balance of payments is in a state of equilibrium. Suppose further that for some reason or

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1. L.W. Towle, International Trade and Commercial Policy, (New York: Harper and Brothers Publishers, 1948), p. 705.

another there occurs an increase in the demand for the currency of another country. Since gold cannot be sent from the debtor to the creditor country, and since now the demand for the creditor country's currency exceeds the supply at the current rate, the value of the debtor country's currency will fall relatively to that of the creditor country's currency to such an extent at which again demand equals supply, i.e., to such an extent at which equilibrium is again restored. This is how, under the paper standard, equilibrium is restored in the short run.

However, since now the value of the debtor country's currency has depreciated relatively to the value of the creditor country's currency, prices of goods and other items that form the balance of payments between the two countries would have, ceteris paribus, undergone consequent relative changes. Thus, imports in the debtor country would become relatively more expensive and less expensive in the creditor country. This tends to encourage exports from and discourage imports into the debtor country while the reverse takes place in the creditor country. Consequently, demand for the creditor country's currency would be reduced relatively to that for the debtor country's currency, and hence a new equilibrium rate of exchange would result. This is the long-run adjustment of the initial disequilibrium in the balance of payments.

It can be seen from the example given above that "the adjustment of international disequilibria involves basically the same changes under a system of independent paper currencies that

it does under the gold standard - namely changes in the international flow of goods and services"<sup>1</sup>. However, the difference lies in the mechanisms used under the two standards. Under the gold standard, it may be recalled, adjustment was effected through gold movements, movements of short-term capital, and changes in prices and incomes. Under the paper standard, on the other hand, the necessary adjustment is effected through changes in the rate of exchange which changes bring forth the equilibrating alteration in the flow of goods and other items comprising the balance of payments. Thus, adjustment under the paper standard is effected through changes in the price structure of the balance of payments. "The gold standard system works through variation of internal prices and incomes relative to export-import prices, and the paper standard system through variation of the prices of exports and imports, and the other items comprising the balance of international payments, relative to internal prices and incomes. Fixed exchange requires primarily adjustment of the internal economy to the balance of payments and flexible exchange the reverse."<sup>2</sup>

Thus, it can be seen that although convertibility into gold is not maintained under the paper standard, yet the convertibility of a currency (its availability for making payments in

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1. Ibid., p. 704.

2. J.H. Williams, "The Adequacy of Existing Currency Mechanisms under Varying Circumstances," American Economic Review, XXVII (1937 Supplement), p. 151.

international transactions) is preserved. And this is the essence of the paper standard as far as international finance is concerned. However, unlike convertibility under the gold standard, convertibility under the paper standard is maintained, but at the price of fluctuating exchange rates. And this is the essential difference between the two standards. Convertibility under the paper standard is maintained through the mechanism of free exchange markets with rates of exchange free to oscillate according to the requirements of the forces of supply and demand.

The expose given above concerning the functioning of the paper standard as regards the convertibility of currencies is perhaps too theoretical to represent a true picture of its functioning in practice. Exchange rates were not in fact permitted to oscillate as freely as required by conditions of demand and supply in order that equilibrium be restored. In certain cases the extent of the necessary changes required to restore equilibrium was reduced by artificial control of demand for foreign exchange. In other cases the monetary authorities intervened in the markets as buyers and sellers of foreign exchange in order to reduce the scale of fluctuation in the rates of exchange. Thus, although fluctuating exchange rates continued to characterize the paper standard established in the thirties, yet fluctuations were not allowed to proceed uncontrolled. Various measures of control were used to reduce them to the minimum required for readjustment. One type of such

measures of control, exchange stabilization funds, is discussed now.

Although countries were forced to abandon the gold standard, it was not believed that exchange fluctuations are by themselves advantageous. Preference was expressed towards the paper standard not because it provided for fluctuating exchange rates but because it avoided the evils of overvaluation which the post-war gold standard implied in most cases, and which became evident especially in the early thirties. Although the inconvertible paper standard was believed to be more appropriate to the conditions of the early thirties, yet in its pure form which implies wild fluctuations in the exchange rates it had the great disadvantage of reducing the flow of international trade and of international movements of capital, especially of short-term nature. Such a reduction in the flow of trade and capital among countries intensified the effects of the depressing conditions in the countries concerned, which conditions themselves originally called for the establishment of the paper standard as a solution. "Uncontrolled exchange rates, determined wholly by the play of market forces, are likely to become the prey from time to time of intense speculative activity. Fluctuations in the international value of a currency are not consonant with internal stability."<sup>1</sup> Thus, the mere avoidance of overvaluation of currencies which is

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1. A.H. Hansen, "The Situation of Gold Today in Relation to World Currencies," American Economic Review, XXVII (1937 Supplement), p. 140.

implied by the pure paper standard did not constitute by itself a good enough reason for its adoption. Overvaluation was deemed disadvantageous because it was believed to be the cause of the low flow of international trade and international capital movement, which low flow constituted a deterrent to efforts made to draw the economy out of depression. Hence, the paper standard was called upon to achieve a further task, other than the mere avoidance of overvaluation. That was the increase in the flow of international trade and international movement of capital. And this required, among other things, a certain degree of stability in the exchange rates. Consequently, stabilization funds were established in the various countries which adopted the paper standard. England, for example, established its Exchange Equalization Account in June 1932 and similar exchange equalization accounts were also set up in other countries. <sup>(1)</sup> Such funds had similar objectives. The monetary authorities in the countries concerned would enter the foreign exchange market as buyer or seller and would use such stabilization funds for the purpose of eliminating three types of exchange rate fluctuations:

first, fluctuations due to speculative forces; this is the type of fluctuation for the elimination of which stabilization funds were primarily set up;

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1. The United States Exchange Stabilization Fund was set up in 1934 after the devaluation of the dollar.



second, fluctuations due to seasonal forces;

third, fluctuations due to fortuitous movements of capital and to capital flights.

It can be seen that such stabilization funds were not set up to prevent changes in exchange rates which are due to long-run basic changes in the competitive position of a country; instead, they were to be used for the maintenance of day-to-day stability in the exchange rates, i.e., to prevent unnecessary erratic and otherwise reversible fluctuations.

Exchange rates were to be neither rigid nor highly fluctuating, but rather flexible and compatible with the maximization of benefits accruing from international division of labour and specialization.

A further step towards exchange stability was taken when in September 1936 England, France and the United States signed the tripartite Monetary Agreement to which most of Western European countries subsequently adhered. "The Tripartite Agreement did not involve the creation of an international institution for the purpose of currency stabilization. It was, instead, an accord among the member countries by which each would cooperate in maintaining the value of the other's currencies in its own market with its own stabilization fund." <sup>1</sup> Its main objectives were that the signatory countries would cooperate to

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1. H.G. Brainard, International Economics and Public Policy, (New York: Henry Holt and Company, 1954), p. 285.



prevent excessive fluctuations in the exchange rates of their currencies, that they would allow a major change in the exchange rates of their currencies only after consultation among themselves, "and that they would not, in any case countenance any competitive depreciation or excessive undervaluation".<sup>1</sup> As such the Agreement was a step forward towards monetary internationalism. It marked the end of extreme monetary nationalism which had started in 1931. "The major nations thereby gave evidence of their recognition of the fact that the monetary policy of one nation may have disturbing repercussions in neighboring countries."<sup>2</sup> "The program of international collaboration through exchange funds stands between the proposal on the one side to re-establish rigid and definite exchange ratios and the proposal on the other side to go over completely to nationally managed paper currencies and freely flexible exchange rates."<sup>3</sup>

The Tripartite Agreement stopped to operate in 1939 with the outbreak of the War, though formally it was not brought to an end. The next arrangement in the field of international finance, the International Monetary Fund, had to await the summer of 1944.

Before ending up this section, it may be appropriate to mention that although the inconvertible paper standard was predominant during the period 1931-1939, yet it was not the only

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1. Crowther, op.cit., p. 325.

2. Brainard, op.cit., p. 286.

3. Hansen, op.cit., p. 139.

existent system. Many countries in Central and Eastern Europe, chief among which was Germany, never officially went off the gold standard nor officially depreciated their currencies. Instead, they artificially maintained the gold content of their currencies by the imposition of an intricate and complex system of exchange controls; import and export quotas and licences; and clearing, trade and payments agreements. Such a system need not be discussed here since it did not maintain the convertibility of currencies. In reality it was the negation of currency convertibility.

#### The International Monetary Fund

During the Second World War, serious thought was given to post-war international financial problems and the way to solve them. The most pressing question in this respect related to the nature of the international financial mechanism that would be set up once the War was over: is the gold standard, with its advantage of stable exchange rates, to be reinstated? Or, is the paper standard, with exchange equalization funds to be reinstated? Or, is the post-war system going to be modelled along the system followed by Germany in the thirties? Or, perhaps, is a new system going to be devised for the post-war world? Whatever the nature of the new system, it was believed that it should be able to achieve two main objectives: first, it should allow the different countries a free hand over internal economic policies; and second, it should foster the expansion of international trade

and international investments, and for this purpose it should achieve stability in exchange rates as well as freedom of trade and currency convertibility. In the absence of a single international currency, the achievement of these objectives called for the setting up of a multilateral system of payments based on convertibility of currencies at stable rates of exchange. And it was in the hope of achieving this that the International Monetary Fund and the International Bank for Reconstruction and Development were created.

In the United States, as early as the spring of 1940 post-war economic and financial problems began to be considered by a governmental group appointed at the initiative of Secretary of State Cordell Hull. At the same time, the Treasury Department's Division of Monetary Research under the leadership of Harry White, who was a member of the group, made independent studies of the same problems and in December 1941 presented a memorandum entitled "Proposal for a Stabilization Fund of the United and Associated Nations". The proposal was later changed to include plans for a development and reconstruction bank. "These proposals of the Treasury Department were studied and plans for a Fund and Bank developed over the next few years by an interdepartmental committee known as the American Technical Committee."<sup>1</sup>

At the same time in which American experts were considering international financial problems, consideration was being given to

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1. J.P. Young, The International Economy, (3rd ed.; New York: The Ronald Press Company, 1951), p. 451.

the same problems in the United Kingdom. And in August 1942, the British Embassy in Washington presented to the State and Treasury Departments copies of a plan entitled "Proposals for an International Clearing Union". The proposals were primarily the work of Lord Keynes, and the plan for an International Clearing Union came subsequently to be known as the Keynes Plan. On April 7, 1943, the British plan for an International Clearing Union and the American plan, known as the White Plan, for an International Stabilization Fund were announced and a series of meetings between American and British experts was subsequently held for the purpose of reaching an agreement regarding the proposals. Agreement was lastly reached in April 1944 on what was called a "Joint Statement by Experts on the Establishment of an International Monetary Fund". Subsequently, President Roosevelt issued invitations to forty-four states to attend a conference at Bretton Woods, New Hampshire in July, 1944, to consider the plan outlined in the Joint Statement. After two weeks of work, the Conference produced the Articles of Agreement of the International Monetary Fund and of the International Bank for Reconstruction and Development. On December 27, 1945, the Articles of Agreement were signed by thirty countries which were joined later by others. Thus, formally, the Fund came into existence on December 27, 1945 but did not actually start working until the spring of 1946.

The International Monetary Fund represents a new arrangement in international finance, a new international monetary system. It is essentially a monetary arrangement which is

international in scope and which at the same time avoids the many disadvantages of the gold standard. It is an international system which relies for its efficient and smooth working on international cooperation and not on automatic forces as was the case under the gold standard. As such, states which are members in the system must temper their national economic policies by a consideration of their international repercussions, although the system leaves to member states an otherwise almost unrestricted free hand over internal economic policies. Thus, the system represents a compromise between the gold standard and the paper standard; it also generalizes, with great modification, the system embodied in the Tripartite Agreement. In essence it may be considered as a system which has developed out of the various prior experiences in the field of international finance.

The objectives of the Fund are stated in Article I of its Articles of Agreement as follows:

"The purposes of the International Monetary Fund are:

- (i) to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and net income and to the development of the productive resources of all members as primary objectives of economic policy.
- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

- (iv) To assist in the establishment of a multi-lateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- (v) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its decisions by the purposes set forth in this Article."

Thus it can be seen from the purposes listed above that the most important objectives of the Fund are stability of exchange rates and freedom of exchange transactions as necessary measures for the effective process of correcting balance of payments disequilibria. In other words, the main objective of the Fund is the maintenance of currency convertibility at stable rates, which is believed to be necessary for the "expansion and balanced growth of international trade". Convertibility, as understood by the Fund's Articles of Agreement, is to be maintained through international cooperation whereby the Fund's resources will be used "to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members", which disequilibrium might threaten the maintenance of convertibility at stable rates.

Every member state is requested upon joining the Fund to declare a par value of its monetary unit expressed in gold or in terms of the U.S. dollar "of the weight and fineness in effect on July 1, 1944"<sup>1</sup>. Thus, gold is used as a base for the calculation of the par values of various currencies, and the rates of exchange between these currencies are determined by their gold parities. The obligations of members to maintain convertibility at stable rates are outlined in Article IV, sections 2, 3 and 4 which treat stability of exchange rates and in Article VIII, sections 2, 3 and 4 which treat freedom of exchange operations. These are reproduced below:

Article IV. Par Values of Currencies

"Sec. 2. Gold purchases based on par values.-

The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin."

"Sec. 3. Foreign exchange dealings based on parity.-

The maximum and the minimum rates for exchange transactions between the currencies of members taking place within their territories shall not differ from parity.

- (i) in the case of spot exchange transactions, by more than one percent; and
- (ii) in the case of other exchange transactions, by a margin which exceeds the margin for spot exchange transactions by more than the Fund considers reasonable."

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1. Article IV, Section 1(a), Articles of Agreement of the International Monetary Fund.



"Sec. 4. Obligations regarding exchange stability.-

- (a) Each member undertakes to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations.
- (b) Each member undertakes, through appropriate measures consistent with this Agreement, to permit within its territories exchange transactions between its currency and the currencies of other members only within the limits prescribed under Section 3 of this Article. A member whose monetary authorities, for the settlement of international transactions, in fact freely buy and sell gold within the limits prescribed by the Fund under Section 2 of this Article shall be deemed to be fulfilling this undertaking."

Article VIII. General Obligations of Members

"Sec. 2. Avoidance of restrictions on current payments.-

- (a) Subject to the provisions of Article VII, Section 3(b), and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.
- (b) Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement."

"Sec. 3. Avoidance of discriminatory currency practices.-

No member shall engage in, or permit any of its fiscal agencies referred to in Article V, Section 1, to engage in, any discriminatory currency arrangements or multiple currency practices except as authorized under this Agreement or



approved by the Fund. If such arrangements and practices are engaged in at the date when this Agreement enters into force the member concerned shall consult with the Fund as to their progressive removal unless they are maintained or imposed under Article XIV, Section 2, in which case the provisions of Section 4 of that Article shall apply."

"Sec. 4. Convertibility of foreign held balances.-

(a) Each member shall buy balances of its currency held by another member if the latter, in requesting the purchase, represents

(i) that the balances to be bought have been recently acquired as a result of current transactions; or

(ii) that their conversion is needed for making payments for current transactions.

The buying member shall have the option to pay either in the currency of the member making the request or in gold.

(b) The obligation in (a) above shall not apply

(i) when the convertibility of the balances has been restricted consistently with Section 2 of this Article, or Article IV, Section 3; or

(ii) when the balances have accumulated as a result of transactions effected before the removal by a member of restrictions maintained or imposed under Article XIV, Section 2; or

(iii) when the balances have been acquired contrary to the exchange regulations of the member which is asked to buy them; or

(iv) when the currency of the member requesting the purchase has been declared scarce under Article VII, Section 3(a); or

(v) when the member requested to make the purchase is for any reason not entitled to buy currencies of other members from the Fund for its own currency."

It is to be noticed from the provisions of these articles that convertibility of a currency as defined by the Articles of Agreement of the Fund is restricted to payments and transfers for current international transactions and does not extend to capital transfers. "Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation: (1) All payments due in connection with foreign trade, other current business, including services and normal short-term banking and credit facilities; (2) Payments due as interest on loans and as net income from other investments; (3) Payments of moderate amount for amortization of loans or for depreciation of direct investments; (4) Moderate remittances for family living expenses. The Fund may, after consultation with the members concerned, determine whether certain specific transactions are to be considered current transactions or capital transactions." <sup>1</sup> Thus, capital transfers may be restricted and the currency may still be regarded as convertible by the Fund. In fact, the Fund specifically prohibits its members to use its resources "to meet a large or sustained outflow of capital" (Article VI, Section 1 (a)) and allows them to "exercise such controls as are necessary to regulate international capital movements" (Article VI, Section 3).

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1. Articles of Agreement of the International Monetary Fund, Article XIX (i).

This is not the only limitation on convertibility as defined by the Articles of Agreement of the Fund. There are two other limitations which apply to the freedom of current transactions in general as well as to the convertibility of foreign held balances, and four limitations which apply to the convertibility of foreign held balances alone. All of these limitations are, nevertheless, compatible with convertibility as defined by the Fund.

One of the two limitations on convertibility in general is the right given to members under Article VII, Section 3, temporarily to impose restrictions on current transactions (after consultation with the Fund) in a currency which has been formally declared scarce by the Fund. The Fund will declare a currency scarce "if it becomes evident to the Fund that the demand for a member's currency seriously threatens the Fund's ability to supply that currency".<sup>1</sup> However, restrictions imposed on freedom of exchange operations in the scarce currency must not be more restrictive than is required to limit the demand for the scarce currency to its supply; and they are to be relaxed and removed whenever conditions permit.

The other limitation which applies to convertibility in general consists of the right given to members to apply any restrictions approved by the Fund pursuant to the provisions

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1. Articles of Agreement of the International Monetary Fund, Article VII, Section 3(a).

of Article VIII, Section 2(a). The following passage develops this point in more detail:

"A member applying restrictions pursuant to Article XIV, Section 2 may cease to avail itself of these restrictions and still continue to apply such other restrictions whose introduction has been approved by the Fund pursuant to the terms of Article VIII. A member may also cease to avail itself of its transitional arrangements while continuing to apply the same (or any other) restrictive system which the Fund is willing to approve under the terms of Article VIII. If a member relinquishes its transitional arrangements and wishes to continue to apply restrictions on current payments, (a) the restrictions would be subject to approval of the Fund; and (b) in case of Fund approval, the member's currency would in spite of these restrictions, be considered 1 'convertible', pursuant to Article XIX (d)."

The other four limitations which apply only to convertibility of foreign held balances and which are also in conformity with convertibility as defined by Article XIX(d) are stated above in Article VIII, Section 4(b) (ii), (iii), (iv) and (v) and do not call for further elaboration.

Article XIX (d) is the only Article in which an explicit definition of currency convertibility may be found in the Articles of Agreement; even there, convertibility is only negatively defined. The relevant part of the clause is the following: "A member's holdings of convertible currencies means its holdings of the currencies of other members which are not availing themselves of the transitional arrangements

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1. International Monetary Fund, Legal Aspects of Restrictions on Current Payments under Articles VIII and XIV, SM/54/106, Washington, D.C., October 21, 1954, p. 5. (Typescript.)

under Article XIV, Section 2,..." Article XIV, Section 2, reads as follows: "In the post-war transitional period members may, notwithstanding the provisions of any other articles of this Agreement, maintain and adapt to changing circumstances (and, in the case of members whose territories have been occupied by the enemy, introduce where necessary) restrictions on payments and transfers for current international transactions. Members shall, however, have continuous regard in their foreign exchange policies to the purposes of the Fund; and, as soon as conditions permit, they shall take all possible measures to develop such commercial and financial arrangements with other members as will facilitate international payments and the maintenance of exchange stability. In particular, members shall withdraw restrictions maintained or imposed under this Section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the resources of the Fund." Thus, technically, a member's currency may not be considered as convertible by the Fund so long as the country in question continues to avail itself of the provisions of Article XIV, Section 2. A member whose currency is considered convertible by the Fund is not allowed to exercise payments restrictions on current transactions unilaterally, i.e., without the prior approval of the Fund. It will thus have to accept the obligations of Article VIII, Section 2, 3 and 4 without modification by the provisions of Article XIV, Section 2. And

all restrictions which a member is allowed to maintain under Article VIII have to obtain the prior approval of the Fund. On the other hand, restrictions imposed under Article XIV, Section 2, do not require the prior approval of the Fund. These latter restrictions are referred to as "transitional arrangements", and to qualify as such, a restriction must: (a) "have been in effect since the member joined the Fund unless the member is one whose territories were occupied by the enemy, in which case it can introduce new restrictions where necessary"; and (b) "be applied because the member is not satisfied that without the restriction it could settle its balance of payments in a manner which would not unduly encumber its access to the Fund's resources"<sup>1</sup>. Therefore, the first requirement for a country's currency to be declared as convertible by the Fund is that the country should not avail itself of the transitional arrangements provided for by Article XIV.

From this discussion of the definition of convertibility given in the Articles of Agreement of the Fund, it may be said in recapitulation that convertibility thus defined applies only for payments made on current account and does not extend to capital transfers as well. Moreover, even convertibility of payments on current account may be subject to restrictions which the different countries are allowed to impose with prior approval by the Fund. These restrictions relate to the scarce currency

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1. Ibid., p. 2.

provision and to such limitations as are allowed by the Fund pursuant to the terms of Article VIII. Also, convertibility of foreign held balances may be denied under specific conditions outlined in the Articles of Agreement of the Fund. Finally, no country's currency is considered convertible by the Fund so long as that country avails itself of the transitional provisions outlined in Article XIV, Section 2.

If this is the definition of convertibility according to which the Fund requires its members to manage their currencies, then how can a country maintain convertibility in face of an adverse balance of payments position? The question to be discussed now relates to the means through which the International Monetary Fund as a mechanism helps its members to maintain their currency convertibility in case of an unfavorable balance of payments situation.

In order to understand the role of the Fund in helping its members maintain the convertibility of their currencies, it must be pointed out that the Fund is essentially an agency in charge of a pool of currencies consisting of the currencies of its members and of gold. The Fund has acquired these currencies as a result of subscriptions which members are required to make. Every member must pay in full a subscription to the Fund equal to its quota. Part of the subscription is made in gold and the remainder in the currency of the member concerned.<sup>1</sup> Thus

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1. The part paid in gold is the smaller of:

- (i) twenty-five percent of the member's quota;
- or
- (ii) ten percent of its net official holdings of gold and U.S. dollars.



the Fund has at its disposal a fund (around \$ 8 billion) consisting of gold and of the local currencies of its members. It is through the use of this fund that it helps its members in maintaining convertibility.

Suppose a member's balance of payments is in disequilibrium and the country is suffering a deficit on its current account. Suppose further that the country concerned cannot meet the deficit out of its reserves and that it cannot acquire credit facilities in order to pay for it. The role that the Fund plays in this respect depends on whether the disequilibrium in the balance of payments of the country concerned is of a short-run nature or whether it is fundamental.

In case the disequilibrium is short of a fundamental disequilibrium, the country concerned is allowed to purchase the currency or currencies it needs from the Fund against its own currency.<sup>1</sup> Thus, the Fund sells to its members the currency or currencies they are in need of to settle their short-run balance of payments deficits. In this way, the Fund helps its members in cases of other than fundamental balance of payments disequilibria to avoid the introduction of restrictions on payments for current account, to avoid a change in the exchange rate of their currencies, and even to avoid changes in internal prices and incomes, in short, to maintain the convertibility of their currencies

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1. The amounts of and charges on purchases of currencies by members as well as the conditions of purchase and repurchase will be discussed in detail in Chapter II.



The role of the Fund, however, differs when disequilibrium in the balance of payments of a member is a fundamental one.<sup>1</sup> In such a case, the Fund will most probably refuse a request for purchase presented by the country incurring the deficit. The solution to such a situation lies in a change of the par value (depreciation) of the country's currency. Thus, when the Fund is convinced that the deficit in a member country's balance of payments is chronic, i.e., fundamental, it will suggest a change in the par value of the country's currency as a solution and will not sell the country concerned the currency or currencies needed to pay for the deficit which it is incurring. However, although changes in the par value of currencies are provided for in the Fund's Articles of Agreement, yet any substantial changes (more than ten percent of the initial par value) may not be introduced unilaterally. And changes in the par value may only be made in order to correct a fundamental disequilibrium. Thus, for any change to be allowed, there must first exist a case of fundamental disequilibrium in the balance of payments of the country proposing the change, and the change must be believed to be necessary in order to correct the fundamental disequilibrium.

Accordingly, the role of the Fund in case a disequilibrium develops in the balance of payments of any one of its members

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1. The term "fundamental disequilibrium" is not defined by the Articles of Agreement of the Fund; its definition is left to the Executive Directors. It is believed, however, to mean basic disturbances of a lasting character.

differs with respect to the nature of such disequilibrium, whether it is of a short-run nature and expected to disappear in a short period, or whether it is fundamental and of a more lasting nature. In the first case the resources of the Fund will be used to supplement the reserves of the member country concerned in order to maintain parity and freedom of exchange transactions on current payments; in the second case a change in the par value of the currency concerned is regarded as the appropriate solution to be followed, since "the resources of the Fund are intended to help bridge only temporary disequilibria".<sup>1</sup>

As a conclusion, it may be said that the International Monetary Fund is an organization which represents a relatively new experiment in the field of international finance. It tries to reach a compromise among the various systems which were previously applied. Thus, gold is not completely discarded, but is used as a base upon which the parities of the members' currencies are set. Moreover, gold continues to play a great role in the settlement of international financial obligations. The Fund retains the stability of exchange rates which was maintained under the gold standard, but, in addition, introduces an element of flexibility to these rates. The Fund also reserves to its members a free hand in carrying out the internal economic policies which they deem desirable, thus greatly reducing the impact of international financial factors on the internal economy.

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1. Towle, op.cit., p. 722.

Finally, in carrying out their obligations with regard to the stability of exchange rates, members exercise functions similar to those exercised by stabilization funds set up in the thirties; moreover, the Fund is a new experiment in international financial cooperation, an attempt at which was previously made in the Tripartite Agreement.

## CHAPTER II

### CONDITIONS OF CONVERTIBILITY

Now that the term "monetary convertibility", as it is going to be used in this study, has been defined, it is appropriate to inquire into the conditions which must be satisfied if convertibility is to be maintained. Accordingly, the present chapter endeavours to outline the requirements for convertibility in general, notwithstanding particular considerations which a specific country or currency area must satisfy for the purpose of maintaining convertibility. With this reservation in mind, it was thought preferable for the purposes of the present discussion to classify the conditions of convertibility under the following four headings:- balance in international accounts, proper internal financial situation, suitable world payments and economic situation, and lastly, adequate international liquidity. However, it must be admitted that in view of the close interaction between the various conditions of convertibility, any such classification as the one presented above which treats each condition separately is highly unrealistic and, therefore, can only be permitted for purposes of analytical study.

#### Balanced International Accounts

The first condition that must be satisfied by a country for the purpose of maintaining currency convertibility is the

development of a strong payment position, more specifically, the realization of a state of balance in that country's international accounts. "An abortive attempt at convertibility would undermine confidence and would do irreparable damage. Therefore, a country must have a strong payments position before it undertakes convertibility."<sup>1</sup> If convertibility is to be maintained, then the balance of payments should not show inherent disequilibrating tendencies; it should, thus, be in equilibrium over a given period of time. Failing this, there would develop, in the absence of other corrective measures, a persistent drain on international liquidity, and a time would ultimately come when the level of the country's international liquidity would be reduced to dangerous levels. In such a case, the country in question would be forced to suspend convertibility. Thus, equilibrium in the balance of payments represents a condition of convertibility in so far as such equilibrium is made necessary to preserve the country's international liquidity intact. "The assumption of the obligations of convertibility presupposes that under such conditions it (i.e. the country undertaking convertibility) could achieve an approximate over-all balance in its payments position."<sup>2</sup>

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1. Ivar Rooth, "Address by Ivar Rooth, Managing Director of the Fund," International Financial News Survey, VI (September 11, 1953), p. 88.
  2. International Monetary Fund, Annual Report, Washington, D.C., 1949, p. 29. (Parenthesis added by the author.)

However, it is not enough, for the present purpose, that any balance in international accounts should obtain; for an equilibrium in the balance of payments may be forced by the pursuit of policies inherently antagonistic to the letter and spirit of currency convertibility. As a condition of convertibility, the required balance in international accounts should obtain without the need to resort to policies disruptive of convertibility itself.<sup>1</sup> But this may be made more clear once certain basic definitions and explanations are first given.

The balance of payments of a given country is a register of all the economic transactions of this specific country with the rest of the world. It "concerns only those economic activities of a country and its people which overflow national boundaries and enter the realm of international transactions".<sup>1</sup>

In theory, all the items included in it are registered on a double entry basis: every transaction having a debit side and a credit side at the same time. Accordingly, the balance of payments must always balance in an accounting sense and, as such, it can never be out of equilibrium. "This inherent inevitability of balance is merely a restatement of an obvious truism: no country (or individual) can buy, give, or lend more or less than it receives by sale gift, or loan from all the rest of the world, except in so far as it draws upon or increases its

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

accumulated claims on the rest of the world or increases or decreases its debts." <sup>1</sup> Thus, if all the items in the balance of payments are included, it is elementary accounting that the result would always be in balance. Such inevitable balance, however, is not highly significant:

"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 effected, 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." <sup>2</sup>

Therefore, a discussion of balance of payments disequilibrium and of the methods devised to restore equilibrium must not be based on the inclusion of all the items in the balance of payments. That is why it is considered necessary for such a purpose to classify all transactions which constitute the balance of payments into two major types: autonomous, and compensatory or accommodating. Compensatory transactions may be made by individuals or groups (including governmental authorities); thus, the automatic loss of international liquidity by exchange dealers, private banks or central exchange authorities constitutes a common example of compensatory payments. Moreover,

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1. Ibid., p. 4.

2. Ibid., p. 9.



they may be either automatic, unplanned and unforeseen, or discretionary, planned and foreseen. "Their distinguishing feature is that they have taken place only because the other items in the balance of payments are such as to leave a gap of this size to be filled."<sup>1</sup> The distinguishing feature of autonomous transactions, on the other hand, is that they take place irrespective of the size and nature of the other items in the balance of payments. Generally, autonomous transactions include commodity trade, services and capital transactions "which are made for motives quite other than to put the balance of payments into balance".<sup>2</sup> Compensatory transactions include, inter alia, the loss by central monetary authorities of international liquidity in order to satisfy the requirements for foreign exchange, or the receipt by the authorities in question of funds in form of a loan or grant made for the express purpose of meeting a gap obtaining in the other items of the balance of payments, or the compulsory acquisition by such authorities of foreign assets owned by citizens of the country in question for the express purpose of financing a balance of payments gap.<sup>3</sup>

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1. J.E. Meade, The Balance of Payments, (London: Oxford University Press, 1952), p. 11.

2. Ibid.

3. This assumes that exchange transactions are centrally controlled by governmental authorities. In the case of an open exchange market, allowance should, of course, be made for the acquisition or loss of foreign exchange or gold by private individuals or private financial institutions.



The relation between the two types of transactions is one of reversed equality: if there develops a deficit for example in the autonomous account of a magnitude of, say,  $-X$ , there would show up, in the compensatory account, a surplus of  $+ X$ . This is so because the two accounts together include all the items of the balance of payments, which items, as shown above, have<sup>1</sup> to balance by necessity.

Now that the balance of payments has been defined and its division into different accounts described, an explanation of the term "equilibrium" in the balance of payments is attempted at. It may be recalled that the present interest in balance of payments equilibrium derives from the presumption that such an equilibrium constitutes one of the conditions of currency convertibility. Therefore, the definition given here of the term "equilibrium" is made to serve the specific purpose of showing in what sense does a state of balance in a country's international accounts constitute a condition of convertibility.

Notwithstanding the inevitable equilibrium in the accounting sense, a balance of payments is generally said to be in equilibrium when, over a period of time, "the total supply

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1. Another common break-down of the balance of payments is the division of the autonomous account into current account and capital account. Current account includes, customarily, commodity trade and services; capital account on the other hand, includes all capital movements which are not of the accommodating type. (The definition of current account and capital account that is used in the present chapter is that outlined in the Articles of Agreement of the International Monetary Fund. Refer to Chapter I, supra.)

and demand for means of foreign payment are equated, without continuous short term capital or gold movements in one direction, or default, or measures of control employed to maintain this equality"<sup>1</sup>. "Equilibrium is that state of the balance of payments over the relevant time period which makes it possible to sustain an open economy without severe unemployment on a continuing basis."<sup>2</sup> Thus, equilibrium in the balance of payments may, therefore, obtain when total receipts are equal to total payments on the autonomous account; under such a condition the net balance of the compensatory account would be zero. When total autonomous receipts fall short of total autonomous payments, then a deficit is said to have developed in the balance of payments. And since the net compensatory and autonomous balances must be equal and opposite, a deficit in the balance of payments may be measured by the positive balance which obtains in the compensatory account. Alternatively, a surplus is said to have developed in the balance of payments when total autonomous receipts exceed total autonomous payments; and the magnitude of the surplus may be measured by the negative balance which obtains in the compensatory account.

But the existence of an actual net balance in the compensatory account may be too narrow a criterion for measuring

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1. Kahn, op.cit., p. 9.

2. Charles P. Kindleberger, International Economics, (Illinois: Richard D. Irwin, Inc., 1953), p. 397.

a disequilibrium in the balance of payments. This may be so because the competent authorities in the country concerned may be pursuing certain definite policies the effect of which would be either to wipe out completely or, at any rate, to reduce the potential deficit in the balance of payments.<sup>1</sup> Thus, a country may not have any deficit in its balance of payments, as defined above, but the authorities may, nevertheless, be avoiding such a deficit by strict exchange and trade restrictions. Similarly, a country may be avoiding an actual deficit by the adoption of internal policies especially geared toward this purpose - such as, for example, an internal deflationary policy which reduces national income and prices, and hence results in increased unemployment. Moreover, a country may also avoid an actual deficit by permitting a depreciation in its currency's exchange rate. Consequently, the distinction should be made between an actual deficit in the autonomous balance and a potential deficit. The size of the former may be conveniently measured by the positive net balance which obtains in the compensatory balance. The size of the potential deficit, on the other hand, may be measured by the positive balance which would have obtained in the compensatory balance failing any depreciation of the exchange rate and in the

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1. The discussion is purposely carried out in terms of a deficit of the balance of payments because it is believed that international financial accounts are not symmetrical, but rather suffer from an inherent bias towards deficit.

absence of governmental measures especially devised to restrict the local demand for gold or foreign currencies. And since 'convertibility, as defined by the Fund,' requires freedom of exchange transactions and inherently implies, if it is to be meaningful at all, the absence of restrictive trade controls, and since it also requires stability in the rates of exchange, and since in spirit it is contributive to high levels of employment and real income, therefore, in defining the term "equilibrium" in the balance of payments as a condition of convertibility, it is not enough to consider the actual deficit that obtains in a country's balance of payments. Accordingly, the realization of equilibrium in the balance of payments should mean, for the present purpose, the realization, over a period of time, of a state of balance between the debit and credit sides of the autonomous account without the need to resort, for the special purpose of achieving such a state of balance, either to inflation or deflation at home, or to exchange or trade restrictions (except those imposed on capital transactions), or, finally, to exchange rate fluctuation.

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1. The minimum which the Articles of Agreement of the International Monetary Fund require is freedom of exchange transactions for current payments.
  2. Both currency convertibility and "the promotion and maintenance of high levels of employment and real income and... the development of the productive resources of all members" are equally among the objectives of the Fund. (Articles of Agreement, Article 1.)

There still remains to determine the duration of the period of time over which the balance of payments of a country contemplating the establishment of, or actually maintaining, convertibility must be in equilibrium. It should be mentioned, from the outset, that no one single period can be determined to fit all cases. The duration of the said period depends on such factors as the nature of the items which constitute a country's balance of payments and the type of disturbance to which it is normally exposed. Generally, it can be said that the period should be long enough to give way for reversible items in the balance of payments to consume themselves. Thus, if the balance of payments of a given country is subject to wild seasonal fluctuations (in one season it develops an acute deficit while in another it accumulates a sizable surplus), then the period under consideration must be long enough to permit the one disturbance to counteract and, more or less, cancel the other, so that over the whole period, an equilibrium would be achieved. Similarly, if the international accounts of a country are subject to cyclical disturbances, then the period over which the balance of payments must be in equilibrium should be long enough to include a complete cycle. In this case, the period would extend from about five to ten years. Countries, the main exports of which are primary commodities have shown themselves especially prone to cyclical disturbances. So that, it is generally preferable, in dealing with such countries, to take a period which is long enough to eliminate seasonal as well as cyclical fluctuations. The general criterion to be followed

in determining the duration of the period over which a country's balance of payments must be in equilibrium is that, during the period, the country should be able, year in and year out (or season in and season out), to achieve a balance in its international account without unduly draining its international liquidity, and without resort to restrictions on current account, deflation, or exchange depreciation.<sup>1</sup> Since, however, it is very unlikely that a country's balance of payments would not be exposed to cyclical disturbances, there seems to be more weight to the argument which considers a period longer than one year in duration. In summary, the first condition of convertibility consists of the realization of a state of balance in a country's international accounts over a period of time which is usually more than one year but not more than ten years, and without resort to policies which are not in accord either with the letter or with the spirit of currency convertibility.

#### Proper Internal Financial Situation

A country purporting to establish convertibility, or determined to maintain it, must enjoy a proper internal financial situation. This is the second condition of currency convertibility. A country's international payment problems are not considered as solved unless and until its internal financial situation is based on sound foundations. 'Disequilibrium in the

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1. Again the argument here is distorted in favour of a deficit rather than a surplus in the balance of payments.

balance of payments is probably always apt to develop if a country is unduly following an internal deflationary or inflationary policy. So that a proper internal financial situation is really a most important prerequisite for balanced international accounts. Some writers consider it to be only one among other requirements for equilibrium in the balance of payments. However, in view of its importance with regard to countries bent on economic development and with regard to the wild inflationary pressures which developed after the Second World War thereby acting as a major hindrance in the face of a movement toward currency convertibility, it is here considered alone as constituting a condition of currency convertibility by itself; nonetheless, it must be kept in mind that its distinctive character as a condition of convertibility derives from the consideration that it is a necessary condition of achieving and maintaining equilibrium in international accounts.<sup>1</sup>

Generally speaking, the causes which may give rise to balance of payments disturbances may be divided into two groups: real and monetary. Disruption of productive capacity due to

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1. The argument that follows is heavily concentrated on a discussion of inflationary rather than deflationary tendencies, because, although both may lead to balance of payments disturbances, only the former represents a danger to convertibility; and because in underdeveloped countries, (with which this study is mainly involved) the prospects of an inflation outweigh by far those of a deflation.



war and an adverse change in demand for exports due to a change in preference are among the real causes of disturbances. The development of inflationary pressures with the effect of increased imports and reduced exports is a monetary cause which may lead to disequilibrium in the balance of payments. It is with monetary causes of disequilibrium and more specifically with inflation that the present discussion is concerned.

Suppose that a given country has already achieved equilibrium in its balance of payments over the relevant period of time. Suppose further that, due to some cause, an inflationary process develops in this country. (An inflationary process is considered to have begun when aggregate demand for all purposes - consumption, investment and government- exceeds the supply of goods and services at current prices). Under this circumstance there tends to develop, assuming all other things to remain constant, a deficit in the balance of payments of the country concerned. The deficit would arise because domestic demand has been inflated beyond what can be met by current production for the home market and by imports financed by receipts from current exports.<sup>1</sup> Thus excess demand would bid away home produced goods from export markets to local consumption, thereby reducing the exports of the country. Moreover, that part of the excess demand remaining unsatiated by

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1. Current exports include in this context foreign loans and foreign grants as well.



the process of diverting export goods to local markets would, if not prevented, spill over into larger imports than the country can pay for by current exports,<sup>1</sup> thereby increasing imports. Imports may be further increased by reason of the redistribution of income and wealth which inflation gives rise to if given time to operate unchecked. To the extent that inflation redistributes income and wealth in favour of high-income, profit-receiving groups,<sup>2</sup> and to the extent that the propensity to import of such groups is higher than that of lower-income groups, then to that extent inflation tends to increase imports, thus rendering the balance of payments deficit still more acute. For all these reasons, the development of an inflationary process would tend to result in an increase of imports and a reduction of exports, and therefore, ceteris paribus, in a balance of payments deficit. This is the income effect of inflationary pressures. But this is not all. Although inflation is considered to have started when demand for all purposes exceeds supply of goods and services at current prices, it does not involve this alone. Such an excess of demand is only the initial effect of monetary expansion. The secondary effect, which almost invariably follows an excess of demand, is a rise in prices and costs, which rise further increases the

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1. Current exports include in this context foreign loans and foreign grants as well.
  2. The reasons why inflation results in a redistribution of income and wealth in favour of high-income, profit-receiving groups are given below in Chapter IV.

strain on the balance of payments. With prices in the home country now higher than prices abroad, exports would tend to fall off due to their reduced competitiveness in outside markets, and imports would tend to increase by reason of the greater attractiveness of unchanged prices abroad. This is the price effect of monetary expansion. One further point needs emphasizing here. It is not the fact of absolute rise in prices which is responsible for the balance of payments deficit. It is rather the relationship of price movements in the home country to movements abroad. Thus it is only when prices and costs at home increase by more than the increase in prices and costs abroad that a deficit in the balance of payments may develop because of the reduced competitiveness of exports and the increased attractiveness of imports. What is important in this connection is relative price movements at home with respect to price movements abroad.

Therefore, the development of an inflationary process in a given country is apt to cause a deficit in that country's balance of payments. And since equilibrium in international accounts (as defined above) is a necessary condition of currency convertibility, then inflationary pressures must be suppressed if convertibility is to be maintained. Countries that contemplate the establishment of convertibility and that hope to maintain it should see to it that no monetary expansion is to be allowed if it cannot be afforded in view of the country's international receipts and international liquidity. This task is made the more difficult in view of the present determination of industrial

countries to maintain high levels of employment and of under-developed countries to secure rapid development. It is even believed by some that the all-important objective is the maintenance of high levels of employment or the achievement of rapid economic development, and that such objectives should take precedence over all other objectives, including that of maintaining currency convertibility and a multilateral payment system. Moreover, it is argued that, since currency convertibility imposes reins on rapid economic development, it should, therefore, be discarded in order not to check such development. It is the deep conviction of the author that what may appear to some to be a disadvantage of convertibility for countries bent on economic development is, in fact, the greatest advantage that it can present to such countries, and that inflation itself is incompatible with balanced economic development.<sup>1</sup> It is on the basis of this conviction that a discussion of the various measures of controlling inflation is now undertaken.

Before actually beginning the discussion of the various measures to control inflation, a digression may be necessary in order to point out to certain prerequisites which must first obtain if the various measures of control are to be effective and which prerequisites if not existent or are only partially available, would greatly reduce the effectiveness of such measures.

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1. This will be discussed in greater detail in Chapter IV.

One very important prerequisite is the availability of adequate and reliable statistics which may be used in devising the proper policies to control financial expansion and against which may be measured the effectiveness of such policies. In view of the paucity of statistical data in underdeveloped countries, it is really difficult to overemphasize this prerequisite.

The second prerequisite is the existence of an institutional framework through which policies may be effected to curb inflationary pressures. Of special importance in this context is the presence of a central bank or any other agency entrusted with the function of devising and supervising the execution of monetary and credit policy, a wide and sensitive money and securities market, and an adequate banking system responsive to the directions of the central bank.

The third prerequisite is the presence of a well equipped and well trained personnel in order to make the necessary decisions with regard to the type of policies that must be followed and with regard to the timing of such policies. This again is a field in which underdeveloped countries are especially deficient.

It is generally claimed that the only effective method of restoring financial stability is an increase in production which would tend to reduce prices by satiating excessive demand. However, although this may be the best method of curbing inflation, it usually takes a long period of time in order to make its effects

felt. And "stabilization after long-continued inflation is a painful process, because inflation has induced a pattern of behaviour based on the expectation that prices will continue to rise"<sup>1</sup>. Therefore, some other measures, besides the time-consuming, and often difficult, process of increasing production, must be resorted to in order to control inflationary pressures, pending or failing such an increase in production. Such measures are here conveniently divided into three groups: monetary policy, fiscal policy, and other anti-inflationary measures. Each one of these will now be discussed separately.<sup>2</sup>

a) Monetary Policy. Since inflation implies a higher than "normal" proportion of money and money assets to national income, then to curb undue financial expansion would primarily require a reduction and/or a prevention of increase in the supply of money and near-money assets, that is, a reduction of the public's liquidity. Liquidity may be obtained through various ways. The most common and quantitatively the most important one is the increase in bank credit. Another important one also is the increase in money supply through budget deficits. Other ways of increasing an economy's liquidity include the conversion of near-money assets into money, a more active use of

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1. E.M. Bernstein and I.G. Patel, "Inflation in Relation to Economic Development", Staff Papers, II (November 1952), p. 385.
  2. The discussion of the measures of controlling inflation is meant primarily to apply to underdeveloped countries.

money, and a surplus accruing in the balance of international payments. Bank credit and budgetary deficits are usually the two causes which are mostly responsible for increasing liquidity in an underdeveloped country.<sup>1</sup>

The orthodox monetary measure used to reduce monetary expansion is the rediscount rate of the central bank. By raising the rediscount rate, monetary authorities would increase the cost of credit and would, therefore, discourage banks from increasing their liquidity through resort to the central bank. This, however, may not curtail bank credit.<sup>2</sup> Another monetary measure for controlling bank credit is to reduce the availability of such bank credit, rather than to increase its cost. Thus, central banks may carry on open market operations (selling securities in this case), or may impose higher reserve requirements, or, still, may even place a direct maximum limit to the amount of

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1. The velocity of circulation may be taken as constant in the short run; the conversion of near-money into money is of little significance in underdeveloped countries since the use of securities is greatly limited; and, finally, inflationary pressures are likely to wipe away any surplus that may otherwise develop in the balance of payments.
  2. A higher bank rate may not curtail credit because demand for credit may be insensitive to its cost in view of the continuous rise in prices and in view of a possible future shortage of credit.

credit that a bank may grant. However, in view of the relative unimportance of securities and money markets in general, open market operations may not prove as effective in underdeveloped countries as they may otherwise be. Thus, in such countries, direct controls over the availability of credit may very well prove to be the most effective monetary measure of controlling bank credit. One further reservation should, however, be mentioned in this respect. Since in an underdeveloped country it is not advisable to restrict bank credit for all purposes, and, since, on the contrary, credit for certain specific purposes should be facilitated in order to contribute to economic development, then it is much more commendable to use selective credit controls rather than to restrict bank credit in general. The various monetary controls of bank credit, however, do not equally lend themselves to selective use; the rediscount rate and the direct limitation of credit are perhaps most adequately fit for the purpose of controlling bank credit selectively.

Other monetary measures of restraining inflation include the declaration of all or part of the surplus money or near-money as worthless or inactive by force majeure<sup>1</sup> or by withdrawing part of it from circulation by compulsory blocking of loans, or finally, by floating a loan to which the public can voluntarily subscribe. It is only recently (after the Second

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1. Such as was done in Germany and Belgium after the Second World War.

World War) that such measures came to be considered as falling<sup>1</sup> under the scope of monetary policy proper.

b) Fiscal Policy. Fiscal measures affect the level of aggregate expenditures either directly or indirectly through their effects upon the incomes and assets of non-governmental units. Thus, an increase in government expenditures would ceteris paribus, increase total expenditures in the economy, and vice versa; and an increase in government receipts would, ceteris paribus, reduce total expenditures in the economy, and the reverse is also true.

Measures of fiscal policy may be divided into two classes: those which influence the relation between changes in income and changes in spending such as progressive income tax rates, and those which influence the level of total spending only such as changes in government spending if they do not alter income distribution.

The use of fiscal measures to control inflation entails the use of the instruments of public finance as counteragents to inflationary pressures developing in the rest of the economy. Thus, in time of inflation, tendencies to excessive spending may be curbed by direct withdrawals of spending power through

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1. For a presentation of post-war monetary policy refer to I.G. Patel, "Monetary Policy in Postwar Years," Staff Papers, III, (April 1953), pp. 69-101.



the use of taxation or by measures operating as disincentives on consumption and investment. Since what is desired is a reduction in money expenditures, an increase in taxation may serve the purpose because, by itself, a tax reduces expenditures by reducing disposable money incomes or money assets at hand.

In underdeveloped countries bent on economic development, tax policy seems probably to be the most appropriate fiscal measure devised to curb inflation. A sufficient reduction of government expenditures may well prove impractical and incompatible with the requirements of economic development. Furthermore, the amount of funds that the authorities concerned are able to raise through loans from the public is usually very limited. However, this is not to say that tax policy must be used blindly. A certain degree of selectivity in its use would be highly recommended. Thus, taxes on general consumption should be preferred to those on savings, although this may prove to be socially unjust and politically unfeasible.

Nevertheless, judged as a means of restraining inflation, fiscal policy is itself subject to limitations that should not be overlooked. The first limitation is a statistical one: to the extent that fiscal policy is more dependent on global statistical data than other measures of controlling inflation, and to the extent that statistical data are not as exact and precise as may be required, then, to that extent, the effectiveness of fiscal policy is limited. A second limitation is that which

relates to the extent of control of fiscal policy. No matter how effective fiscal policy may prove in curbing inflationary pressures in certain spheres of the economy, there still remains certain other spheres, such as the private investment sector, where its effectiveness is almost insignificant. "There is no very obvious method in the strictly fiscal field for adequate control of private investment; and if the money supply is elastic and the prospects of profits are good, the situation here may get completely out of hand."<sup>1</sup> Doubtless there are some fiscal measures, like profit taxes, which may work in such spheres; but any belief of precise control in these spheres through the use of fiscal policy alone is based upon illusion.<sup>2</sup> The third limitation to fiscal policy is its comparative inflexibility.<sup>3</sup> Budgets are usually drawn up only once every year; moreover, fiscal measures require a great deal of time in order that they may be implemented since they are subject to administrative delays and political pressures. All this creates delays and contributes to the comparative inflexibility of fiscal policy. "A world in which, on the whole, the fiscal machine will only work with tolerable administrative efficiency

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1. Lionel Robbins, The Economist in the Twentieth Century, (London: MacMillan & Co. Ltd., 1954), p. 71.

2. Ibid.

3. Such inflexibility is greatly reduced through the adoption of specific measures, e.g., supplementary budgets used in the United Kingdom and credits additionnels used in Lebanon.

if it is not asked to accommodate itself to changes more than once a year is a world in which, if the only overall control is fiscal, all sorts of things can go wrong in the intervals. The economic weather is apt to change from day to day."<sup>1</sup>

c) Other Anti-Inflationary Measures. This includes various specific measures devised to curb inflation but which it was not thought proper to include either under monetary policy or under fiscal policy. Among them may be mentioned direct controls such as price controls, rationing, and deliberate direct measures to reduce certain types of expenditure, mainly capital expenditure, through the use of licences and fees. Such direct controls may prove to be necessary if inflation is to be effectively restrained in underdeveloped countries, due to the relative ineffectiveness of monetary and fiscal policies in such countries. However, the effective use of such direct controls requires a great deal of administrative skill and efficiency, which requirement may, in turn, reduce their effectiveness in underdeveloped countries.

Under this third class of anti-inflationary measures may also be included a proper wage policy. The competent authorities should see to it that during the process of inflationary expansion, wages are not allowed to rise to levels sufficient to cause a rise in general costs and prices to an extent at which

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1. Robbins, op.cit., p. 73. (The underlined word is italicized in the original text).

a wage-price spiral may develop. The prevention of the development of a wage-price spiral should, theoretically, prove easier to achieve in underdeveloped countries, because of the relative weakness of labour unions.

### The World Payment Situation

The third condition of convertibility may be summarized in the need for a world payment situation which breeds strength in the balance of payments of the country maintaining convertibility and which creates the proper and adequate atmosphere necessary for the maintenance of convertibility. Because a proper world payment situation directly reacts on the balance of payments of a country, and because, hence, it is necessary for achieving equilibrium in the balance of payments, it is sometimes included in a discussion of the need for equilibrium in the balance of payments and is not considered to constitute, by itself, a separate condition of convertibility. Nonetheless, it is here discussed alone as a condition of convertibility, mainly because of the important role which postwar payment developments in the world have played in discussions of currency convertibility, and also, because of the peculiar position which the "dollar shortage" assumed in post war payment problems. However, as it was mentioned earlier in this chapter, the conditions of convertibility are closely linked to each other and interact among each other making any separate discussion of any one of them highly erratic, except of course, for analytical

purposes. Accordingly, it should always be kept in mind that the various conditions of convertibility constitute an integral whole, very often the one determining the other to a larger extent. With this reservation in mind, it is now proposed to undertake the discussion of the "world payment situation" qua condition of convertibility.

The inconvertibility of a currency, along with trade and payment restrictions which are its necessary concomitants, provide the goods and services of a country with an effective shelter against competition from abroad. So that, in making its currency convertible, a country indicates its willingness to expose itself to world-wide competition. It would thus have to buy its imports on an exclusively price and quality basis, regardless of their origin and of the currency in which payments are made. In turn, it would have to sell its exports on the same bases. Thus, convertibility imposes a great deal of strain on the country undertaking it, and, hence, such a country must be in a strong enough position to be able to defend the maintenance of its currency convertibility in the future. The primary responsibility of such a task lies on the country concerned itself. However, this does not mean that alone, and by itself, a country is responsible to maintain convertibility. Since convertibility relates to payment relations between one country and its trade partners, it has, therefore, to embrace certain aspects of those partners' economic

relations with the country concerned. This means that a country undertaking convertibility must have the assurance that its trade partners would not discriminate against it so that they may be able to convert more of their earnings in it into a desired convertible currency. (Thus, if the trade partners of the country establishing convertibility have not yet been able to achieve convertibility themselves, then they would always be tempted to discriminate against such a country to the great detriment of its capacity to maintain convertibility.)<sup>1</sup> Therefore, if a country is to effectively maintain the convertibility of its currency, it must not be discriminated against; and that would satisfactorily be assured after the whole payment situation abroad had been eased. As a condition of convertibility, world trade must be carried on with as little trade and payment restrictions as possible, and the world payment situation must be generally favourable (especially for countries which account for a great part of world trade).<sup>1</sup> "In determining the pace of their movement toward convertibility, few countries can afford to ignore the extent to which other countries with which they have important economic links are likely to move in the same direction."<sup>1</sup>

Therefore in order that a truly multilateral payment system (which is the essence of convertibility) may function

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1. International Monetary Fund, Annual Report, Washington, D.C., 1954, p. 13.

smoothly, it is necessary that the payment difficulties of the various constituent currency areas be somewhat eased. There must not be a tendency for imbalances to be concentrated on few countries. Large disparities in payment positions must first be abolished. "In other words there cannot be large differences in the relative strength of the important currencies. In addition there cannot be large overall deficits or tendencies toward deficits for individual countries, especially the major trading nations. Finally, there must be a willingness on the part of all members (in the multilateral system) to give up discriminatory trade and exchange arrangements."<sup>1</sup>

One further point should be added here. In order that the multilateral payment system may function smoothly, it is of extreme importance that movements of capital from the capital saturated countries and from countries with more or less continuing balance of payments surplus to underdeveloped countries and countries which show a more or less sustained deficit be encouraged.

A proper world payment situation as a condition of currency convertibility may be summarized as follows. There should not obtain a situation where the world is distinctively divided into surplus countries and deficit countries, i.e. there should not be a tendency for deficits to concentrate on a specific group

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1. Raymond F. Mikesell, "The Emerging Pattern of International Payments," Essays in International Finance, No. 18 (April 1954), p. 10. (Parenthesis provided by the author.)

of countries. Deficit countries must follow all necessary policies (including perhaps disinflation, exchange rate alteration and increase in productivity and production) to turn the balance in their favour. Surplus, countries on the other hand must allow more imports by reducing their tariff barriers and must invest abroad. World trade and payments must also be freed of the strangling effects of restrictions. These are the broad requirements for a stable and smooth multilateral payment system. However, if such a system is to function with tolerable satisfaction, "it is necessary, not only that the different centres shall more or less keep in step, but also that somehow the aggregate volume of expenditure in the world as a whole shall be adequate and shall not fluctuate unduly either way"<sup>1</sup>. This requires a stabilization of the evolution of world demand, or at least of the demand of that part of the world which is willing to cooperate in a multilateral payment system.<sup>2</sup>

There still remains now to discuss postwar trade and payment developments and to outline in brief some of the measures that should be taken to improve the present world payment situation, thereby rendering it more adequate for the smooth functioning of a multilateral payment system.

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1. Robbins, op.cit., p. 166.

2. Ibid., p. 167.



In a discussion of postwar trade and payment situation, two problems arise which require explanation. The first one is to explain why numerous countries have tended in the postwar period to incur deficits in their international payments; and the second is to show the reasons why the general balance of payments difficulties of the postwar world tended to manifest themselves chiefly in a shortage of dollars rather than in that of any currency else. The first one is the general problem of balance of payments difficulties and the second is the specific problem of what has come to be called "the dollar shortage". However, the two problems are more or less two sides of the same picture; they should not be thought of as completely separate phenomena.

The period to which the present discussion relates is that extending from the end of the Second World War to the end of 1955. When the war ended in 1945, belligerents (which constituted the majority of countries as far as their share in world trade is concerned) found themselves face to face with considerable problems which they had to solve in reconstructing world trade. The economies of Western Europe and connected areas were completely out of balance. Their international accounts were showing extreme deficits which they could make good only by imposing strict trade and payment restrictions. The reasons for such an unbalanced situation are not hard to find. The most important one is the disruption, due to war, of production and distribution facilities. Productive factors

were either destroyed by action of war or had been shifted to the urgent use of war production. Thus there was a good deal of time required before the civil productive power of these countries could be restored to prewar levels. Another reason for the general international payments imbalance in which almost all countries found themselves in the immediate post-war period is the comparatively large requirements for imports. Imports were desired for the purpose of reconstructing the devastated economies in order to reestablish their productivity levels; they were also in great demand as a result of the wartime backlog of consumer demand which had its origin in the war inspired inflation and in the relative scarcity, during wartime, of consumer goods and services. And since directly after the war, those countries could not themselves satisfy that pent-up consumer demand, it had to spill over, if not prevented, into increased imports. Thus, the great need for imports was twofold: to reconstruct the devastated economies thereby putting them again on solid grounds, and to satisfy the pent-up consumer demand which had its origins in internal inflations due to war financing. Still another reason for the postwar payment imbalance is the change in the structure of international indebtedness which was caused by the war. Of specific significance in this connection is the change in the position of England from a creditor to a debtor country. This was primarily caused by the loss of income from invisible sources, mainly investments abroad which had to be liquidated

in order to finance the war. Finally, a major reason for the general postwar imbalance is the sizeable inflationary pressures which swamped the various countries of the world to different extents. The origin of such pressures is to be found in the process of war financing. However, this was not all. Fresh inflationary pressures were also let loose in the postwar period, primarily as a result of too rapid a reconstruction program or too ambitious a developmental one. Such inflationary pressures joined hands with those originating during the war period in subjecting the international payments of the countries concerned to tremendous strains. These, very briefly and generally, are the causes of the post-war tendency to general disequilibrium in balances of payments.

The tendency to a general imbalance in postwar international payments has manifested itself primarily in a scarcity of the dollar. Hence such terms as the "dollar shortage" and the "dollar gap". A discussion of the meaning and causes of the dollar shortage will now be undertaken.

It must be admitted right from the beginning that it is very difficult to define the dollar shortage in quantitative terms. Over and above the realized deficit, there also exists another latent deficit, which is not allowed to be realized by reason of the various policies which countries are purposely following, such as exchange and trade restrictions. To this latent deficit there exists an offsetting factor,

namely, what would have been bought from the dollar area in absence of American aid and military expenditures abroad. Because it is very difficult to weigh exactly these two quantities, it is preferable in this connection not to attempt a quantitative definition of the postwar dollar shortage. It is sufficient here to define it, only loosely, as a tendency to a disequilibrium in the balance of payments of the dollar area with the rest of the world, a disequilibrium which manifests itself in a deficit in the international accounts of the rest of the world with the dollar area.

The reasons for the development of a dollar shortage in the postwar period are numerous and not difficult to find. The most important one resides in the emergence of the United States of America as the only country of any great economic significance which had not suffered large losses in its productive power but which, on the contrary, had increased it, during the war. It was the only major country to which the other devastated countries could turn their faces in order to obtain their required imports for reconstruction, development or consumption. As such, most of the imports of those countries had, by necessity, to come from the United States; hence the scarcity of the dollar and the dollar shortage. The disappearance of Germany and Japan as suppliers of finished goods and as markets of raw materials tended further to accentuate that tendency. Moreover, the disruption, for political reasons, of East-West trade after the war had similar effects. So that, non-dollar countries found themselves

in a debit position out of which, at least until reconstruction had been tolerably achieved, they could hardly find a way. These were the most important reasons for the appearance of the dollar shortage directly after the war. However, its continuance after reconstruction had been completed and production levels restored is due, in the main, to the disproportionate extents to which inflationary pressures have been permitted to make themselves felt in non-dollar countries with respect to dollar countries. This is due mainly to the needs for reconstruction and development as well as to the original disparity between dollar countries and non-dollar countries with respect to war-inspired inflationary pressures. "The overwhelming dollar problem of the postwar period had its origin in the great destruction of the war and the eagerness to proceed with reconstruction even when there was a shortage of real resources. But the persistence of the dollar problem, even on a declining scale, was caused by the world-wide inflation. In part this inflation was the belated effect of the large amounts of money created during the war. In part it represented the creation of new money to complete reconstruction rapidly or to secure rapid industrialization in the underdeveloped countries."<sup>1</sup>

However, the dollar shortage has been greatly reduced since the end of the War. It is claimed by the Fund that "even

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1. Rooth, op.cit.

with a wide definition of the term, the statistical dollar gap of Western Europe disappeared"<sup>1</sup>. Thus, the present obstacles to the further removal of quantitative restrictions lie as much in the desire for protection of particular industries which such restrictions afford as in the continuance of payment difficulties.<sup>2</sup> Notwithstanding the great improvement which the non-dollar world realized in its payment position with the dollar countries since 1945, there still exist some elements of uncertainties which may place certain countries in a precarious position if they wholly remove their trade and exchange restrictions at present. The balance of payments of the rest of the world is thus still supported by an annual sum of around US \$4 billion of government expenditures.<sup>3</sup> Moreover, many countries still suffer from restrictions placed on the entrance of their goods into foreign markets. However, on the whole, it may be said, that the international economic climate is getting increasingly propitious for the relaxation of restrictions. "The increases in output and real income in many countries, the stronger competitive position of European industrial exporting countries, the more balanced distribution of monetary reserves, and the course of economic activity in

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1. International Monetary Fund, Annual Report, Washington, D.C., 1954, p. 32.
  2. International Monetary Fund, Annual Report, Washington, D.C., 1955, p. 2.
  3. These do not include military supplies and equipment.

the United States, and the continued maintenance of internal stability in a number of countries have worked as favorable factors."<sup>1</sup>

However, notwithstanding this improvement in world payment situation, very few countries in the world, all of which (with the exception of the United States and Canada) are of minor importance in world trade, do maintain convertibility today. What, in this respect, should be done to achieve a world payment situation which proves favourable to currency convertibility?

The first point to be discussed in this connection relates to the policies which surplus countries, on the one hand, and deficit countries, on the other, should follow. In order that the desired world payment situation may be realized, deficit countries should try their best to increase their exports to the dollar area, or to third countries where they can convert their export proceeds into dollars. The necessary increase in dollar exports, however, "will not be forthcoming unless home demand is limited by avoiding inflation, unless production is shifted to goods which offer prospects for export sales in the Western Hemisphere, and unless facilities are provided to market and service these goods. Above all, if exports are to be increased on a large enough scale, the goods will have to be offered at prices competitive with both domestic

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1. International Monetary Fund, Annual Report, Washington, D.C., 1955, p. 74.



output and other imports in the markets of Western Hemisphere countries".<sup>1</sup> As it was mentioned earlier in this chapter, international investment plays an important role in the establishment of a better multilateral payment system. Thus, an adequate flow of capital (especially to underdeveloped countries) may prove extremely beneficial in this respect in so far as it encourages the expansion of world trade. Deficit countries have the obligation, in order to attract an adequate flow of foreign capital, to indicate to surplus, capital exporting countries that they are taking effective measures to place their internal financial situation in order. As such, the main task of deficit countries in restoring an adequate world payment situation is to exercise effective restraints on excessive expenditure and high costs.

Surplus countries, on the other hand, should keep their economies operating at a high level and should minimize the extent of fluctuation to which their economies may be subjected. This argument applies with special significance to countries that account for a large part of world trade and in the economies of which international trade constitutes an insignificant sector, such as the United States. Accordingly, surplus countries should follow policies which encourage high levels of production and international trade. Nor should the encouragement of international investment be ignored. Furthermore, surplus countries

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1. International Monetary Fund, Annual Report, Washington, D.C., 1949, p. 2.



have the obligation to lower their high tariff barriers and any other artificial barriers that restrain imports. The United States has very often been accused of the imbalance that still exists in world payments, primarily on the basis of its high trade barriers and its various discriminatory measures tending to discourage imports. Thus, it is sometimes claimed that any smooth functioning of a multilateral payment system requires, in particular, the maintenance of stability in internal U.S. economy and the allowance of a greater extent of competition in U.S. foreign trade. The United States has been singled out because it is the most important surplus country as far as international trade is concerned.

Another requirement for a better world payment situation that is often forwarded is a revaluation of the price of gold, in fact, a rise in the dollar price of gold. This argument is cherished, in general, by almost all deficit countries, and, in particular, by the gold producing countries (mainly the Union of South Africa); on the other hand, it is strongly opposed by the United States.

The proponents of the argument for the revaluation of the dollar price of gold claim that the dollar price of gold has been frozen since 1934 while the dollar has, in effect, lost about half of its purchasing power as a result of the inflation which ensued since 1939. Thus, a realistic revaluation of the price of gold, the argument goes on, would materially contribute toward facilitating the world payment

situation, since it would inflate the gold holdings of the world by about 100 percent. Thus, it is believed by these countries that it is in the interest of the world at large that the United States raises the dollar value of gold.<sup>1</sup> The United States point of view, however, is that she would not consent to any policy which would inflict tremendous inflationary pressures upon her economy, as an increase in the dollar price of gold would necessarily do. As such, the practical chances of adopting such a step in the near future are not very great. It must be admitted, however, that a proper monetary policy could be envisaged to put a check on the inflationary pressures which may arise as a result of the devaluation of the dollar, provided, however, (and the proviso is important) that non-dollar countries do not use their now-inflated gold holdings to unduly increase their purchases from the United States. An increase in the dollar price of gold may, in fact, have two major advantages: first, it would increase the nominal value of gold reserves, and second, it would tend to increase the supply of gold in the long run. On this basis, the proposal to increase the dollar price of gold should probably be reconsidered.

Finally, it is necessary, for the proper functioning of a multilateral payment system, to have an efficient international

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1. Other countries do not by themselves raise the price of gold in terms of their currencies since this would mean a devaluation of their currencies in terms of the dollar.

payment institution. It is sometimes claimed that the present International Monetary Fund can do the job provided the sphere of its jurisdiction is widened (to include especially trade as well as payment problems) and provided its resources are substantially increased. On the other hand it is believed that a properly functioning multilateral payment system would require a completely new organization to administer it. Whatever the exact nature of the organization, the important question is to have an efficient and effective agency.

#### Adequate International Liquidity

Finally, having satisfied the previously mentioned three conditions of convertibility, a country should have adequate international liquidity before undertaking the convertibility of its currency. This implies, generally, that a country contemplating to undertake the convertibility of its currency must be well equipped to meet the drains on its gold and exchange resources caused by an unfavourable development in its international accounts without resort to trade or, for that matter, exchange restrictions (including fluctuations in the exchange rate of its currency which are not in accord with convertibility). Even though a country has achieved a satisfactory and balanced payment position over a period of time, and even though it has achieved an appropriate internal financial situation, and in spite of a favourable world payment situation, there is apt to develop (within the said period of time) a deficit in the balance of payments of that country, which deficit would require the country concerned to have available at its disposal a stock of international liquidity which would be used to cover that deficit and hence to

maintain convertibility. Thus, a country which is endeavouring to maintain the convertibility of its currency must possess adequate international liquidity which would act as a buffer during the period in which adjustments for unfavourable developments in the international payment position are being made.<sup>1</sup> If it is admitted that the function of international

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1. This should not be taken to mean that the only function which international liquidity might serve is the correction of balance of payments disturbances in a way conducive to the maintenance of convertibility. International liquidity might also be used by a country to maintain high employment levels at home in face of severe deflationary developments in a major trading partner. The pressure on international liquidity to be used in this manner and for this purpose would be greater in countries where the foreign trade sector assumes a greater importance in relation to the total economy. Thus, under this second use of international liquidity, the country would be primarily engaged in preventing an importation of depression rather than in maintaining the convertibility of its currency. This second aspect of the functions of international liquidity may be called the "high level employment aspect". The first one, that which is primarily concerned with the maintenance of convertibility, may be conveniently called the "multilateral trade aspect". It is this latter aspect of the functions of international liquidity that will be discussed here, for it is believed that the high level employment aspect exercises no direct bearing on the general question of the conditions of convertibility. (Of course, the maintenance of a high level of employment might contribute to the maintenance of convertibility through its advantageous effects upon the balance of payments.)

liquidity in this connexion should be to act as a buffer stock which would cushion the effects of disequilibrating developments in the international payment position of a country and, hence, to help that country maintain the convertibility of its currency, it must also be admitted that 'international liquidity should be used to correct balance of payments disequilibria of a short-term or cyclical nature only. A fundamental disequilibrium in the balance of payments should, as shown in the previous chapter, be corrected by changes in the par value of the currency in question.' Accordingly, international liquidity should serve as a short-term buffer in face of balance of payments disturbances, and its volume must be adequate to settle any such temporary difficulties. The emphasis in this connection is on the word "temporary". International liquidity, in so far as it serves as a condition of convertibility, must be adequate to meet reversible, temporary and fortuitous balance of payments difficulties only; long-run and sustained deficits should be dealt with through alterations in the exchange rates. This is the exact function of international liquidity in its capacity as a condition of convertibility: to serve as a buffer in face of short-term balance of payments deficits and, in this way, to avoid restrictions on trade and payments as well as to avoid unnecessary exchange rate fluctuations, thereby contributing to the maintenance of convertibility.

It is now appropriate to turn to a consideration of the assets that may provide a country with international liquidity.

Generally speaking, international liquidity includes the assets available for a country to meet international financial obligations. As such, the criterion according to which an asset may or may not be considered as part of a country's international liquidity is twofold: the availability of the asset to the monetary authorities of the country concerned for the purpose of meeting international payments, and its acceptability by potential creditors. According to this criterion, assets that may be included under international liquidity may be conveniently divided into three groups: monetary reserves, secondary reserves (such as the access to gold or foreign exchange held by the International Monetary Fund) and commodities and equities which are internationally marketable. These will now be discussed in turn.

Article XIX (a) of the Articles of Agreement of the International Monetary Fund defines the monetary reserves of a member country as follows: "A member's monetary reserves means its net official holdings of gold, of convertible currencies of other members, and of the currencies of such non-members as the Fund may specify".<sup>1</sup> However, this definition, as it stands, is somewhat vague, and thus requires further elaboration.

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Convertible currencies are so defined as to include the currencies of members which have notified the Fund that they are not availing themselves of the provisions of Article XIV Section 2, and also of such non-members as the Fund may specify. Furthermore, monetary reserves may also include holdings of the currencies of members still availing themselves of the transitional arrangements of Article XIV, Section 2, on condition that such holdings carry specified rights of conversion into another currency or into gold. The Fund must first declare such balances as balances of a convertible currency, upon which declaration they may be included in monetary reserves. It must be remembered, however, that only such balances of the currency concerned are treated as if they were balances of a convertible currency, and that it is not the currency itself which is deemed convertible.

Article XIX (b) defines what is meant by the term "official holdings", which is included in the definition of monetary reserves, as follows: "The official holdings of a member means central holdings (that is, the holdings of its Treasury, central bank, stabilization fund, or similar fiscal agency)". (The term "similar fiscal agency" is defined to mean an agency which actually performs an important function or functions similar to those normally performed by a Treasury, central bank or a stabilization fund). The holdings of these institutions are called "central holdings" and include all their



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holdings irrespective of the department of such institutions which may actually own the holdings or of the purposes for which such holdings are owned. Furthermore, official holdings may also include other than central holdings, namely, the holdings of gold and convertible currencies of a member's other official institutions and other banks, in so far as they are substantially in excess of working balances. However, in order that such holdings of other official institutions or other banks may be included in monetary reserves, the Fund must first, and after consultation with the member concerned, give its approval to that effect. Thus, holdings of other official institutions and other banks may be included in monetary reserves only to the extent that they are substantially in excess of working balances; and working balances are measured by a consideration of all the facts of the individual case, since there is no rigid rule which applies in this respect. "The general idea is that a working balance is one which is necessary to meet the requirements of its owner, taking into account normal receipts and payments, for a period not unreasonably protracted" (Fund Circular No. 9, paragraph 9). However, in determining that part of the holdings of a member's other official institutions and other banks which part may be included in official holdings, some deductions are made from their gross holdings. "These deductions are in respect of the liabilities of that member's other official institutions and other banks to the other official institutions and other banks

of other members arising from the holdings of the currency of the member" (Fund Circular No. 9, paragraph 10).

The term "holdings" stated in the definition of monetary reserves outlined in Article XIX (a) is to be understood as meaning ownership (i.e. title). Thus, a claim to gold or convertible currency, unsupported by the ownership of the gold or currency in question, does not constitute holding for this purpose. "For example, pledged gold is the holding of the pledgor, because the pledgor retains the ownership of it. Again, currency drawn by a member under a loan and in its ownership because deposited in a bank account which it owns, is part of its holdings; but currency which a member has not drawn under a loan agreement or commitment and which it does not yet own, although it may later get ownership of it, is not a holding" (Fund Circular No. 9, paragraph 11). Accordingly, there is a holding of gold or currency only if gold or currency is actually owned.

Two more terms still require explanation: "net" and "currency". The term "currency" is defined by Article XIX (d) as follows: "The term currency for this purpose (i.e. of calculating monetary reserves of a member country) includes without limitation coins, paper money, bank balances, bank acceptances, and government obligations issued with a maturity not exceeding twelve months".<sup>1</sup> Furthermore, paragraph 12 of Fund Circular No. 9 provides that "government obligations for this definition (the Fund's definition of 'currency')<sup>1</sup> must have

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1. Parenthesis added by the author.

been issued with an original maturity not exceeding twelve months, and it does not suffice that a government obligation issued with a longer original maturity will actually mature within twelve months from the date on or as of which the calculation of monetary reserves is made".

As for the explanation of the term "net", it is to be mentioned that the Articles of Agreement of the Fund (Article XIX (e)) prescribe the method that must be followed in calculating the monetary reserves of a member. Although gold and convertible currencies, as explained above, must be included in monetary reserves, the Articles of Agreement provide for certain deductions which are made in respect of "currency liabilities". "These (currency liabilities) are the liabilities represented by the holdings of the currency of the member whose monetary reserves are being calculated, by the Treasuries, central banks, stabilization funds, similar fiscal agencies, other official institutions, or other banks of other members or of such non-members as have been specified by the Fund. ....The essence of a currency liability is thus a holding of the currency of the member whose monetary reserves are being calculated" (Fund Circular No. 9, paragraph 21). All currency liabilities, as hereby described, must be deducted in the calculation of monetary reserves; and no deductions from currency liabilities are provided for by the Fund. Therefore, "net" official holdings of a member means its gross official holdings of gold and convertible currencies minus all its currency liabilities as defined above.

With regard to the Fund's definition of a member's monetary reserves, it must be mentioned that the Fund's purpose behind such an elaborate definition is twofold, namely, the determination of repurchase obligations and the payments of charges.<sup>1</sup> In calculating monetary reserves for repurchase purposes (and only for repurchase purposes) the Articles of Agreement provide for the exclusion of certain holdings of gold and convertible currencies (Articles of Agreement, Schedule B, paragraphs 3 and 4). Thus, "in the case of members whose metropolitan territories were occupied by the enemy, no account is taken of gold newly produced from mines in those territories during the five years after entry into force of the Articles of Agreement (i.e., during five years from December 27, 1946)" (Fund Circular No. 9, paragraph 14). In addition to such newly mined gold, no account is to be taken, in calculating monetary reserves or increases in them during any financial year, of the three following types of holdings: (a) holdings of currency previously inconvertible but which became convertible during the year; (b) holdings of gold or convertible currency which are the proceeds of a long-term or medium-term loan contracted during the year; or (c) holdings of gold or convertible currency which have been transferred or set aside for repayment of a loan during the subsequent financial year.

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1. Members' obligations with regard to repurchases and payments of charges are discussed below.

It can be seen of what has already been said that the Fund's definition of a member's monetary reserves includes three main categories: (1) holdings to be included; (2) holdings to be excluded; and (3) holdings to be deducted from the total of holdings which are included. However, monetary reserves may be defined either broadly or narrowly, depending on the purpose which such a definition is to serve. As mentioned above, the Fund's definition of monetary reserves is intended to serve the purpose of determining a member's repurchase obligations and its obligations to pay charges pursuant to the provisions of the Articles of Agreement. But the purpose of defining reserves for the present discussion is to partially determine a country's international liquidity position which position constitutes one of the conditions necessary for the maintenance of currency convertibility. As such, the Fund's definition of monetary reserves may be considered too narrow to be adequate for the purpose of the present study, upon which consideration it is accordingly advisable to introduce certain modifications into the said definition.

It must be admitted that a country's holdings which constitute its monetary reserves as defined by the Fund perfectly meet the tests of international liquidity and thus constitute the core and most important part of a country's international liquidity. However, for the purpose of the present discussion, other holdings may also be included in monetary reserves though they are not so included under the Fund's definition, and though they do not meet the tests of international liquidity equally,



well. These are essentially the holdings of gold and convertible currency owned by commercial banks and other financial institutions which are not Treasury, central bank, stabilization fund, similar fiscal agencies, other financial institutions or other banks, but which, nonetheless, are considered to be part of the "official family" and, hence, are closely accountable to the monetary authorities. Furthermore, there are some other holdings that may, under special circumstances and from time to time, be included in monetary reserves. These are essentially gold and convertible currencies other than official holdings (as defined by the Fund) and held by other than institutions which are included in the official family of a country. Such holdings, may in some countries and under given conditions function in the same way as the other constituents of monetary reserves. The provision which must be satisfied if such balances are to be considered as part of monetary reserves for the purpose of this study is that they should be available to the monetary authorities when the need for them arises. Such holdings, therefore, should not be ignored in a consideration of a country's international liquidity. Their holders may yield them to monetary authorities when required to do so by law or when induced to do so by financial considerations.<sup>1</sup>

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1. Even though they are not yielded to monetary authorities, their effect on international liquidity should not be ignored to the extent that their holders use them to meet international payments.

To sum up, monetary reserves as a condition of currency convertibility consist of holdings which must meet the following two tests: (a) availability to monetary authorities and (b) acceptability by potential creditors. Assets which perfectly meet these two tests are those holdings of gold and convertible currencies which the Fund includes in its definition of monetary reserves. Certain other holdings also meet the requirements of both tests, though not as perfectly as those included in the Fund's definition of monetary reserves. These other holdings constitute of gold and convertible currencies held by financial institutions considered to be part of the official family, and of gold and convertible currencies otherwise held. The essence of the inclusion of such other holdings in a consideration of a country's international liquidity is the proviso that they are available to, and mobilizable by, monetary authorities in case of need.

The second component of international liquidity to be discussed here is what may be called "secondary reserves". These consist of balances of gold or convertible currencies upon which a country may draw under certain specific and predetermined conditions. They are not included in monetary reserves because they are not actually available for use. They only constitute a country's right of access to gold and convertible currencies under specific conditions. They include the right to incur balances in multilateral payments agreements as well as established lines of credit against which gold or foreign



exchange may be drawn. The most important source of secondary reserves, however, is the right given to a member country under the provisions of the Fund's Articles of Agreement, to buy, with its own currency, gold or other currencies held by the Fund. The amounts of and charges on such purchases from the Fund, as well as the conditions of purchase and repurchase will now be discussed.

It is to be recalled in this connection that, as mentioned before in Chapter I, among the functions of the Fund is to provide its members with the required foreign exchange in case of need. Thus, one of the functions of the Fund is the provision of international liquidity to supplement the insufficient monetary reserves of its members. However, such liquidity is only granted to members in order to adjust their international payment position to temporary and reversible disequilibria. Only for such a purpose may the Fund agree to sell to a member the foreign exchange it requires. The Fund would authorize such purchases for the purpose of helping the member concerned to finance temporary current deficits and to counteract speculative pressures. Thus, the mere appearance of a balance of payments deficit does not constitute an adequate enough reason to authorize a member to buy foreign exchange from the Fund. It is, besides, necessary to consider the causes that brought about such a deficit. If the causes are not deemed to be fundamental and are not due to policies wilfully followed by the member in question (mainly internal inflationary policies), in general, if the causes come within the scope of the Fund, then

"the access to the Fund's resources should be made as free and unencumbered as would seem justified in view of the member's quota".<sup>1</sup> "Protection against undue pressure following upon the adoption of convertibility is obviously a purpose which it is proper to serve by allowing members that need it to draw upon the Fund."<sup>2</sup> Accordingly, the attitude of the Fund regarding the authorization of purchases by members depends, in general, upon whether the problem to be met by currency purchases is of a temporary nature or not and upon whether the policies which the member subsequently follows are considered to be adequate to overcome the problem within the period over which the Fund's assistance extends. Primary concern is, however, given to the policies wilfully followed by the member. In addition, the Fund's policy in this respect gives special consideration to a country's general credit worthiness, particularly with regard to its dealings with the Fund. "In this respect the member's record of prudence in drawing, its willingness to offer voluntary repayment when its situation permitted, and its promptness in fulfilling the obligation to transmit monetary reserves data and in discharging repurchase

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1. Address by M.W. Holtrop, Chairman of the Board of Governors of the I.M.F., at the Ninth Annual Meetings of the Board of Governors, cited in International Financial News Survey, VII (October 8, 1954), p. 119.
  2. Address by Ivar Rooth, Managing Director of the Fund, at the Ninth Annual Meetings of the Fund and the International Bank, cited in International Financial News Survey, VII (October 1, 1954), p. 110.

obligations would be important."<sup>1</sup> This is all thought necessary in order that the resources of the Fund may be used in their proper function of financing swings in trade balances in contradistinction to long-run, continuous deficits and in order that they may not be used too rapidly. Thus, the resources of the Fund constitute a second line of reserves for members carrying out policies pursuant to the Fund's objectives as set out in Article I of the Articles of Agreement. They are especially made available to members which need them in carrying out the task of maintaining currency convertibility, or in pursuing policies which are in effect directed towards the avoidance of the intensification of restrictions and the acceleration of their relaxation or removal. "The Fund is equipped to make its resources available to members, either to help them in meeting special temporary balance of payments difficulties, or in association with other measures undertaken by them, in ensuring exchange stability and avoiding restrictions, and in maintaining or establishing the convertibility of their currencies."<sup>2</sup>

Article V of the Articles of Agreement, Sections 3(a) and 5, deal with the conditions governing the use of the Fund's resources, and the ineligibility of members to use the Fund's resources respectively. These sections are reproduced below.

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1. International Monetary Fund, Annual Report, Washington, D.C., 1952, p. 87.
  2. International Monetary Fund, Annual Report, Washington, D.C., 1955, p. 84.

"Section 3. Conditions governing use of the Fund's resources.-

- (a) A member shall be entitled to buy the currency of another member from the Fund in exchange for its own currency subject to the following conditions:
- (i) The member desiring to purchase the currency represents that it is presently needed for making in that currency payments which are consistent with the provisions of this Agreement;
  - (ii) The Fund has not given notice under Article VII, Section 3, that its holdings of the currency desired have become scarce;
  - (iii) The proposed purchase would not cause the Fund's holdings of the purchasing member's currency to increase by more than twentyfive percent of its quota during the period of twelve months ending on the date of the purchase, nor to exceed two hundred percent of its quota, but the twenty-five percent limitation shall apply only to the extent that the Fund's holdings of the member's currency have been brought above seventy-five percent of its quota if they had been below that amount;
  - (iv) The Fund has not previously declared under Section 5 of this Article, Article IV, Section 6, Article VI, Section 1, or Article XV, Section 2(a), that the member desiring to purchase is ineligible to use the resources of the Fund."

"Section 5. Ineligibility to use the Fund's resources.-

Whenever the Fund is of the opinion that any member is using the resources of the Fund in a manner contrary to the purposes of the Fund, it shall present to the member a report setting forth the views of the Fund and prescribing a suitable time for reply. After presenting such a report to a member, the Fund may limit the use of its resources by the member. If no reply to the report is received from the member within the prescribed time, or if the reply received is unsatisfactory, the Fund may continue to limit the member's use of the Fund's resources or may, after giving reasonable notice to the member, declare it ineligible to use the resources of the Fund."

These are the legal provisions governing purchases of the resources of the Fund by its members. Out of the transactions of members with the Fund, there have arisen, however, certain precedents which are by now firmly established, and which should be noted here. "Unless there are overwhelmingly strong reasons for not doing so, the Fund will invariably grant members' requests for gold tranche drawings."<sup>1</sup> Such drawings within the gold tranche refer to drawings that would not increase the Fund's holdings of the drawing member's currency beyond an amount equal to the member's quota.<sup>2</sup> Members may expect "the overwhelming benefit of any doubt" which might arise in connection with requests to authorize such drawings.<sup>3</sup> Although there is no such principle that applies to drawings beyond the gold tranche, various members have in fact been authorized to make such drawings. This points out to the fact that more substantial help than is represented by authorization to make drawings within the gold tranche is granted to members that are following policies consistent with the Fund's objectives. In practice, however, the Fund's attitude towards drawing within the first credit tranche (i.e., drawings that raise the Fund's

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1. Ibid.

2. The gold tranche refers to that part of a member's quota which is paid to the Fund in gold; it is equal either to 25% of the member's quota or to 10% of the member's net official holdings of gold and U.S. dollars, depending on the member's subscription in gold.

3. International Monetary Fund, Annual Report, Washington, D.C., 1952, p. 42.

holdings of a member's currency by more than 100 percent but not over 125 percent of its quota) has been a liberal one. Members may rest assured that in face of temporary balance of payments difficulties, their requests for drawings within the first credit tranche would be favourably regarded, provided, however, they are themselves exerting efforts to solve their problems. "There is not as yet the same body of precedent for drawings beyond the first credit tranche, but several such transactions have been approved. Should the need arise, and should the justification be substantial, members need not doubt that drawings on subsequent tranches will be permitted. Foremost among the developments that the Fund foresees as justifying liberal approval of such drawings are transactions in support of the establishment or maintenance of convertibility."<sup>1</sup>

It can be seen from the provisions of Article V, Section 3(a), which are reproduced above that a member is allowed to purchase currencies from the Fund to an extent that would not increase the Fund's holdings of the member's currency by more than twenty-five percent of its quota during the period of twelve months ending on the date of the purchase. Moreover, purchases which would increase the holdings of a member's currency by more than two hundred percent of its quota are not allowed. However, the articles of Agreement provide for a waiver of these conditions.

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1. International Monetary Fund, Annual Report, Washington, D.C., 1955, p. 85.



Thus, Article V, section 4, states that: "The Fund may in its discretion, and on terms which safeguard its interests, waive any of the conditions prescribed in Section 3(a) of this Article, especially in the case of members with a record of avoiding large or continuous use of the Fund's resources. In making a waiver it shall take into consideration periodic or exceptional requirements of the member requesting the waiver. The Fund shall also take into consideration a member's willingness to pledge as collateral security gold, silver, securities, or other acceptable assets having a value sufficient in the opinion of the Fund to protect its interests and may require as a condition of waiver the pledge of such collateral security". The first use of this section concerning the waiver of the conditions of Article V, Section 3(a) was made in August 1953 in connection with a transaction with Turkey. The use of the waiver provision may be taken to indicate the increased flexibility with which the Fund carries out its transactions with member countries.

Members which draw on the Fund's resources, however, are required to pay charges that vary according to the amount of currency purchased outstanding, and to the period that passes before repurchases are effected. The payment of such charges is imposed for the dual purpose of raising funds to defray the administrative expenses of the Fund and of discouraging members from buying large amounts of currencies for long periods of time, thereby avoiding the freezing of the Fund's resources.

Article V, Section 8, deals with charges imposed on members' purchases of currency from the Fund:

"Section 8. Charges.-

- (a) Any member buying the currency of another member from the Fund in exchange for its own currency shall pay a service charge uniform for all members of three-fourths percent in addition to the parity price. The Fund in its discretion may increase this service charge to not more than one percent or reduce it to not less than one-half percent.
- (b) The Fund may levy a reasonable handling charge on any member buying gold from the Fund or selling gold to the Fund.
- (c) The Fund shall levy charges uniform for all members which shall be payable by any member on the average daily balances of its currency held by the Fund in excess of its quota. These charges shall be at the following rates:
  - (i) On amounts not more than twenty five percent in excess of the quota: no charge for the first three months; one-half percent per annum for the next nine months; and thereafter an increase in the charge of one-half percent for each subsequent year.
  - (ii) On amounts more than twenty-five percent and not more than fifty percent in excess of the quota: an additional one-half percent for the first year; and an additional one-half percent for each subsequent year.
  - (iii) On each additional bracket of twenty-five percent in excess of the quota: an additional one-half percent for the first year; and an additional one-half percent for each subsequent year.
- (d) Whenever the Fund's holdings of a member's currency are such that the charge applicable to any bracket for any period has reached the rate of four percent per annum, the Fund and the member shall consider means by which the Fund's holdings of the currency can be reduced. Thereafter, the charges shall rise in accordance with the provisions of (c) above until they reach five percent and failing agreement, the Fund may then impose such charges as it deems appropriate.



- (e) The rates referred to in (c) and (d) above may be changed by a three-fourths majority of the total voting power.
- (f) All charges shall be paid in gold. If, however, the member's monetary reserves are less than one-half of its quota, it shall pay in gold only that proportion of the charges due which such reserves bear to one-half of its quota, and shall pay the balance in its own currency."

However, charges in effect now are not the same as those stipulated for in Article V, Section 8; certain changes have been introduced to them. Table 1 gives the charges resulting from transactions effected after January 1, 1954.

The Fund's policy in making its resources available to members revolves around the all important objective of preserving the revolving character of such resources and of avoiding their freezing; for it is believed that if the Fund is to achieve its purpose, the greatest possible use should be made of the resources at its disposal. It is in accordance with this conviction that Section 7 of Article V dealing with the conditions of repurchase by members of currencies formerly purchased by them from the Fund was drafted. The provisions of Article V, Section 7, are as follows:

"Section 7. Repurchase by a member of its currency held by the Fund.-

- (a) A member may repurchase from the Fund and the Fund shall sell for gold any part of the Fund's holdings of its currency in excess of its quota.
- (b) At the end of each financial year of the Fund, a member shall repurchase from the Fund with gold or convertible currencies, as determined in accordance with Schedule B, part of the Fund's holdings of its currency under the following conditions:

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1. The financial year of the Fund ends on April 30. (Footnote added by the author.)

TABLE 1.

CHARGES ON FUND HOLDINGS OF A MEMBER'S CURRENCY IN EXCESS  
OF THE MEMBER'S QUOTA

Charges for Each Period in which Funds Holdings of a Member's Currency Exceed Its Quota by:	Average Effective Rates for Stated Periods on Fund Holdings of a Member's Currency that Exceed Its Quota by:		
	0/50 Percent	50/75 Percent	75/100 Percent
	(1)		
	(2)		
	(Per cent per annum excluding service charge)		
	(Per cent per annum including service charge)		
	Charges Resulting from Transactions Effected after January 1, 1954.		
Service charge: one half of one per cent			
0 to 3 months	0.0	0.0	0.0
3 to 6 months	2.0	2.0	2.00
½ to 1 year	2.0	2.0	2.00
1 to 1½ years	2.0	2.5	2.00
1½ to 2 years	2.5	3.0	2.00
2 to 2½ years	2.5	3.0	2.12
2½ to 3 years	3.0	3.5	2.30
3 to 3½ years	3.5 (3)	4.0 (3)	2.50
3½ to 4 years	4.0	4.5 (4)	2.71 (3)
4 to 4½ years	4.5 (4)	5.0 (4)	2.94 (4)
	5.0 (4)		3.17 (4)
			2.00
			2.00
			2.00
			2.17
			2.38
			2.60 (3)
			2.83 (3)
			3.07
			3.31 (4)
			2.00
			2.00
			2.25
			2.50
			2.75
			3.00 (3)
			3.25 (4)
			3.50 (4)

(1) Aggregate Charges payable by the member, expressed as a percentage and divided by the number of years of the period.

(2) The service charge is payable once per transaction and is stated as per cent of amount of transaction.

(3) Point at which consultation between Fund and member becomes obligatory.

(4) Maximum charges. Fund has discretion to make lower charges.

Source: International Monetary Fund, Annual Report, Washington, D.C., 1954, p. 136.

- (i) Each member shall use in repurchases of its own currency from the Fund an amount of its monetary reserves equal in value to one-half of any increase that has occurred during the year in the Fund's holdings of its currency plus one-half of any increase, or minus one-half of any decrease, that has occurred during the year in the member's monetary reserves. This rule shall not apply when a member's monetary reserves have decreased during the year by more than the Fund's holdings of its currency have increased.
- (ii) If after the repurchase described in (i) above (if required) has been made, a member's holdings of another member's currency (or of gold acquired from that member) are found to have increased by reason of transactions in terms of that currency with other members or persons in their territories, the member whose holdings of such currency (or gold) have thus increased shall use the increase to repurchase its own currency from the Fund.
- (c) None of the adjustments described in (b) above shall be carried to a point at which
  - (i) the member's monetary reserves are below its quota, or
  - (ii) the Fund's holdings of its currency are below seventy-five percent of its quota, or
  - (iii) the Fund's holdings of any currency required to be used are above seventy-five percent of the quota of the member concerned." 1

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1. Schedule B of the Articles of Agreement specifies the composition (as to gold and convertible currencies) of that part of monetary reserves used in effecting repurchases. Its relevant sections are paragraphs 1 and 2 which read as follows:

"1. In determining the extent to which repurchase of a member's currency from the Fund under Article V, Section 7(b), shall be made with each type of monetary reserve, that is, with gold and with each convertible currency, the following rule, subject to 2 below, shall apply.

(a) If the member's monetary reserves have

In addition to repurchase obligations discussed here, and pursuant to the same purpose for which repurchase obligations are imposed, sales of gold or foreign exchange to members by the Fund are made with the understanding that gold or foreign exchange thus sold "should not remain outstanding beyond the period reasonably related to the payments problem in respect of which it (gold or exchange) has been purchased from the Fund".<sup>1</sup> More specifically, when members sell their currencies to the Fund in exchange for gold or other currencies, they are expected by the Fund to repurchase

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not increased during the year, the amount payable to the Fund shall be distributed among all types of reserves in proportion to the member's holdings thereof at the end of the year.

- (b) If the member's monetary reserves have increased during the year, a part of the amount payable to the Fund equal to one-half of the increase shall be distributed among those types of reserves which have increased in proportion to the amount by which each of them has increased. The remainder of the sum payable to the Fund shall be distributed among all types of reserves in proportion to the member's remaining holdings thereof.
- (c) If after all the repurchases required under Article V, Section 7 (b), had been made, the result would exceed any of the limits specified in Article V, Section 7 (c), the Fund shall require such repurchases to be made by the members proportionately in such manner that the limits will not be exceeded."

"2. The Fund shall not acquire the currency of any non-member under Article V, Section 7(b) and (c)."

1. International Monetary Fund, Annual Report, Washington, D.C., 1954, p. 102. (Parenthesis added by the author.)

their own currencies, which have thus been used, within a period of three years, with an outside limit of five years. As such, the period over which purchases from the Fund may remain outstanding should not exceed three to five years. Members would invariably be denied access to the Fund's resources if a reduction of the Fund's holdings of their currencies by an amount equivalent to that for which the request for access to the Fund's resources is presented cannot be reasonably envisaged within this period.

One final word should be mentioned concerning the access of member countries to the resources of the Fund; this is with respect to what is called "stand-by credit arrangements". With the end of the post-war transitory period and the recent improvement in the world's payment situation, the need to clearly establish members' right of access to the Fund's resources became more pressing. The Fund has, thus, with the objective of granting a clear right of access to its resources for a specified amount, provided for stand-by credit arrangements to be concluded with its members, under which arrangements members concerned would have the right to engage in transactions covered by the arrangements without further review by the Fund. "The stand-by arrangement was intended to remove the doubts that have led some members to the view that in formulating their policies they could not rely on Fund assistance"<sup>1</sup>. Thus, the

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1. International Monetary Fund, Annual Report, Washington, D.C., 1953, p. 51.

essence of a stand-by arrangement is to give members an assurance that during a fixed period of time the Fund will authorize transactions up to a specified amount, even though there might not be any intention of an immediate drawing. Drawings effected under a stand-by arrangement would be authorized by the Fund whenever a member requested and without further consideration of the member's position. The right given to a member under a stand-by arrangement is violably affected only if, before a request for drawing is received by the Fund, the uneligibility provisions of the Articles of Agreement had been invoked against the member, or if the Fund had decided to suspend transactions altogether.

In considering requests for stand-by credit arrangements, the Fund, in fact, applies the same rules and standards that it applies to requests for immediate drawings. "The Fund will agree to a stand-by arrangement only for a member for which it would otherwise be prepared to approve an immediate purchase of exchange of the same amount." <sup>1</sup> The predominant custom has been for each stand-by drawing account to be set up for a period not exceeding six months, which might be renewed upon request by the member and upon approval by the Fund. Longer periods, however, may also be approved. In addition to the service charge payable in case of an actual purchase, there is imposed a charge of one-fourth percent per annum at

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1. Ibid.



the time that a stand-by arrangement is concluded or renewed. The additional charge is payable in gold or US dollars, or partly or wholly in the member's own currency, under conditions in which its reserves are so low as to meet the provisions of Article V, Section 8 (f).

The third type of holdings which constitute international liquidity consists of commodities and equities available to the monetary authorities of a country and internationally marketable. These include, without limitation, private securities of unquestioned credit and short maturity, and stocks of silver or precious metals which are readily salable at an approximately predetermined price. The possession of such assets by a country tends to affect its international liquidity.

It is now thought appropriate to turn to a consideration of the adequacy of international liquidity. It must be said at the outset that any such standard of adequacy must be based upon a consideration of the purposes which international liquidity is meant to serve and upon the obstacles which are likely to be encountered in fulfilling these purposes. It was mentioned earlier in the present chapter that the purpose which international liquidity is meant to serve in this respect is the financing of short-term, reversible balance of payments deficits in order to avoid the intensification (or introduction) of restrictions and the devaluation of the exchange rate, thus contributing to the ulterior objective of maintaining currency convertibility. Consequently, it is only after a country has



succeeded in balancing its external accounts over the relevant period of time that a discussion of the adequacy of its level of international liquidity can be meaningfully undertaken. No level of international liquidity is adequate to finance a chronic and continuing imbalance in a country's external accounts. As such, the following discussion of the standard of adequacy of international liquidity assumes that the external accounts of the country in question are balanced over the relevant period of time, but that, nonetheless, substantial balance of payments deficits may be incurred in some years<sup>1</sup> within the said period.

Before beginning the discussion of the various quantitative tests of the adequacy of international liquidity, it is perhaps well to keep in mind that there is no one test that may be applied to all cases. Various tests have been devised for the measurement of adequacy, the usefulness of each depending on the particulars of the case at hand. As such, there is still no unanimity as to the appropriateness of any one single test of adequacy irrespective of the circumstances to which it is meant to be applied. Not only this, but it is sometimes believed that no quantitative test, whatever its nature, can measure the adequacy of international liquidity with reasonable exactitude, and that, therefore, qualitative tests - which relate to the completeness and exhaustiveness of the elements that constitute international liquidity - should, instead, be used.

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1. The relevant period of time over which the balance of payments must be in equilibrium has already been determined above.

Notwithstanding this, however, but keeping this reservation in mind, three types of quantitative tests for adequacy will now be discussed.<sup>1</sup> Each one of the following tests involves a period to which the test refers, a measure (index) of the potential drains on international liquidity during that period, and a comparison between the level of international liquidity and the size of the index.

a) Adequacy in relation to internal factors

The first test of the adequacy of international liquidity relates such adequacy, not to deficits in the balance of payments directly, but to indices of such deficits based on internal phenomena only. Thus, for example, it is said that international liquidity is adequate if it does not fall short of a given specified proportion of domestic money supply. An increase in domestic money supply (M) creates, it is claimed, a strong tendency towards an increased demand for foreign exchange either to finance a genuine increase in imports or to finance capital exports. Whether this holds true or not, however, depends on the freedom of access of residents to the foreign exchange market, on the availability of domestically - produced import substitutes, and on the presence of profitable local investment outlets. And, since in underdeveloped countries the last two conditions are least likely to be present

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1. The following discussion of the various tests of adequacy is primarily taken from an unpublished report presented on May 7, 1952, by Iain Mackinnon of the International Monetary Fund's Research Department on "The Criteria and Measurement of Adequate Reserves."

then the test which relates the size of liquidity to money supply is more likely to apply to underdeveloped countries than otherwise. The primary advantage of such a test is the precision which it affords: there is an absolute criterion (say 30 percent of money supply) against which the adequacy of international liquidity may be easily measured. However, its value is greatly reduced once its limitations are considered. Its greatest limitation lies in that it does not allow for future changes in the supply of foreign exchange; because of such changes, a fall in the level of international liquidity below the specified proportion may not necessarily mean that the said level is inadequate to meet future payment deficits. Moreover, the given proportion which serves as the criterion of adequacy is itself chosen on a more or less arbitrary basis and does not allow for changes in demand for foreign exchange arising from causes other than a change in M, such as, for instance, the expectation of future price movements in imports and exports. There is nothing which assures that if M changes, demand for international liquidity will also change pari passu.

b) Adequacy in relation to external factors

Under this type of tests, adequacy is measured by a comparison between international liquidity and an index chosen on the basis of external phenomena. There are two tests of this type. The first relates the level of international liquidity to a minimum proportion of current imports in one year, or to average imports during a selected period in

the past. The standard of adequacy chosen here has the advantage of being objective and easily determined; however, since it is based solely on past experience, it suffers the disadvantage of making no allowance for future deficits in external accounts. A level of international liquidity which was found adequate in the past may not necessarily prove to be so in the future.

The second test in this connection compares the ratio of international liquidity to current exports with the difference between current exports and expected minimum future exports. The standard used here involves an improvement over the standard used in the first test, in the sense that more realistic estimates of the future drains on international liquidity are introduced. However, this is done at the cost of completely neglecting the import side which represents an important element in any such estimates.<sup>1</sup>

c) Reserves and the balance of payments

Here again, two standards of adequacy are given whereby both internal and external factors are used by directly measuring balance of payments deficits. The first standard of adequacy relates the level of international liquidity to deficits which obtained in a given previous period. The calculation of adequacy is usually made on the basis of a "historical

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1. It is possible that imports are neglected on the assumption that their current level must be maintained in order to maintain a high level of income and employment.

coefficient of variability" indicating the possible range of fluctuations of the balance of payments deficit or surplus. Beside the disadvantage implied in the calculation of future drains on international liquidity by solely utilizing historical data, there is the greater disadvantage indicated by the interdependence between the level of international liquidity and the size of the variability indices. Such an interdependence, which is shown by the high correlation obtaining between the two variables, greatly invalidates the conclusions reached under this standard.

The second standard is based on the principle that deficits alone, rather than total payment fluctuations, should provide the adequacy index. Deficits which thus provide the adequacy index are calculated in the following manner:

Assume that: I = minimum expected payments  
and X = minimum expected receipts  
and I' = maximum expected payments  
and X' = maximum expected receipts  
and L = level of international liquidity.

Since an expected deficit cannot be less than  $(I - X')$ , therefore,  $L > (I - X')$  ..... (1)

puts a lower limit to the calculation of adequacy.

Similarly,  $L > (I' - X)$  ..... (2)

puts an upper limit to the calculation of adequacy.

And since formula (1) is too optimistic to be of any practical value, and since formula (2) exaggerates the

need for international liquidity, then a more satisfactory calculation of expected deficits would be that obtaining on the assumption of minimum receipts and minimum payments.

Hence the index of adequacy would be

$$L > (I-X) \dots\dots\dots (3)$$

The computation of minimum expected payments and minimum expected receipts is made for the relevant period of time, usually three to ten years, and is subject, of course, to errors of estimation. It may be claimed that with the present available information, any accurate forecast of future movements in the balance of payments would prove impossible. But the adequacy index at hand does not call for this. It only requires an estimation of minimum future payments and receipts and not of actual values. And it is reasonable enough to assume that the former estimate involves much narrower margins of error. It is true that even an estimate of minimum future values would still remain subject to difficulties of forecasting; however, such difficulties are no different from, and hence no greater than, those encountered in any economic problem which involves time-projection.

In order to be considered as adequate for the purpose of maintaining convertibility, international liquidity must

be sufficient not only to finance expected current deficits & that might periodically arise, "but also to maintain confidence in the currency and thus discourage speculative pressures"<sup>1)</sup>. Thus if as a result of a deficit in the balance of payments international liquidity falls to a dangerously low level, traders and exchange dealers in general would take steps to protect their own position, which steps may involve further drains on international liquidity which otherwise would have not been necessary. It follows, therefore, that if international liquidity is to exercise its functions properly, its level must be high enough to leave, even at the bottom of the cycle, substantial amounts which are uncommitted and ready for immediate use. However, confidence in the strength of a country's currency is a two-way phenomenon. Just as a higher level of international liquidity promotes confidence in a country's external position, so does confidence in a country's position reduce the level of international liquidity necessary to sustain this confidence. Accordingly, international liquidity is not adequate, in fact, until the public thinks that it is adequate. And probably it may not prove very wrong to assume that a moderate level of international liquidity well maintained and slightly increasing is more conducive of confidence than one which is substantially higher but continuously falling.

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1. International Monetary Fund, "Prospects for Exchange Convertibility," International Financial News Survey, VI (March 26, 1954), p. 293.



## CHAPTER III

### THE SALIENT FEATURES OF THE LEBANESE ECONOMY

A description of the relevant features of the Lebanese economy may now be in order. The present chapter attempts at a general and brief presentation of the various features of the Lebanese economy which have a more or less direct bearing on the purpose and subject matter of this study. Certain aspects of the Lebanese economy, e.g. the foreign sector, are discussed with more detail and elaboration than others, mainly because of their importance in a discussion of the requirements and the desirability of a convertible Lebanese currency. A general picture of the economy is first drawn up and then the more important features are presented with more elaboration. Accordingly, the present chapter falls into the following major sections: basic features of the economy; the foreign sector; currency and banking; and public finances and development policy. Each of these major sections will now be discussed separately.

#### Basic Features of the Economy

The Republic of Lebanon has an area of around 10,170 square kilometers and an estimated population of about 1,400,000 persons.<sup>1</sup> "Considering the density of the population, its

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1. There are no recent official population figures; the last census was made in 1932.

standard of living, the paucity of natural resources, and limited development possibilities, the country must be regarded as overpopulated.<sup>1</sup> Nonetheless, despite the relatively high density of population (around 135 inhabitants per square kilometer), Lebanon enjoys a significantly higher standard of living than almost all its Middle Eastern neighbours.

By physical configuration and climate, the country is divided into four regions, running more or less parallel from North to South. First, there are the coastal plains which have a Mediterranean climate and vegetation. Second, there are the Lebanon Mountains which enjoy a heavy rainfall and which have a wide range of altitude and cultivation. Third, falling between the main two mountain ranges is the central plateau known as the Beqaa', which consists of fertile land but which receives less precipitation than the Lebanon Mountains. Finally, along the Eastern frontiers with Syria falls the second mountain range, the Anti-Lebanon, which is largely barren.

The Lebanese topography is heavily indented with comparatively small rivers. However, as none of these rivers is navigable, their importance lies almost exclusively in their

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1. International Bank for Reconstruction and Development, Report on the Economy of the Lebanon, No. E45, Washington, D.C., 1948, revised June 8, 1949, p. 3. (Typescript.)

water supply<sup>1</sup> and in the hydroelectric potential which they represent. There are practically no important proven mineral deposits in Lebanon apart from certain building materials.

Because of the mountainous topography of the country (about 40% is rocky ground or wasteland), cultivable area is restricted. It is estimated that only about 25% of the total surface is at present under cultivation; and, although presently cultivated area (around 270,000 hectares) can probably be increased by 50%, the irrigated part (which is estimated at about 44,000 hectares) can be trebled if existing water resources were put to fuller use. However, though the area under cultivation is greatly restricted by the mountainous topography of the country, a wide variety of crops can be cultivated because of such topography and of the climatic conditions which it gives rise to. Thus, bananas, sugar cane and citrus fruits are grown along the coast, whereas a wide range of fruits of the temperate zone is grown on the mountain slopes and cereals, grapes and vegetables in the inland valleys. Hence the highly diversified make-up of the Lebanese agriculture.

There are no official figures regarding the national income of the country; however, the Economic Research Institute of the American University of Beirut has estimated per capita incomes for 1950 at about US \$ 250. This compares favourably

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1. Deserving of special mention in this respect is the Litani River in Southern Lebanon.

with US \$ 100 for Egypt, US \$ 125 for Turkey and US \$ 100 for Syria. However, although national income figures arrived at by the Economic Research Institute may not command an absolute exactitude, they are helpful in indicating the relative importance of the various sectors of the Lebanese economy, and in revealing certain fundamental characteristics of the economy. Table 2 below presents national income figures for 1950 by sectors of the Lebanese economy, both in absolute and percentage terms.

It may not be wrong to say that Lebanon is the least predominantly agricultural country of the Arab Middle East. It is estimated that while about one-half of its population directly depends for its living on agricultural pursuits, the agricultural sector of the economy accounts for only 19 percent of total national income of the country. Agricultural products of Lebanon include a variety of crops among which are

TABLE 2.

NATIONAL INCOME OF LEBANON BY SECTORS OF THE ECONOMY

1950

(in LL million) Percent of Total

Agriculture	206	19
Industry	133	13
Construction	43	4
Trade	300	29
Transportation & Communication	44	4
Services	100	10
Finance	40	4
Real Estate	96	9
Government	72	7
Rest of the World	12.5	1
Total	<u>1046.5</u>	<u>100</u>

Source: Information privately secured from the Economic Research Institute, American University of Beirut.

fruits, cereals, and vegetables. Cereals are mostly consumed locally, whereas fruits and vegetables find ready markets in the neighbouring Arab countries. Lebanon is thus developing export surpluses in fruits and vegetables, and it is believed that fruit growing is one of the most promising developments in Lebanese agriculture. Accordingly there has been recently (especially since the late nineteen forties) a shift of emphasis in Lebanese agriculture from grain towards trees, especially apple trees. On the other hand, the Ministry of Agriculture is now embarking on a program for increasing the annual product of wheat from its present level of around 60,000 tons to a projected level of 100,000 tons.<sup>1</sup> However, the primary causes which have inspired this step are believed to be predominantly political and strategic rather than economic.

The industrial sector employs about one tenth of the active population of Lebanon (roughly estimated at about 400,000 persons compared to a total population of 1,400,000 persons) and accounts for about 13 percent of total national income of the country. The industrial sector is a developing sector which is receiving much more governmental attention than the agricultural sector. Such attention takes the form

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1. The estimated annual local consumption of wheat in Lebanon is around 150,000 tons.

of tariff protection of local industries, of subsidies, of income tax exemptions,<sup>1</sup> and of medium- and long-term industrial credits. Major industries in Lebanon include textiles (mainly cotton), both weaving and spinning, food processing, beverages and leatherware. Apart from cotton thread and cotton cloth, industrial products are almost exclusively consumed locally.

The most distinctive feature of the Lebanese economy is the preponderance of the trade sector over the other sectors of the economy. The definition of the trade sector in the national income study of the Economic Research Institute is too narrow for the present purpose. Over and above "trade" proper, there should be included, in a definition of the trade sector for the present purpose, income arising from transport by sea, air and land which transport has the effect of facilitating trade operations proper, whether through movement of goods or persons. Furthermore, income arising from financial operations (banking and exchange operations which are necessary to finance either trade or the abovementioned type of transportation) must also be included in a broad definition of the trade sector. Accordingly, the trade or commercial sector of the Lebanese economy should include the national income figures which appear in Table 2 for "Trade", "Transport"

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1. For income tax exemptions, refer to the Law of February 5, 1954.

and "Finance".<sup>1</sup> As such, the trade sector of the Lebanese economy accounts for about 37 percent of total national income. That is, alone and by itself, trade in Lebanon produces almost about two-fifths of total national income whereas, as shown above, agriculture produces only 19 percent and industry only 13 percent. Herein lies the most important distinctive characteristic of the Lebanese economy: although diversified, it is predominantly mercantile.

The importance of trade in a country like Lebanon should not be astonishing, especially in view of the geographical position that the country enjoys as a link between the East and the West, and in view of the natural aptitude of its inhabitants who live by the Sea. "Lebanon, mainly because of its geographical position and the special mercantile qualities of its population, is primarily a country of small middlemen and merchants."<sup>2</sup> "The channelling, for centuries, of an important part of Middle Eastern commercial and financial operations through Lebanon created an experienced class of merchants, entrepreneurs and bankers."<sup>3</sup> However, as mentioned

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1. Total figures of both "Transport" and "Finance" sectors are included because of the predominantly commercial character of the banking system in Lebanon and because that part of transport which may not be considered as facilitating trade operations proper is probably too insignificant to warrant exclusion.
  2. Paul J. Klat, Review of Lebanon's Economy, Beirut, 1953, p. 1. (Typescript for the I.M.F.)
  3. International Bank for Reconstruction and Development, The Economic Situation and Creditworthiness of Lebanon, Washington, D.C. AS2, 1952, p. 4. (Typescript.)



before, trade does not consist of direct trade alone (whether internal or external) but also includes, and this is important in Lebanon, re-export trade and service transactions. Thus, the mercantile class in Lebanon thrives on a prosperous import and re-export trade as well as on such service transactions as gold brokerage, transit trade, entreposage, exchange and commodity arbitrage, exchange transactions, and commodity transactions such as switch operations. As will be shown below large revenues are earned annually from such and similar services rendered by Lebanon. The large seaport in Beirut and its new international airport have greatly contributed towards making it the center of Eastern Mediterranean trade. With its large seaport free zone area, Beirut has become one of the most important entrepot centers in the Middle East. The free zone was started by the French authorities in the thirties. But, it never attracted considerable business due to the strong competition of Haifa. Since the outbreak of hostilities in Palestine and the closing down of Haifa to Arab countries, Beirut's free zone area has developed considerably. This development is also attributable to the recent accumulation by neighbouring Arab countries, of large riches, either because of the phenomenal development of the oil industry or because of the rise in agricultural revenues. Entreposage is either done on Lebanese territory or more often in the free zone area, where goods, mainly agricultural, undergo transformation processes. Another important factor which

has materially contributed to the tremendous development of these service transactions is the completely free exchange market in Lebanon.<sup>1</sup> This freedom of exchange operations has made possible exchange and commodity arbitrage as well as commodity transactions involving several foreign currencies, although in some cases the merchandise in question never touched Lebanese territory. Such triangular transactions were extremely important especially when there were large differences between the official and the free market rates of the various important currencies of the world. (However, now that these disparities have either disappeared or have been greatly reduced, such triangular operations have accordingly dwindled in amount.) "Moreover, Beirut's well established free market is attracting to Lebanon highly profitable financial transactions with countries having exchange control either because these controls themselves allow cooperation with a free market or as a way to circumvent such controls."<sup>2</sup> It must be mentioned in this connection that because of the reduced disparity between official and free market exchange rates of international currencies and because of the recent general relaxation of exchange controls the world over, Beirut's free zone area is turning from a center of triangular operations to a center of entrepot trade

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1. As will be shown below, the last exchange control was officially abolished on May 24, 1952.

2. Klat, op.cit.

where goods are transformed and then sold out. This change in the role of Beirut's free zone area has very important implications on Lebanon's balance of payments situation, as will be shown below. Lebanese service transactions are thus no more an effet de hazard or the result of differences in exchange legislation among countries; they are more and more becoming the function of the geographical position of Lebanon as the natural intermediary between the Middle East and the West. This has essentially been the result of the recent trend towards the integration of the Lebanese economy into an Arab and Middle Eastern regionalism thereby making Beirut the principal commercial as well as financial center of the area. Such a regional economic integration is being encouraged by the Lebanese competent authorities: the Arab Economic Agreements of 1953 are a forward step in this direction.

### The Foreign Sector

The present discussion of the foreign sector of the Lebanese economy is divided into four distinct parts: (a) the importance of foreign trade; (b) the balance of payments; (c) foreign exchange policy; and (d) foreign trade policy.

a) The importance of foreign trade. According to Table 2 above, national income arising in the trade sector

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1. Paul J. Klat, "Le Commerce et Ses Incidences Sociales," L'Economie Libanaise et le Progres Sociale, (Beirut: Les Lettres Orientales, 1955), p. 95.

proper, in both its domestic and external compartments, was of the order of around LL 300 million in 1950. This figure, it was said, clearly shows the importance of trade in relation to the other sectors of the economy: the trade sector proper (exclusive of "finance" and "transportation") accounted for about 29 percent of total national income in 1950, and was thus the most important sector of the economy.<sup>1</sup> The thesis to be exposed here is not only that the trade sector is the largest contributor to national income in Lebanon, but also that national income deriving from foreign trade alone is larger than that accruing from any other sector of the economy. The national income study made by the Economic Research Institute shows that out of the LL 300 million generated by the trade sector proper in 1950 around LL 200 million (i.e. two-thirds) accrued from foreign trade alone. This means that foreign trade in Lebanon has in 1950, and by itself, contributed to national income more than any other sector, with the exception of agriculture. It must be mentioned, however, that the figure of LL 200 million almost certainly underestimates national income arising actually in the foreign trade sector, because it does not include that part of national income accruing in both the "finance" and "transportation" sectors and for which foreign

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1. Of course this is based on the presumption that the criterion of importance of a sector in the national economy is measured by its relative contribution to total national income.

trade, broadly speaking, is responsible. Unfortunately, no figures are available as to the division of national income, between domestic and foreign sources, deriving from the abovementioned two sectors. For want of a better criterion, however, it is here estimated that national income arising in both "finance" and "transportation" is distributed between the domestic and the foreign sectors in the same ratio as income in the "trade" sector. On this basis, national income arising from the trade sector should be about LL 256 million in 1950, or about 24 percent of total national income. This figure, though very rough, shows the eminence of foreign trade in the Lebanese economy, thereby pointing out to a very important distinctive feature of that economy.

b) The balance of payments. An attempt will now be made at presenting the figures and at evaluating the general make-up and structure of the Lebanese balance of payments. No official study of the balance of payments of Lebanon has been made to date. Prior to March 13, 1950, Lebanon formed with Syria a customs union and foreign trade figures for the two countries were published together, no differentiation being made between imports to or exports from Syria and Lebanon. Goods and capital moved freely between the countries and were not recorded as imports or exports when they crossed the frontiers. Accordingly, it was only since 1950 that Lebanon had its foreign trade figures published separately.

The most recent study of the balance of payments of Lebanon since 1950 is the one made by E. Fei and P. J. Klat and the staff of the Economic Research Institute and which appeared in September 1954.<sup>1</sup> Unfortunately, the said study covered only 1951 and 1952, and the figures which it contains were later found in want of certain corrections. That is why the book will not be used for the present discussion. Instead, corrected balance of payments figures for the period 1951-1954 were privately obtained from Prof. Paul J. Klat of the American University of Beirut. These figures are given in Table 3 below.

It is of significance to note two main features which the figures presented in Table 3 bring forth. The first is the persistent appearance of a deficit on the merchandise trade account, and the second, the constant accruece of a surplus in the total balance of autonomous accounts. The deficit on merchandise trade account (including non-monetary gold) amounted to LL 259.5 million in 1951, LL 290.4 million in 1952, LL 275.5 million in 1953 and LL 370.4 million in 1954, whereas, on the other hand, the surplus on the total autonomous account amounted to LL 18.9 million, LL 26.3 million, LL 32.9 million and LL 57.0 million respectively. As such, the Lebanese balance of payments has

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1. Edward Fei and Paul J. Klat et al., The Balance of Payments of Lebanon 1951 and 1952, (Beirut: Dar El-Kitab, 1954).

TABLE 3.  
BALANCE OF PAYMENTS OF LEBANON  
1951-1954  
(in LL. Million)

	1951		1952		1953		1954	
	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit
<b>A. Goods and Services</b>								
Merchandise Trade	124.9	385.3	122.1	401.0	134.4	373.7	172.1	522.2
Non-Monetary Gold	15.2	14.3	25.0	36.5	3.6	39.8	23.6	43.9
Foreign Travel	35.0	14.7	47.6	23.1	58.4	29.3	92.3	30.1
Transportation & Insurance	16.3	9.2	21.2	8.5	23.6	18.7	27.2	19.3
Investment Income	15.6	11.8	16.2	9.2	27.8	9.7	32.4	9.9
Government, not included elsewhere	79.5	9.8	72.2	6.6	59.0	6.7	65.1	6.7
Transit	62.0	--	42.2	--	21.0	--	...	(1)
Miscellaneous Services	35.7	--	36.0	--	43.2	--	27.7	(2)
<b>TOTAL (A)</b>	384.2	445.1	382.5	484.9	371.0	477.9	510.4	632.1
<b>B. Private Donations and Capital Movements</b>								
Emigrants' Remittances & Transfers	58.4	4.0	71.7	2.7	79.5	3.3	85.5	3.2
Government	0.5	--	2.5	--	4.3	--	18.2	--
Charitable & Cultural Institutions	10.2	--	13.5	--	10.7	--	15.2	--
Capital Movements (Net)	14.7	--	43.7	--	48.6	--	63.0	--
<b>TOTAL (B)</b>	83.8	4.0	131.4	2.7	143.1	3.3	181.9	3.2
<b>TOTAL (C)</b>	488.0	449.1	513.9	487.6	514.1	481.2	692.3	635.3
<b>D. Surplus (Credit - Debit)</b>								
<b>TOTAL (D)</b>	18.9	--	26.3	--	32.9	--	57.0	--
<b>E. Compensatory Financing</b>								
Monetary Gold	--	23.9	--	15.4	--	13.1	--	60.1
Foreign Exchange	0.9	--	--	10.4	--	20.8	2.0	--
Bank Liabilities to non-Residents	4.1	--	--	0.5	1.0	--	1.1	--
<b>TOTAL (E)</b>	5.0	23.9	--	26.3	1.0	33.9	3.1	60.1

(1) Included in "Miscellaneous Services".

(2) Includes "Transit" as well.

Source: Information privately secured.



registered an increasing surplus all through the period 1951-1954 despite a persistent and, on the whole, increasing balance of trade deficit. This being the case, the relatively large deficit of the balance of trade (amounting to about 53 percent of total balance of payments figures in 1954) must have been more than outweighed by surpluses obtaining either in the services account or in the capital account or in both. Table 4 which is a condensation of Table 3 shows that the balance of trade deficit was in fact more than outweighed (by the size of the balance of payments surplus) by surpluses accruing on the services and capital accounts.<sup>1</sup>

TABLE 4.

BALANCE OF PAYMENTS OF LEBANON BY TRADE  
SERVICES, AND CAPITAL ACCOUNTS\*

	1951-1954 (in LL Million)			
	<u>1951</u>	<u>1952</u>	<u>1953</u>	<u>1954</u>
Trade Account	-259.5	-290.4	-275.5	-370.4
Services Account	198.6	188.0	168.6	248.7
Capital Account	79.8	128.7	139.8	178.7
TOTAL	18.9	26.3	32.9	57.0

\* Figures are given net.

Source: Table 3, supra.

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1. The excess of the summation of the services and capital accounts over the balance of trade deficit in each year is in fact the balance of payments surplus for that year.

This points out to one of the important features of the balance of payments of Lebanon, namely, that it suffers from a relatively sizable deficit on the merchandise trade account, but that it registers a total surplus due to the highly favourable services and capital accounts. The services account includes, on its credit side, such items as transportation and insurance, investment income, profits from transit trade, and tourism, which has recently become most important of all. (Refer to the high figure which foreign travel registered on the credit side of the balance of payments in 1954.) Of special importance in the capital account are emigrants' remittances and capital movements.<sup>1</sup> Before indulging in an evaluation of the structure and make-up of the Lebanese balance of payments it is of great importance to emphasize again the fact that it is only through the sizable surplus which accrues on both the services and capital accounts that Lebanon has managed not only to make good its large balance of trade deficits, but also to accumulate annual balance of payments surpluses.<sup>2</sup>

Section E of Table 3 entitled "Compensatory Financing" refers to the way in which annual balance of payments surpluses

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1. Tourism and capital movements are further discussed below in evaluating the structure of the Lebanese balance of payments as a whole.
  2. It was estimated by Prof. Paul J. Klat of the Economic Research Institute, A.U.B., that the Balance of payments of Lebanon for 1955 registered a surplus of about LL 43 million,

were held. Thus in 1951 monetary gold holdings increased by LL 23.9 million whereas foreign exchange holdings and bank liabilities to non-residents were reduced by LL 0.9 million and LL 4.1 million respectively, thereby registering a net increase of LL 18.9 million in all, which is equivalent to the balance of payments surplus. In 1952 monetary gold holdings, holdings of foreign exchange and bank liabilities to non-residents increased by LL 15.4 million, LL 10.4 million and LL 0.5 million respectively, making a total increase of LL 26.3 million. In 1953 gold holdings as well as holdings of foreign exchange increased by LL 13.1 million and LL 20.8 million respectively, whereas bank liabilities to non-residents decreased by LL 1.0 million, thereby registering a net increase of LL 32.9 million in all. Finally, in 1954 only gold holdings increased by LL 60.1 million while foreign exchange holdings and bank liabilities to non-residents decreased by LL 2.0 million and LL 1.1 million respectively, showing a total increase of LL 57.0 million, which again is equivalent to the balance of payments surplus for that year.

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which figure represents the increase in Lebanon's holdings of gold and foreign exchange in 1955. Prof. Klat believes that the balance of trade deficit continues to be large and that, hence, the balance of payments surplus was due to the favourable services and capital accounts. (Refer to Le Commerce du Levant, February 23, 1956, p. 4.)

For an evaluation of the Lebanese balance of payments, it should be admitted right from the start that the balance of payments of Lebanon is in a fairly satisfactory shape despite the heavy annual deficits that are recorded in the trade balance.<sup>1</sup> This is revealed by the continuous surpluses which have been obtained in the past five years. However, to say this is not in the least to say that it is in perfect condition. Despite total surpluses which have accrued during the past five years, the structure of the balance of payments of Lebanon, nonetheless, suffers from many weaknesses.

One of its important weaknesses is the heavy dependence on sources of revenue which are highly precarious and unstable. Reference is here made to the various services which Lebanon is rendering to foreigners, such as exchange transactions, triangular trade operations, transit trade, tourism and estivage, and to the sizable revenues which it is yearly receiving in form of grants and emigrants' remittances. Many of such services are the result of disparities in the exchange control regulations of the various countries and as such cannot be regarded as a continuing, or at least, stable source of revenue. Others, although they may not be the result of legislative differences among countries, cannot, either,

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1. The following discussion concerning the evaluation of the Lebanese balance of payments is mainly based on a lecture given by Prof, Paul J. Klat on "Le Commerce et ses Incidences Sociales", op.cit.

be depended upon to provide a steady source of revenue since they are affected by factors beyond Lebanon's control. This is especially true of tourism and estivage. Income from these sources depends to a large extent on a will outside that of Lebanon and on factors which are beyond its control. Of a similar nature are the sizable emigrants' remittances and grants which Lebanon receives annually. It may be sufficient for only a mild international crisis, or for even a local crisis which results in a more strict application of exchange restrictions in any one of the countries where Lebanon's tourists, donators or emigrants are located, in order that its income from such items may be appreciably reduced. The instability of revenue from such services and from capital grants and remittances is all the more important when it is recalled that such resources have in previous years contributed an average net annual sum of about LL 290 million. As such, a 15 percent reduction in this amount would not only wipe away all surpluses which are of the present magnitude (around LL 34 million per year) but would also cause a deficit of around LL 10 million per year.

Another weakness in the Lebanese balance of payments derives from its dependence on capital movements, the net amount of which during 1951-1954 was, on the average, around LL 42 million annually. Part of this capital has come from

<sup>1</sup>  
Egypt. Such capital is essentially "hot", which very frequently remains in the country of refuge under the form of current accounts in banks pending its ultimate withdrawal for investment in other more politically stable countries (mainly in the United States or Switzerland). Another sizable amount of Lebanon's total net capital imports has been coming from the oil countries of the Persian Gulf - Saudi Arabia, Kuwait, Bahrain and Qatar. Such capital is essentially transient capital which comes first to Beirut and then leaves the country in search of more secure or remunerative investment. Beirut serves essentially for it the role of a financial center, and, subsequently, of a point of departure. This is not to say that all incoming capital from the Arabian Peninsula is of this nature. There are of course exceptions. Capital imports which remain in the country seek, on the whole, two outlets. They are either kept as bank current accounts or else invested predominantly in real estate. In both cases, there are inherent dangers. If, on the one hand, capital funds are kept under the form of bank current accounts, they can be withdrawn from the country with insufficient notice, to the possible detriment of the country's bank liquidity. But if, on the other hand, they are invested in outlets such as real estate, they would

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1. A substantial amount of the net surplus movement of capital in 1952 has come from Egypt as a result of the unsettled political situation in that country. Such capital movements have recently diminished, however.

then have served to dispossess the country of part of its properties in favour of foreigners. Capital importation is beneficial only when imported capital is invested in productive enterprises which adds up to the national income of a country and hence enables it later to pay back the capital funds originally imported, plus interest. But if foreign capital is to remain idle balances in the vaults of banks (liable to be withdrawn from the country at short notice) or if it is to dispossess the importing country from part of its real estate, its benefits become very doubtful. Although at the time at which such capital is incoming it serves to swell the credit side of the importing country's balance of payments, yet it carries with it the inherent dangers which would be realized when it is later withdrawn.

It has been said above that the net inflow of foreign capital into Lebanon has been at the rate of LL 42 million per year. It is revealing to mention in this context that a reversed movement of capital of the same order would wipe away annual balance of payments surpluses and would precipitate a deficit. Steps should, therefore, be taken to stabilize incoming capital movements, especially in view of the increasing importance which such movements are assuming in the balance of payments of Lebanon.

A third weakness in the Lebanese balance of payments is the recent reduction in the country's revenue from gold



transit.<sup>1</sup> Revenue from such trade derives from the disparity in the prices of gold between the East and the West and from the premia at which gold is sold in the various free markets of the world. The recent reduction in revenue deriving from gold transit trade has been primarily due to the decision taken by the Union of South Africa to sell part of its annual gold production in the free markets of the world. Such a step has more or less tended to wipe away the large premia which previously existed between official and free market prices of gold, and to unify prices in various markets. Hence the reduction in Lebanon's revenue from gold transit trade.

Against the above weaknesses, the balance of payments of Lebanon enjoys certain signs of strength which will now be discussed. The first sign is the increase in Lebanon's export trade proceeds since 1952, which is mainly due to developments in agriculture and to the conclusion of various trade agreements with such countries as Federal Germany, France, Turkey, Eastern European countries and certain Arab countries. Such agreements are believed to have increased Lebanon's sales abroad since they have essentially served as an advertisement medium and may have consequently induced otherwise reluctant countries to accept Lebanese products. Lebanon's sales abroad

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1. Unfortunately, no dependable data could be secured to illustrate such a reduction.

increased from LL 122.1 million in 1952 to LL 134.4 million in 1953 (a 10% increase), and to LL 172.1 million in 1954 (a 28% increase). It is expected that its receipts from merchandise trade would continue to increase in the future in view of the developments in trade and industry and of the government's present policy of concluding other similar trade agreements.

Another sign of strength is the development and stabilization of revenue from certain services which Lebanon renders to non-residents and which revenue has so far been considered as unstable. Of special significance in this respect is tourism. Few years ago, tourism consisted essentially of around 10 to 15 thousand estiveurs who came primarily from neighbouring Arab countries to spend part or all of the summer season in Lebanon. Their number fluctuated tremendously from year to year, depending on the economic conditions of their respective countries. Since the opening of Beirut's International Airport in 1951 Lebanon has come to know a new type of tourists, referred to as international tourists. Their number amounted to 210,000 in 1951, 320,000 in 1952, 385,000 in 1953 and 450,000 in 1954. It is not only the number of such tourists which is important in this connection; of more importance is the fact that the sources of Lebanon's present tourist trade are no more localized as they used to be in the past. International tourists come to Lebanon today from all various parts of the world. This

reduces greatly the possibility of large fluctuations in revenues from tourist trade, thereby rendering them more steady and uniform. Except in the event of a world war, Lebanon's revenues from tourism appear to be apt to develop and to become more stable (or less uncertain).

Apart from tourism, it may be said that Lebanon's revenue from services in general has tended recently to be consolidated. This is essentially due to the continuous integration of the Lebanese economy into an Arab and Middle Eastern regionalism. Lebanese services are becoming less and less the result of different exchange and other legislation in various countries abroad, and more and more the function of the geographical position of Lebanon which makes of it the natural intermediary between the Middle East and the West. Lebanon is adopting the function of a commercial intermediary in lieu of its previous function as exchange intermediary. Although revenue from gold transit trade has been reduced as mentioned above, yet total revenue from various service items in the balance of payments has instead been appreciably increasing since 1953.<sup>1</sup> This bears witness to the fact that

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1. It is recalled that the Arab Economic Agreements between the members of the Arab League were concluded in 1953. These agreements may be considered as a forward step towards the integration of the Lebanese economy into an Arab regionalism which integration, it is here claimed, has materially contributed towards the stabilization of Lebanon's revenue from services.

Beirut has been able to adapt itself to its new role which it is called upon to play without great difficulty. It has proven in this respect to possess a remarkable flexibility which is an invaluable asset to an intermediary trading center. This ability of adaptation is testament of the ingenuity of a race of intermediaries whose special skill consists of conforming their services to the needs of the moment.

The most important sign of strength for the present purpose is the growing strength of the Lebanese currency. The government, through the Exchange Stabilization Fund,<sup>1</sup> has lately been buying dollars in Beirut's free market in order to prevent the dollar - pound rate from falling below 320 piasters to the U.S. dollar.<sup>2</sup> Dollars thus purchased were mostly used in buying gold which in turn was placed in the note circulation cover. Thus, from LL 93 million worth of gold at the end of 1951, the value of gold in the note cover increased to LL 253 million at the end of 1955. Furthermore, Lebanon's official holdings of gold and foreign exchange increased markedly during the same period. Table 5 below gives the value of such holdings during the period 1950-1955 inclusive.

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1. The Exchange Stabilization Fund is further explained below.
  2. The rate of the Lebanese pound to the U.S. dollar rose from an annual average of LL 3.73 in 1951 to LL 3.66 in 1952, LL 3.42 in 1953 and LL 3.20 in 1954. In the latter year, it would have risen further had the government not interfered in the market to prevent such a rise.

TABLE 5.

OFFICIAL GOLD AND FOREIGN EXCHANGE HOLDINGS  
OF LEBANON  
1950-1955  
(in US \$ million)

<u>End of</u>	<u>Gold</u>	<u>Foreign Exchange</u>		<u>Total</u>	<u>Total</u>
		<u>French Francs</u>	<u>Other</u>		
1950	20.0	16.1	2.4	18.5	38.5
1951	26.3	12.0	1.2	13.2	39.5
1952	30.6	10.9	0.7	11.6	42.2
1953	34.7	12.8	7.7	20.5	55.2
1954	63.1	11.6	1.4	13.0	76.1
1955	73.7	10.1	2.7	12.8	86.5

Source: International Financial Statistics,  
IX, February 1956, pp. 142-143.

The immediate cause for the appreciation of the Lebanese pound is the annual surplus which has been obtaining in the balance of payments of the country. The strength of the Lebanese currency, which strength has attracted substantial amounts of foreign capital into Lebanon, thereby making of Beirut the financial as well as the trade center of the Arab Middle East, has depended upon the vigour of the foreign sector of the economy, upon the gold reserves which the country was able to accumulate during the past years, and upon the confidence of foreigners in it. Such a strong currency has been largely responsible for the sizable net movements of foreign

capital into the country. Had it not been for these capital movements, the balance of payments would have most probably recorded a deficit rather than a surplus, with the necessary result, ceteris paribus, of reducing the country's holdings of gold and/or foreign exchange. Such a development would have certainly tended to undermine confidence in the currency and would have, hence, led to large capital outflows, whether foreign or domestic. As such, the strength of the Lebanese currency, which is immediately due to the favourable balance of payments position of the country and which may thus be considered as a sign of strength of the balance of payments, has in turn reacted to give more strength to that position by materially contributing to the growth and stability of the capital account.

c) Foreign exchange policy. Exchange control was introduced into Lebanon on December 3, 1939. The French mandatory authorities established an Office des Changes to centralize all exchange transactions. Restrictions on imports into the country were imposed by requiring prior import licensing, and export proceeds, as well as other foreign exchange proceeds, were to be repatriated and sold to the Office des Changes at official rates. Payments for invisibles as well as capital transfers were strictly controlled, being invariably subject to the prior approval of the Office des Changes. Exchange transactions with countries of the franc

area were almost completely exempt from such restrictions. On July 15, 1941, following the entrance into the country of the Allied troops, Lebanon was declared a member of the Sterling Area, and exchange transactions with other members of the Area received similar treatment to that accorded to exchange transactions within the franc area.<sup>1</sup> The exchange control system introduced on December 3, 1939 remained essentially the same, with various minor changes, until November 5, 1948, when the Lebanese Government officially recognized some exchange transactions at free rates.<sup>2</sup> The government had in fact legalized the black exchange market.

On June 30, 1947, Lebanon as a member of the International Monetary Fund declared the par value of its currency to the Fund and undertook to maintain it.<sup>3</sup> However, partly because of the nature of Lebanon's foreign exchange receipts (the bulk of them deriving from invisible sources of revenue) and partly because of the relative inefficiency of the exchange control administration, Lebanon was unable (considering the fact that the new parity overvalued its currency) to maintain

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1. During the period extending between May 30, 1943 and March 13, 1946 the Lebanese currency was maintained freely convertible into sterling.
  2. Refer to Decree No. K/13532 of November 5, 1948.
  3. The par value of the Lebanese currency is LL 2.19148 = US \$1. Official rates are: buying LL 2.19, selling LL 2.21 per US \$1.



the new parity, and consequently black market exchange operations, at rates substantially remote from official ones, came to play an increasingly important role in total exchange transactions. In fact, the existence of a black exchange market in Lebanon dates back to the introduction of exchange control in 1939, though its importance increased in subsequent years. So that, in this respect, the legalization of the black foreign exchange market in 1948 was no more than a mere adaptation of law to existent practices.

The most important provisions of Decree No. K/13532 included the permission to carry out exchange operations at free market rates, but required that foreign exchange proceeds be repatriated and that 10 percent of them be surrendered to the Office des Changes at official rates. It also provided that foreign concessionary companies operating in the country (mainly oil companies) were required to purchase, at official rates of exchange, the equivalent of 80 percent of their requirements of local currency. Subsequently, the exchange control system introduced in 1948 was gradually relaxed until on May 24, 1952 the last remaining exchange control requirement (pertaining to concessionary companies) was officially abolished.

Whether they pertain to current account, services or capital transfers, exchange transactions in Lebanon today are completely free from any restrictions. There exists, however, a multiple rate structure: all transactions (except for a few

insignificant official transactions) are effected in the free exchange market in which rates remote from parity are in effect and in which there are broken cross-rates.<sup>1</sup> Rates in the free market are left free to oscillate in response to various relevant forces. However, through the intervention of the Exchange Equilization Fund,<sup>2</sup> the U.S. dollar rate has been prevented since the second half of 1953 from falling below LL 3.20 per US \$1. In fact, since then, the dollar rate has been relatively stable, on the whole varying between LL 3.20 and LL 3.25 only.

Because Lebanon is availing itself of the transitional arrangements of Article XIV, Section 2, of the Articles of Agreement of the International Monetary Fund, its currency is

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1. In 1955, the free market US dollar rate to the Lebanese pound varied between US \$1 = LL 3.20 and US \$1 = LL 3.25.
  2. The Exchange Equilization Fund was established in October 1949. Today it has no funds at its disposal, and consists essentially in the authority given to the Ministry of Finance to form a council or board, the function of which is to see to it that instructions are duly given to the Issue Department of the Banque de Syrie et du Liban in order to interfere in the free exchange market when necessity arises. Although established in 1949, the Fund started operations only in August 1953 when, upon the government's insinuation, the Issue Department purchased US dollars in the free market to prevent the dollar rate from falling below LL 3.20.

de jure considered inconvertible. However, although de jure inconvertible, the Lebanese currency may be considered to enjoy a de facto convertibility. For, it is recalled that the two primary prerequisites which must be met if a currency is in essence to be convertible are a) the freedom of exchange transactions on current account and b) the maintenance of stable exchange rates and of orderly exchange arrangements. Lebanon today not only maintains the freedom of exchange transactions on current account, but goes further than that by maintaining the freedom of exchange transactions for all purposes, as mentioned above. In this respect, it has gone further than the minimum required by the Fund. Moreover, for the past almost three years (i.e. since the beginning of August 1953) the Lebanese pound's exchange rate vis-a-vis the US dollar has varied between LL 3.20 and LL 3.25 only, which is within the one percent fluctuation allowed by the Fund. Finally, although in theory Lebanon may be accused by the Fund of authorizing the presence of a multiple exchange rate structure, yet the accusation bears no practical significance since exchange transactions at official rates are almost inexistent today. For all these reasons, it may be said that the Lebanese currency today enjoys a de facto convertibility.

In giving the causes behind the present Lebanese exchange system, one must say, right from the start, that the said system has been largely the result of a long process of

evolution and does not owe its existence to any preconceived policy on the part of the Lebanese Government. Legislation that legally established the system was very often no more than the mere adaptation of law to existent practices.

Along with this process of evolution, which to a great extent explains the present exchange system in Lebanon, there must also be mentioned two other factors which help, though to a lesser extent than the previous one, in understanding the causes behind the aforesaid system. These are, first, the belief cherished by a group of financiers and bankers whose points of view often proved of practical effectiveness in directing public policy in this respect, that freedom of exchange operations would be the best policy that fits the special make-up of the Lebanese economy as a trade center for a large area and as an economy dependent on imports for a large part of its food supply; and second, the tradition of liberalism and freedom which characterizes the other sectors of the economy and which stamps the various aspects of life in Lebanon. As such, a free exchange system is more than otherwise in line with conditions in other sectors of the Lebanese economy and with the tradition of liberalism which identifies the various aspects of Lebanese life at large.

d) Foreign trade policy. In a country which highly depends on income from foreign trade and where (due to adminis-

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1. Deserving of special mention here is the late Mr. Michel Shiha.

trative laxity) it may not be easy to carry out a strict control of foreign trade operations (especially when a separation between imports for local consumption and imports which are eventually reexported is involved) there is a more or less natural reluctance to introduce strict foreign trade restrictions. In Lebanon, the liberalization of foreign trade underwent a parallel development to that of the relaxation of exchange controls. So that, for all practical purposes, there are no trade restrictions of any type today, except, however, for a few commodities (around 20) "which are of a type produced locally, and the importation of which still requires licensing. Since the beginning of 1955, all trade, export and import, can be done freely with a minimum of legal or administrative control".<sup>1</sup> This freedom of trade has been very instrumental in establishing the country's position as the main entrepot, trade and tourist center in the Middle East.

In addition, it must be said that customs receipts are looked upon by the government in Lebanon as a major source of public revenue, of which around 40 percent are estimated to have come from such receipts in 1955. Accordingly, the great majority of tariffs in Lebanon are specifically imposed for revenue purposes and not for protecting local production. Three categories of tariffs may be identified:

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1. Economic Research Institute, Business Legislation in Lebanon, Beirut, 1956, p. 59.  
(Memiographed.)

first, the maximum tariff which is usually applied to imports from certain non-members of the United Nations (U.N.) and which is normally equivalent to about twice the ordinary tariff;

second, the ordinary tariff which normally applies to imports from U.N. members as well as from certain privileged non-member countries; and

third, the preferential tariff which applies to imports from countries which have signed with Lebanon trade agreements to this effect. Today preferential treatment in this respect is accorded to countries which have signed the Arab Trade Agreements: Syria, Jordan, Iraq, Saudi Arabia and Egypt. Special preferential treatment is furthermore extended by individual agreement to Syria, Jordan and Iraq.

The ordinary tariff is predominantly the most important in the Lebanese tariff schedule. It usually consists of an ad valorem duty of 25 percent.<sup>1</sup> Upon this basis, it may be said that, on the whole, Lebanon's customs policy is primarily meant for revenue rather than for protective purposes. It is, however, worthwhile to mention here that tariff policy is being

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1. Since ad valorem duties are calculated on the basis of official rates of exchange which are only about two-thirds of free rates actually paid by importers, then all ad valorem duties must be reduced by one third of their value in order to acquire a more realistic figure of the duties actually paid by importers.

increasingly used as a means of protecting local production against foreign competition. Thus, a higher than ordinary duty is usually imposed on industrial imports which are of a type produced locally, and all raw materials used in industry are exempted from custom duties; furthermore, agricultural machinery and equipment as well as agricultural seeds are also exempted from customs. However, notwithstanding these exceptional cases, Lebanon's tariff policy remains essentially geared towards the objective of raising public revenues and constitutes no major deterrent to the principle of free trade recognized in other fields of economic policy.

Finally, a word must be said about Lebanon's trade agreements. These are primarily of two types; first, agreements with the Arab countries which have been already mentioned, and second, agreements, mainly with European countries, which are bilateral at least in form. Such agreements of the latter type "are more in the nature of an advertising medium which indicates to the other party what commodities are available for sale and what commodities are needed, than binding bilateral trade compacts"<sup>1</sup>. Since most of them are of a relatively recent date, it may not be very easy to assess their importance in Lebanon's economy as yet. One thing may, however, be said. Since even those agreements which are bilateral in form do not, in fact, imply narrow bilateralism and the consequent artificial

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1. Economic Research Institute, op.cit., p. 60.



channelling of trade, trade agreements in Lebanon have not yet constituted any serious threat to the freedom of foreign trade, and hence, Lebanon's foreign trade policy remains essentially free.

### Currency and Banking

The present section attempts at giving a general insight into the evolutionary process through which the monetary system of Lebanon has passed and at analyzing the present monetary and banking system in view of its main characteristics which are believed to exercise a direct bearing on the argument developed in the coming two chapters of the dissertation.

The monetary system of Lebanon dates back to 1920 only. Before that, Lebanon's monetary system formed part of the monetary system of the Ottoman Empire as a whole, and Ottoman currency circulated as legal tender in the country. In 1920, however, the French military authorities<sup>1</sup> created a new monetary unit, the Syrian pound, which was to circulate as the sole legal tender in both Syria and Lebanon beginning on January 1st, 1921. The value of the new pound was fixed at 20 French francs redeemable in checks drawn on Paris or Marseilles. The right of issue was granted to the Banque de Syrie,<sup>2</sup> a French

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1. At that time Lebanon formed part of the High Commissariat of Syria and Cilicia occupied by the French Army of the Levant.

2. In 1924, the Banque de Syrie changed its name to Banque de Syrie et du Grand Liban and to Banque de Syrie et du Liban in 1939. It is henceforth referred to as BSL.

company that had taken over the privileges and agencies of the Syrian and Lebanese branches of the Ottoman Bank.

The military decree of 1920 was replaced in 1924 by a convention signed by the governments of the Lebanese and Syrian Republics on the one hand and by BSL on the other, which convention starting on April 1, 1924, was to last for fifteen years. The convention redefined the monetary unit (which now became the Lebanese-Syrian pound)<sup>1</sup>, but its par value was kept unchanged. The link between the newly created Lebanese pound and the French franc set the Lebanese currency on a franc exchange standard. Contrary to the belief that such an arrangement would stabilize the external value of the local currency, this link with the franc had caused the value of the Lebanese currency to fluctuate wildly during the subsequent twenty five years or so.

The convention of 1924 specifically recognized the privilege of BSL as the sole agency with the right to issue Lebanese and Syrian banknotes. For this purpose it was to have two Issue Departments, one for each country. The convention also gave BSL the right to undertake commercial banking transactions in the two countries, for which purpose it had to have

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1. Two different series of notes were issued: the one bearing the inscription Grand Liban and the other Syrie; however, both bank notes were to circulate freely and were considered legal tender in either territory. BSL was to hold currency reserves jointly in the name of the two countries.

a banking department, the accounts of which were to remain separate from those of the two Issue Departments. Furthermore, BSL was given the monopoly right to be the sole receiver and holder of governmental deposits. It thus acted as the governments' fiscal agent.

In 1937, Lebanon, separately from Syria, signed another convention with BSL for a duration of twenty-five years beginning with April 1, 1939.<sup>1</sup> The new convention was essentially the same as the old one with very minor changes. The subsequent major monetary development of interest here is the conclusion in January 1948 of a monetary agreement between Lebanon and France.<sup>2</sup> "Since the Franco-Lebanese agreement was not, at that time, accompanied by a parallel agreement between France and Syria, it marked the parting of the ways between Syria and Lebanon, whose currencies till that time had been legally interchangeable and factually identical. The Lebanese currency now assumed a separate status, possessing its own cover, and enjoying possibilities with respect to the use of French franc balances which the Syrian pound, for the time being, did not share."<sup>3</sup> Each country subsequently called in the other country's currency notes circulating in its

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1. BSL today functions under the provisions of the 1937 convention.
  2. The Lebanese Parliament ratified the Franco-Lebanese monetary agreement on August 31, 1948.
  3. F.A.G. Keesing, The Monetary and Banking System of Lebanon, International Monetary Fund, Washington, D.C., 1955, p. 2. (Typescript.)

territory. The result was a net Lebanese claim on Syria of about LS 45 million. The debt was paid by Syria in French francs between 1952 and the end of 1954.

Having acquired an independent currency of its own, Lebanon went ahead in reorganizing its note issue. Thus, on May 24, 1949 a Monetary Law was issued which redefined the Lebanese pound in terms of gold,<sup>1</sup> and prescribed new provisions for the note cover. The monetary law of May 24, 1949 along with Decree No. K/15105 of May 27, 1949 provide for a 100 percent cover of all notes in circulation:

- 50 percent of gold and foreign exchange
- 50 percent of government loans and securities, loans guaranteed by the government, securities of institutions accepted by the State and commercial bills. Commercial bills are not to exceed 15 percent of notes in circulation.

Table 6 below gives the composition of the note cover in both absolute and percentage terms for the period 1948-1955 inclusive.

It can be seen from Table 6 that the amount of gold in the note cover increased from 2 percent of note circulation at the end of 1948 to 95 percent at the end of 1955. This was achieved by the purchase of gold (mainly against French francs during the first five years of the period under review) by BSL at the request of the Lebanese Government. Some of the

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1. The Lebanese pound was made equal to 405.512 milligrammes of pure gold.

TABLE 6.

NOTE CIRCULATION AND NOTE COVER1948-1955

End of:	1948	1949	1950	1951	1952	1953	1954	1955								
	LL.Mil.	LL.Mil.	LL.Mil.	LL.Mil.	LL.Mil.	LL.Mil.	LL.Mil.	LL.Mil.								
Note Circulation	185	168	196	208	200	205	242	266								
Note Cover	%	%	%	%	%	%	%	%								
Gold	3.7	2	42	25	70	36	93	45	109	55	127	62	218	90	253	95
Foreign Assets	39.2	21	39	23	28	14	13	6	-	-	7	3	-	-	-	-
Advances to Lebanese Government	46.2	25	45	27	-	-	2	1	-	-	-	-	-	-	-	-
Special Account	95.9	52	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Loans Guaranteed by Lebanese Govt.	-	-	42	25	-	-	-	-	-	-	-	-	-	-	-	-
Advances for Syrian Bank-Notes	-	-	-	-	45	23	45	22	36	18	18	9	-	-	-	-
Treasury Bonds	-	-	-	-	53	27	55	26	55	27	54	26	23.5	10	13	5
	185	100	168	100	196	100	208	100	200	100	205	100	242	100	266	100

Source: I.B.R.D., The Current Economic Position and Prospects of Lebanon, Washington, D.C., A.S. 35, 1955 (Typescript); and Lebanese Government, Official Gazette, XCVI, January 4, 1956, p.16.

gold thus acquired was purchased in the local market at premia, and the rest was mainly purchased from the United States at official prices. It is worthwhile to mention here that the gold cover is valued at purchase price, which<sup>1</sup> is reportedly somewhat higher than its present real value.

As a conclusion, it may be said that BSL continues to effect the note issue according to the 1937 convention and to the provisions of the Monetary Law of May 24, 1949 and of Decree No. K/15105 of May 27, 1949. According to the terms of its Convention, BSL is independent from the Government which may only exercise a right of supervision on the proper application of the rules governing the note issue. Under present legislation, the Lebanese Government has no right to occupy itself with any other aspect of BSL's business.

With regard to the banking system and the monetary organization of Lebanon in general, it is of significance to note here that there is no legislation in Lebanon which specifically applies to banks and banking operations. Banking

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1. A small part of the gold cover was bought against US dollars belonging to the Exchange Office, valued at LL 2.19/US\$1; another part was purchased in New York against US dollars which BSL bought in the free exchange market of Beirut at LL 3.20/US\$1; and, finally, a third part was obtained in the local market at premium prices. In view of the absence of information about the net weight of the gold stock, its actual value could not be exactly ascertained and, thus could not be compared with its book value as it appears in BSL's publications.

transactions are legally regarded as mere acts of commerce and are thus consequently regulated by the Lebanese Commercial Code. Accordingly, persons and corporations carrying out such transactions as well as all other merchants are required, among other things, to keep books and to register with the Chamber of Commerce. Apart from the foregoing, there exists today no other legislation on the subject of banking.<sup>1</sup>

There are 34 Lebanese banks operating in Lebanon today (March 1956) and 13 foreign banks. Of the local banks, only fourteen have a paid up capital of LL 1 million or above; the rest are smaller ones, some of which are mere discount houses. On the whole, almost all of the banks operating in Lebanon today whether local or foreign are primarily interested in financing trade, both internal and external. Accordingly, short-term credit is the most prevalent type of credit. It was because of the insufficiency of medium- and long-term credit facilities that the government has recently, with the help of private capital, established an Agricultural, Industrial and Real Estate Bank. The maximum legal rate of interest is 9 percent per annum to which is usually added up to 2 percent in form of commission and other charges. However, rates as low as 6 percent or even 5 percent per annum are reported to

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1. However, the Commercial Code (Art. 307-314) provides for additional special rules which circumscribe the contractual aspects of certain banking operations.



be charged when the customer concerned is of good credit standing.

Lebanon has no central bank. However, BSL de facto enjoys certain prerogatives which are normally exercised by a central bank. BSL was established on June 2, 1919 as a societe anonyme incorporated according to French law. Its seat is in Paris and its capital (which is entirely paid-up) amounts to F. fr. 300 million. It may be recalled in this connection that by virtue of its 1937 convention, BSL enjoys the sole right of note issue in Lebanon and the sole right to receive and hold government deposits. As such it acts as the government's fiscal agent. Furthermore, BSL has two departments in its Lebanon branch: an Issue Department which is charged with the function of note issue and the accounts of which are supposed to be kept separate from those of the other department, and a Banking Department in which all its other banking activities are concentrated. In fact BSL is the most important commercial bank operating in Lebanon today. However, although as such it is no more than another commercial bank, but in view of the prerogatives which it enjoys, it frequently acts as a banker of last resort to other banks. This is achieved partly by rediscounting trade bills and partly by opening lines of credit to other banks. However, since no official rediscount rate is published (primarily because the quality of trade bills to be rediscounted is judged on an ad hoc basis), BSL retains the privilege of quoting rates in

accordance with the quality of the bill in question. Furthermore, BSL is often looked upon by other commercial banks as a strong and privileged competitor. As such, many banks prefer not to rely on assistance from BSL to which they are reluctant to disclose the names of their customers. Accordingly, banks find some difficulty in obtaining the necessary assistance from BSL when the need manifests itself.<sup>1</sup> "In any case, it seems clear that for psychological reasons, if for no others, several banks will find it hard to look to the BSL for assistance and guidance or to cooperate with it in other respects."<sup>2</sup> Finally, the non-existence of Treasury bills<sup>3</sup> deprives the Government (or BSL) from a potential instrument of open-market policy, as well as it deprives other banks from a highly liquid investment which is easily marketable and readily rediscountable in accordance with objective criteria. And since call money or similar short-term intra-bank credits are non-existent, and since banks seldom negotiate

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1. This applies with greater force to local banks, foreign banks being usually able to get assistance from their headquarters abroad. For this purpose, local banks find it often necessary to remain abundantly liquid.
  2. Keesing, op.cit., p. 9.
  3. BSL is the only Bank which today holds Treasury paper. This consists of Treasury Bonds issued by the government in 1949 to compensate the loss in the value of the French franc assets in the note cover incurred by the franc and sterling devaluations of September 1949.

bills with each other (all of which goes to show the high degree of individualism which characterizes the Lebanese banking system), it virtually means that a money market is practically lacking in Lebanon, or at most, if existent, that it is highly undeveloped.

If and when the need for monetary policy makes itself felt in Lebanon, the present banking system and monetary organization are apt to present various impediments in the face of the effective implementation of such a policy. One such impediment is the lack of legal authority. As mentioned above, present legislation gives the government the authority to supervise the note issue only. This means that the government has presently no authority to intervene in the other activities of BSL which today can, as shown by Table 6, expand the note circulation far beyond its present size without the need to change the rules governing the note cover, and that by moving eligible assets (reserve de couverture) from the Banking Department to the Issue Department. Therefore, the government's right to supervise the Issue Department of BSL does not, under existing conditions, provide it with any means of monetary policy.

Another impediment which deserves special mention here is an institutional one. Notwithstanding the lack of legal authority to implement a given monetary policy, there is also the lack of the proper organization which would be charged with the function of executing such monetary policy. The

government itself does not have the required organization to do the job, whether inside the Ministry of Finance or elsewhere in the administration. It is of interest to mention here that the function of the Ministry of Finance has been almost exclusively concerned with the preparation of the annual budget of the state and the supervision of fiscal operations within the other ministries. As for BSL, it is presently un-recommendable to be put in charge of the function of implementing the government's monetary policy, mainly because it has no authority to control and coordinate the various credit policies of other banks; because certain banks rightly regard it as a strong and privileged competitor and as such are reluctant to have recourse to it when in need of short-term liquidity; because it is a foreign institution; and, finally, because it is not inspired by public interest but is prompted by profit motives.<sup>1</sup> Lastly, the non-existence of Treasury bills and the undeveloped nature of the money market mentioned above constitute a further institutional impediment against the effective implementation of monetary policy in Lebanon.

Apart from the aforesaid legal and institutional discrepancies, there is a third one which consists in the lack of detailed information about economic conditions in general and the banking situation in particular, which information constitutes

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1. BSL is reported to show a tendency, along with other banks, to relax credit requirements under conditions of expansion and to tighten them under conditions of recession.

the indispensable basis for a proper and adequate monetary policy. "Statistics about many essential aspects of the economy do not exist at all. In other cases, figures are fragmentary and do not always afford a reliable picture. This means that the possibility to go into details and to improve a rather shallow understanding of the functioning of the Lebanese economy goes by default. This situation clearly breeds confusion and fosters reasoning along dogmatic lines rather than on the basis of an adequate knowledge of changing reality."<sup>1</sup>

#### Public Finances and Development Policy

With the increase in economic activity in general and in the role of the government in particular, both government receipts and government expenditures in Lebanon have risen markedly. Table 7 below shows the results of the ordinary government budget<sup>2</sup> during the period 1946-1954 inclusive.

It can be seen from the table below that except for 1950, there have been continuing budget surpluses over the nine years under consideration. Such surplus accumulation, however, is due to a conservative underestimation of revenues and to underspending on capital works in particular. It is to be mentioned here that apart from the ordinary budget of the

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1. Keesing, op.cit., p. 14.

2. The fiscal year in Lebanon coincides with the calendar year.

government, there are three other autonomous budgets: Telephone Administration, National Lottery Administration, and Water and Electricity Administration of the city of Beirut. Until 1951, the ordinary budget figures included the net results of the autonomous budgets as well.

TABLE 7.

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ORDINARY BUDGET OF THE GOVERNMENT OF LEBANON

	<u>1946-1954</u> (in LL. million)								
	<u>1946</u>	<u>1947</u>	<u>1948</u>	<u>1949</u>	<u>1950</u>	<u>1951</u>	<u>1952</u>	<u>1953</u>	<u>1954</u>
Receipts	74	86	79	87	83	105	125	141	193
Expenditures	52	61	70	83	84	90	89	117	161
Balance	22	25	9	4	-1	15	36	24	32

\* Figures are rounded to the nearest LL million.

Source: Ministry of Finance, 1954 Budget Closed Accounts, Beirut, 1955; and I.B.R.D., The Current Economic Position and Prospects of Lebanon, Washington, D.C., A.S. 35, 1955, p. 16. (Typescript.)

Surpluses obtaining in the ordinary budget of the government are paid into a Reserve Fund account in the Treasury, which Fund has been used to finance certain public works outside the ordinary budget. Table 8 below shows the movements in the Reserve Fund during the period 1946-1954 inclusive. It is informative here to mention that the net balance of the Reserve Fund as of December 31, 1946 was about LL 27 million while as of December 31, 1954 it amounted to about LL 97 million. However,

TABLE 8.  
MOVEMENTS IN RESERVE FUND\*

1946-1954

(in LL Thousand)

(1) End of Year	(2) Budget Surpluses (Gross Increases in Reserve Fund)	(3) Drawings from Reserve Fund to Budget	(4) Net Budget Surpluses (2) - (3)	(5) Drawings from Reserve Fund for Extra-Budget- ary Public Works	(6) Net Increase (+) or Decrease (-) in Reserve Fund (4) - (5)
1946	27,162	5,240	21,922	20,370	1,552
1947	42,117	16,582	25,265	---	25,265
1948	23,426	14,738	8,688	18,500	-9,812
1949	25,591	21,626	3,965	9,000	-5,035
1950	17,287	18,492	-1,205	19,590	-20,795
1951	32,998	17,742	15,256	---	15,256
1952	58,904	22,488	36,416	4,464	31,952
1953	66,209	42,145	24,064	12,680	11,384
1954	67,122	35,533	31,589	9,489	22,100
TOTAL	360,816	194,586	165,960	94,093	71,867

\* Figures are rounded to the nearest LL 1000.

Source: Ministry of Finance, 1954 Budget Closed Accounts, Beirut, 1955; and,  
I.B.R.D., The Current Economic Position and Prospects of Lebanon,  
Washington, D.C., A.S. 35, 1955. (Typescript).



not all this sum is free and uncommitted: part of the funds is earmarked for certain development projects and another part represents advances to various government departments, which in fact are irrecoverable. Out of the LL 97 million only about LL 43 million were uncommitted at the said date.<sup>1</sup>

Lebanon's only internal debt today consists of Treasury bonds wholly held by BSL and amounting to about LL 57 million at the end of 1955. These bonds were issued in 1949 to compensate for the loss in the value of the French franc assets in the country's note cover resulting from the sterling and franc devaluations of September 1949. Maturity dates are one year and two years and interest rates are 1 percent per annum and  $1\frac{1}{2}$  percent per annum respectively. However, all such bonds are renewable and BSL has been holding the bulk of them since they were issued in December 1949. The government is currently redeeming and cancelling 3 percent each year of the bonds outstanding. The only foreign loan of Lebanon is of a recent date and constitutes a potential obligation only, since Lebanon has not started drawing on the loan yet. On August 25, 1955, the International Bank for Reconstruction and Development extended a loan of US \$ 27.28 million to assist in financing the Litani Project. The loan is for a term of 25 years and bears an annual rate of interest of 3  $\frac{3}{4}$  percent including the

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1. I.B.R.D., The Current Economic Position and Prospects of Lebanon, Washington, D.C., A.S. 35, 1955, p. 20. (Typescript.)

statutory commission of 1 percent per annum. Amortization payments are to begin on August 1, 1961. It was only on December 23, 1955 that the Lebanese Parliament ratified the guaranty agreement between I.B.R.D. and Lebanon concerning the mentioned loan.

Capital works are partly financed from the Reserve Fund formed by the annual surpluses of the ordinary budget and partly by expenditures from the ordinary budget proper. Expenditures from both sources are estimated to have amounted to an annual average of about LL 30 million during the past ten years. The main fields of public investment have been in extending irrigated areas, in road construction and in building Beirut's International Airport. Early in 1953 an Economic Development Board was set up by the government in order to: "(1) formulate an overall development plan, with detailed programs for the development of agriculture, industry, trade, banking, tourism, etc; (2) determine priorities within the development plan and make recommendations to the government as to how the various segments of the plan shall be financed; and (3) supervise the carrying out of the plans, both in detail and in the overall".<sup>1</sup> However, it was only towards the middle of April that the Board started operations.

The most important development project in Lebanon today is the Litani Project which consists of the construction of a

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1. Klat, Review of Lebanon's Economy, op.cit.,  
p. 8.

power and irrigation project on the Litali river. The project has three phases which are estimated to increase the area under irrigation by about ha. 6200, 10 000 and ha. 10000 respectively. The cost of phase "A" of the Project is estimated at about LL 145.81 million to be disbursed over a period of seven years beginning with 1955 in the following manner:

	<u>1955</u>	<u>1956</u>	<u>1957</u>	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>Total</u>
Annual Expenditures in LL million:	0.77	21.79	22.40	28.49	21.23	26.33	24.87	145.81

Local currency costs of the first phase of the Project (estimated at LL 57.12 million) are to be covered by the government while the loan from IBRD is meant to finance the foreign component of estimated costs (about LL 88.68 million). It is to be mentioned in this respect that local currency investment during the first phase, and which the government itself has to provide, is estimated at an average of LL 8 million annually.

It appears that Lebanon has so far managed to carry out its developmental projects without subjecting its economy to inflationary pressures. In fact both wholesale prices index and cost of living index registered a marked decrease over the period extending between 1948 and 1954 as shown by Table 9 below.

However, it should be mentioned in this connection that both price indices have lately shown a tendency to rise. Thus, taking prices in March 1955 as a base, it is to be noted that wholesale prices index moved to 109 in March 1956, and that cost

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1. I.B.R.D., The Current Economic Position and Prospects of Lebanon, op. cit., p.21.

of living index rose to 110 during the same period. The reasons and implications of such price rises are further discussed in Chapter V.

TABLE 9.

WHOLESALE PRICES AND COST OF LIVING INDICES IN LEBANON

$\frac{1948-1954}{(1948=100)}$

<u>YEAR</u>	<u>WHOLESALE PRICES INDEX</u>	<u>COST OF LIVING INDEX</u>
1948	100	100
1949	82	94
1950	76	87
1951	95	94
1952	86	94
1953	78	88
1954	72	83

Source: I.B.R.D., The Current Economic Position and Prospects of Lebanon, Washington, D.C., A.S. 35, 1955, p. 3. (Typescript.)

Conclusion

The salient features of the Lebanese economy for the purposes of the present dissertation may be summarized as follows:

1. Lebanon has a diversified economy and enjoys a per capita income higher than that of almost any other country in the Middle East.

2. Although diversified, the Lebanese economy is essentially mercantile. External and internal trade together

account for more than one-third of total national income, whereas foreign trade alone produces around one-fourth of total national income. The importance of foreign trade reflects the country's position as trade and financial center for the Middle East.

3. Lebanon's balance of payments since the termination of the Syrian-Lebanese customs union has shown continuous surpluses. Merchandise trade deficits are more than counterbalanced by favourable services and capital accounts. Hence the importance of services rendered to non-residents and of inflows of foreign capital funds to the Lebanese economy.

4. Compared with its neighbours, Lebanon enjoys greater stability and a higher degree of freedom and tolerance, whether political, economic or social. It is essentially a free trader and has practically no exchange restrictions, its currency being de facto convertible.

5. There is no central bank in Lebanon. However, a foreign bank, BSL, currently undertakes certain central banking activities. There is little cooperation between the government and BSL or between BSL and other banks operating in the country. Furthermore, various prerequisites for an effective monetary policy are lacking or inadequately available.

6. Lebanon's budget policy centers around the objective of accumulating budget surpluses, and the budget has never been used for fiscal compensatory purposes. The public debt of the

country consists of an internal debt entirely held by BSL and of a potential foreign obligation constituting of a loan granted by IBRD.

7. Lebanon's most important development project today is the Litani River Project which is estimated to cost around LL 300 million in all its three phases. So far, development projects have been carried out without, subjecting the economy to inflationary pressures.

## CHAPTER IV

### THE ADVANTAGES OF CONVERTIBILITY

The present chapter is an attempt to show the advantages which are expected to accrue to Lebanon in case it undertakes to maintain the convertibility of its currency. However, before actually discussing such advantages, mention should first be made, in way of an introduction to the chapter, of the type of currency convertibility which the present study assumes that Lebanon is to maintain. For, since the essence of currency convertibility is the freedom to convert a currency into a means of international payments at stable rates of exchange, then convertibility itself may consist of various types depending on the extent to which this freedom of conversion is unrestrictively maintained.

It is to be recalled that Chapter I of the dissertation includes a definition of currency convertibility as understood by the International Monetary Fund. It may be said here in a summary form that the essence of the Fund's definition of convertibility revolves around the fulfillment of two principal requirements: a) as regards freedom of exchange operations, the maintenance of free exchange operations and of orderly exchange arrangements with respect to payments made for current



transactions; and, b) as regards stability of exchange rates, the maintenance of stable exchange rates, varying only within a range of one percent either way from parity.

(A country may be considered by the Fund to be fulfilling this second requirement if its monetary authorities, for the settlement of international transactions, stand ready to freely buy and sell gold at maximum and minimum prices which may not differ from parity by more than one percent.) Such a definition is, however, too narrow to be meaningfully applicable to the Lebanese set-up. The particulars of the Lebanese economy (namely, the make-up of its balance of payments) seem to render necessary an alteration in the said definition when a consideration of the advantages of a convertible Lebanese currency is under review. The alteration referred to relates to the extent to which freedom of exchange operations is to be authorized. It appears to be more appropriate, and seemingly more meaningful, in considering the advantages of a convertible Lebanese currency, to extend the freedom of exchange operations, which such convertibility entails, to capital as well as to current transactions. This is believed to be called for in view of the important and favourable role which capital transactions assume in the country's balance of payments, and in view of the difficulty, considering the relative inefficiency of a potential foreign exchange administration, of actually differentiating between payments which are in fact made for current transactions and

others which are ultimately meant to effect capital transfers. Thus, whereas the Fund's definition of convertibility implies freedom of exchange operations for current transactions only, convertibility is here defined to include freedom of exchange operations for capital transfers as well. Accordingly, whenever reference is made in the present or in the next chapter as to the convertibility of the Lebanese currency, convertibility should be taken to mean exactly the same as its Fund definition,<sup>1</sup> with the sole difference of extending the freedom of exchange operations to apply to payments for capital transactions in addition to those made for current transactions.

What are then the prerequisites which must first be met in order that the Lebanese currency may be considered to be de jure convertible? It was said in Chapter III above that there exist today practically no exchange restrictions in Lebanon, despite the fact that there is a multiple exchange structure and that broken cross-rates are in effect in the exchange market. It was further said that the exchange rate of the Lebanese pound in relation to the US dollar has been relatively stable during the past three years or so, varying only between LL 3.20 and LL 3.25 per US \$1; the extent of such variation, it is to be remembered, falls within the one

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1. The Fund's definition of convertibility is given in Chapter I, supra.

percent limit allowed by the Fund.<sup>1</sup> Such an arrangement was said to constitute a de facto convertibility of the Lebanese currency. If, however, Lebanon wishes to declare the de jure convertibility of its currency, then it would have to fulfill two primary requirements of major importance in this respect. The first one consists of the declaration, to the International Monetary Fund, of a new par value of the Lebanese currency since the existent parity clearly over-values the Lebanese pound. Having declared the new par value, Lebanon must then undertake to maintain it allowing only for very minor deviations. This is considered by the Fund to be achieved if the Lebanese monetary authorities, in settlement of international transactions, stand ready to freely buy and sell gold at prices the maximum and minimum of which do not differ from official parity by more than one percent. This is the second requirement. Once the abovementioned two requirements are fulfilled and once the almost exclusively legal requirement of abiding by the provisions of Article VIII instead of those of Article XIV (of the Fund's Articles of Agreement) is furthermore met, then the Lebanese currency would be deemed by the Fund to be de jure convertible. There-

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1. This assumes that the par value of the Lebanese pound to the US dollar is LL 3.23/US\$1. The U.S. dollar rate has been chosen for the purpose on hand because of its significance in a consideration of convertibility, which significance derives from the fact that the U.S. dollar is freely convertible into gold at fixed prices (though such convertibility is only extended to monetary authorities of other countries and not to individuals).

fore, if Lebanon is to declare its currency convertible, it essentially requires only to declare a new more realistic par value and to undertake to maintain that new parity through the purchase and sale of gold at stable prices. Other aspects of Lebanon's present exchange system may continue to remain unchanged, without, in any way, imposing restrictions on the country's currency convertibility. Accordingly, a discussion of the advantages of a convertible Lebanese currency is restricted to a discussion of the advantages which may accrue to Lebanon as a result of the declaration of a new more realistic parity, and of the official guaranty to maintain that parity.

It is now proposed to discuss the advantages which Lebanon may come to enjoy as a result of undertaking the convertibility of its currency. Before doing that, however, a presentation of the drawbacks which the establishment of convertibility might inflict upon the Lebanese economy will first be undertaken. The said order of discussion has been chosen because it is believed that the advantages of convertibility to Lebanon outweigh by far its drawbacks. As such, it is thought appropriate to present the alleged drawbacks of convertibility and to show that they do not stand critical analysis, before the attempt to establish the case for its advantages is made. Upon this basis, a brief discussion of what are generally considered to be the most important draw-

backs of convertibility to Lebanon will now be undertaken.<sup>1</sup>

It is often claimed that the establishment of convertibility in Lebanon is imbued with the danger of weakening the currency through the depletion of the present gold cover. It is thus argued that if convertibility is undertaken, then a reduction in official gold holdings, following an attempt to prevent a fall in the value of the Lebanese currency, would result in unfavourable speculative transactions against the currency, which would in turn result in further drains on official gold holdings. Such secondary drains on the gold holdings of the monetary authorities are believed to be the result of the fear which the original reduction in gold holdings inspires. As a proof that such a fear may in fact develop in case official gold holdings are reduced, it is sometimes claimed that BSL has so far, and in line with such conviction, prevented the US dollar rate vis-a-vis the Lebanese pound from falling below LL 3.20/US\$1 but that it has not precluded it from rising. Therefore, it is argued, the establishment of convertibility would certainly imply the reduction (at one time or another) of the country's official gold holdings; such reduction would inspire fear and would consequently react in an unfavourable manner thereby subjecting

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1. Only the drawbacks of convertibility to Lebanon as such are discussed here, the presentation of the difficulties attending its actual maintenance being left to Chapter V. The argument which follows concerning the drawbacks and advantages of a convertible Lebanese currency is intentionally geared to show the desirability of such a currency.

the strength of the currency to great doubts; it is furthermore claimed that the fear of a further reduction in official gold holdings may in fact result in greater drains on such holdings, with the result of actually destroying the strength of the currency.

As it may be seen, the truth of the argument heavily depends on the attitude of the public towards a reduction in official gold holdings. The argument claims that such a reduction will inspire fear which will cause public opinion to react unfavourably, thereby further reducing the gold holdings. However, this assumed fear "is based on conjecture rather than on experience. On the basis of the monetary law of 1949, the BSL has only acquired and never lost gold and a precedent, therefore, does not exist".<sup>1</sup> As such, it cannot be said with certainty that a reduction in gold holdings will result in the assumed unfavourable developments. It is this writer's belief that such developments are unlikely to take place, at least not when short-run and unsizable reductions in gold holdings are sustained in order to iron out reversible fluctuations in the exchange rate of the currency. It appears more likely that "a sizable part of the present gold stock could, in case of need, be used to defend the currency without endangering its position".<sup>2</sup>

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1. Keesing, op.cit., p. 18.

2. Ibid.

Another argument expressed against the establishment of convertibility by Lebanon is the fear that in the course of such action there might occur sudden withdrawals of both domestic and foreign capital which may render the defense of the currency very costly, if not impossible.<sup>1</sup> Thus, it is claimed that the declaration of a more realistic par value of the Lebanese pound (which would certainly be lower than the officially existent one) may be taken to signify a devaluation of the currency. Accordingly, in fear that a further devaluation might be forthcoming, large capital funds would be expected to be withdrawn from the country. Furthermore, it is even argued that although no significant unfavourable reaction of the above type may be recorded against an official devaluation of the Lebanese currency, yet capital would still be expected to be withdrawn from the country in case the existing free market rate of the currency (or some other rate which is close to it) is prevented from depreciating below a certain level (in addition to being prevented from appreciating above a given level as has been the case since the second half of 1953). The reasons for such latter withdrawals are, however, not clear.

As it may have already been noticed, the argument in fact consists of two lines of reasoning both of which lead to the conclusion that convertibility in Lebanon would cause sizable capital withdrawals. The first line of reasoning

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1. Ibid., pp. 18-19



appears to be a somewhat too naive exposition of the particulars of the situation. Although the declaration of a new and more realistic par value implies the official devaluation of the Lebanese currency, it does not entail any significant practical implications in this connection. For, as it may be recalled, almost all exchange transactions are today effected in the free market in which rates remote from parity are in effect. As such, it is not likely that a mere adaptation of law to existent practice would cause the development of a loss of confidence in the currency and of consequent massive withdrawals of capital.

The second line of reasoning in the argument is also untenable, because there is no adequate reason why capital should leave the country in case the monetary authorities undertake not only to prevent an appreciation of the currency, but also to preclude any depreciation beyond a certain level. So far, foreign capital has been entering Lebanon, and no precedent of net capital withdrawal has ever existed.<sup>1</sup> Non-resident holders of Lebanese pounds or assets are aware that the value of the Lebanese currency will not be allowed to rise above LL 3.20/US \$1, but that it may be permitted to fall without limitation. Despite this situation which has existed

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1. This refers to the period 1951-1954 inclusive. Since there are no balance of payments figures for the period prior to 1951, it is not known whether capital had been withdrawn from the country or not, especially during 1950 when the exchange rate of the Lebanese pound fell by around 20% in a few months' time.

since August 1953, there has not occurred any massive retreat of capital from the country. Accordingly, it is very unlikely that a limitation of the downward movement of the Lebanese pound's external value would precipitate sizable capital withdrawals. "Any non-resident who presently holds Lebanese pounds or invests in Lebanese assets knows that the Lebanese currency can hardly appreciate, but that its possible depreciation would not be automatically halted. If this prospect does not act as a deterrent, it would seem illogical to assume that the owners of foreign capital would be frightened by a determined attempt to defend the Lebanese pound."<sup>1</sup>

The third argument to be discussed here against the establishment of a convertible Lebanese currency questions the viability of relatively fixed (but adjustable) rates of exchange in contradistinction to floating or free exchange rates. It is claimed that instead of maintaining a relatively stable and given exchange rate, it is preferable to allow free exchange market forces to perform the function of international equilibrium. Extreme fluctuations from day to day may be prevented through the operation of stabilization funds; but fundamental forces should be allowed to exert their effect on exchange rates without impediment. These are the broad implications of the argument. In presenting the reasons for

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1. Keesing, op.cit., p. 19.

such a preference towards floating rates of exchange, it becomes possible to discern two different versions of the same argument.

The first one claims that a system of floating rates is peculiarly conformable to the general spirit of economic liberalism recognized in the various fields of economic activity in Lebanon, in the sense that it is essentially an automatic system since uncontrolled market forces bring about exchange rate fluctuations which would by themselves equilibrate the external accounts of the country. Accordingly, floating exchange rates are preferable to fixed rates for Lebanon because a system of floating rates, which is essentially liberal, is more in line with other aspects of the country's economic policy, and because it entails the least extent of official intervention.<sup>1</sup>

The first thing that should be mentioned in an evaluation of the above argument is to question the conviction, implied in the argument, that a system of fixed rates is contradictory to economic liberalism; for there is no clear-cut definition of economic liberalism through which one can arrive at an unquestionable answer. Once it is admitted that economic liberalism may lend itself to more than one definition, then an objective standard through which argumentation regarding

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1. Official intervention is resented either by itself, per se, or else because of the claimed inefficiency and corruption of the administration in Lebanon.

whether or not a system of fixed exchange rates constitutes a violation of the principle of economic liberalism would be found to be wanting. Furthermore, granted, for the sake of the argument, that a system of fixed exchange rates does constitute a profanation of economic liberalism, it is not at all certain that pure economic liberalism is everywhere applicable as the best social norm. Accordingly, the argument developed above is based upon assumptions the truth of which is highly questionable.

In addition, the truth of the primary premise in the argument, i.e. that a system of free rates would automatically bring equilibrium in the external accounts of the country adopting it, is also questionable. For, if the money supply in the said country is infinitely inelastic, then there is no doubt that sooner or later the external position would come into equilibrium. But if, on the other hand, the supply of money is elastic, then there would be no guarantee that fluctuations in the exchange rates would necessarily lead to equilibrium in the country's external accounts. The following example may clarify this point.

"Let us suppose for a moment a completely elastic currency and no policy. Let us suppose further a downward movement of the exchange due to some unfavourable 'real' factor operating abroad. Import prices rise; merchants and manufacturers demand more credits in order to hold stocks. The cost of living rises; the trade unions demand increases of wages; the employers ask for more credits to meet the increased wage bill. The credits are granted; there is no contraction elsewhere. There is therefore created a new and increased internal level of expenditure; and the

advantage, such as it was, of the initial fluctuation is wiped out. The exchange falls again... If the money supply is elastic, the effect of exchange fluctuations is not the effect of a pendulum, it is rather.... the effect of a ratchet - the tendency is all one way." 1

Therefore, whether or not fluctuations in the exchange rates automatically establish equilibrium in the external accounts depends primarily on the elasticity of money supply. More specifically, in order to enable a system of floating rates to do what is expected of it, it is necessary that the supply of money be sufficiently inelastic. In the realities of the modern world (Lebanon included), and considering the nature of its present credit system, such relative inelasticity as exists today is the result of policy. Accordingly, "the claim for automatism falls to the ground".<sup>2</sup>

The second version of the argument against stable rates of exchange starts from the intractability of domestic national economic policies. It is argued that domestic policies such as those of full employment and economic development command more of the concern of various governments today and of the resources at their disposal than does the intangible, and often politically less appealing, objective of

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1. Robbins, op.cit., p. 98. (The underlined words are italicized in the original text.)

2. Ibid.

maintaining equilibrium in external accounts. Under such circumstances, the establishment of fixed exchange rates would often invariably act as a disequilibrating factor, since it would be pure chance if the requirements of preponderant internal policies coincide with those of external equilibrium. If such coincidence does not obtain, then the requirements of internal policy under a system of fixed exchange rates would involve, sooner or later, the imposition of exchange and trade restrictions with all the disadvantages attending their use. In order to give precedence to domestic economic policies and at the same time avoid the use of restrictions on external transactions, the argument claims that the best policy would be to let the rates of exchange float continually.<sup>1</sup> Accordingly, it is argued that fixed (or even relatively stable) exchange rates represent a limitation upon the (licensed) pursuit of internal economic objectives (especially that of economic development) in the

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1. A system of fixed but adjustable exchange rates (such as the one provided by the International Monetary Fund) is also considered to be ineffective in this respect: "But for this purpose the Bretton Woods system is not adequate. Under a system of discontinuous adjustment, it is argued, we get the worst of both worlds. We forego the certainty of the fixed system; but we lose the flexibility of the free rate. Moreover, as the fundamental disequilibrium develops, speculation begins to operate. A bear position is built up against the currency affected; and when the change comes, as it has to come, it is in an atmosphere of general crisis, highly inimical to the choice of a new and suitable parity." Refer to Robbins, op.cit., p. 95.



sense that they act as a positively disequilibrating influence upon the external accounts of the country concerned. Thus, in a country bent on economic development, it is preferable to maintain floating exchange rates, if the process of economic development is not to be thwarted, and if an equilibrium in external accounts is to obtain without resort to restrictions and/or massive reductions of international liquidity.

In applying this argument to the peculiarities of the Lebanese economy, it is normally claimed that the objective of economic development is a socially more important and a politically more attractive objective than that of establishing convertibility in order to effect an equilibrium in the balance of payments. And since the establishment of fixed exchange rates puts a certain limit on the speed with which development projects may be executed, then a system of fixed rates should not be maintained by a country which expects to carry out large development projects as does Lebanon. This, in short, is the second version of the general argument when applied to Lebanon.

In attempting to refute the said version of the argument, it must be admitted that the maintenance of currency convertibility by a country does impose certain restrictions upon the rate at which economic development may be undertaken by the country in question. But, whereas such limitations are considered by the proponents of the said argument to constitute the basic reason



for which convertibility is not to be attempted now, they are looked upon by this writer as, perhaps, the most important advantage that attends the establishment and maintenance of currency convertibility by a developing country. The causes behind such a conviction will be explained below in the discussion of the various advantages which Lebanon is expected to procure when and if it declares the convertibility of its currency. Sufficient here to say only that, although it is granted that currency convertibility imposes certain restrictions on the uncontrolled pursuit of the objective of economic development, yet such restrictions constitute a reason for which fixed rates of exchange should be rendered preferable to floating rates, rather than the other way round as the argument chooses to claim.

There still remains to mention a word about the general argument which shows preference towards floating as against fixed or stable exchange rates. It should not be forgotten in such a discussion that a system of fixed or relatively stable exchange rates carries all the advantages which procure from the encouragement and growth of international trade (including services) and of international movements of capital. For stable rates are a sign of the strength of the currencies and economies concerned and are as such (and because international traders and investors are essentially no exchange speculators) conducive of confidence and certainty in future developments, which is of primary importance in encouraging

international trade and international movements of capital.<sup>1</sup>

### The Advantages of Convertibility to Lebanon

Having answered some of the more popular arguments against the desirability of a convertible Lebanese currency, it is now proposed to present the constructive part of the chapter, i.e., to discuss the positive advantages which the establishment of convertibility by Lebanon is expected to produce.

The first advantage consists of the definite limits which the establishment of convertibility imposes on potential financing possibilities and within which the government's monetary and financial policy in general would have to remain so long as convertibility is maintained. Such limits, it was shown above, are sometimes considered as a drawback of convertibility rather than as an advantage. However, they are here considered to constitute an important advantage to Lebanon, especially in view of the country's various development and reconstruction projects which are now being contemplated on a larger scale than at any time before. The government is becoming more and more aware of the necessity of economic development for the country, and is consequently being more strongly

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1. It is believed that the advantages of international trade and of international movements of capital are too obvious to require discussion here.

prompted for more active intervention in expansion schemes. However, this is not to say that economic development is the only factor that may incite undue financial expansion in Lebanon; other factors, mainly of a defense and social welfare nature, may as well lead to the same result. Economic development was singled out here only because of its importance in the present discussion and because it is pregnant with prospects of inflation, considering that it is the easiest measure of financing economic development. Accordingly, the first advantage of convertibility to Lebanon is that it prevents any undue financial expansion which is unwarranted in view of the country's international liquidity and foreign exchange earnings.<sup>1</sup> To claim that no such financial expansion in Lebanon has so far materialized into an actual danger is no conclusive evidence that a prospective danger of the kind does not exist.

It was mentioned in Chapter II above that a proper internal financial situation is one of the prerequisites or conditions of currency convertibility in the sense that the development of inflationary expansion beyond a certain extent imposes heavy strains upon the level of international liquidity of the country concerned and upon its foreign exchange earnings which in turn threatens its ability to

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1. As to how convertibility prevents financial expansion which is unwarranted in view of a country's international liquidity and foreign exchange earnings refer to Chapter II, supra.

maintain the convertibility of its currency. Thus, it was said to this effect that countries contemplating the establishment and maintenance of the convertibility of their currencies should see to it that no monetary expansion is allowed if it cannot be afforded in view of these countries' international receipts and international liquidity. Accordingly, if Lebanon is to maintain the convertibility of its currency as defined in the present chapter, it will have to avert any financial expansion (most probably generated by an unduly rapid process of economic development) which might prove to be too extensive in view of the country's international liquidity and current foreign exchange receipts. This is claimed to be the advantage which convertibility stands to offer to Lebanon in this respect. Of course, implied in such a process of reasoning is the assumption that financial expansion beyond a certain level is bad. More specifically, the argument assumes that inflation is incompatible with balanced economic development. The reasons behind such an assumption will now be exposed.

Broadly speaking, there are two schools of thought in relation to economic development and financial stability. On the one hand there are those who maintain that economic development should not be undertaken with financial stability because such a course of action would greatly retard the process of development; and that internal inflation, with its after-effects upon the external accounts of the country in question,

are apt to develop if rapid economic development is to be achieved. On the other hand, it is sometimes also advocated that financial stability creates in this respect the most favourable atmosphere for balanced economic development. Proponents of both schools of thought do not lack the arguments which they believe are adequate proof of the truth of their respective points of view. Some of the popular arguments of both sides of the issue will now be given in an attempt to show that balanced economic development is essentially uncongenial with inflationary pressures (at least after such pressures have developed beyond a certain stage).<sup>1</sup> It is proposed to begin with a discussion of the arguments for inflation as a means of financing economic development.

It is often claimed that inflation is highly contributive of economic development because it accelerates, though indirectly, the rate of capital formation. This is what is

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1. The following discussion of the arguments for and arguments against inflation as a means of financing economic development is primarily based on an article written by E.M. Bernstein and I.G. Patel on "Inflation in Relation to Economic Development", which appeared in I.M.F., Staff Papers, II (November 1952), pp. 363-398; and on the article by Felipe Pazos on "Economic Development and Financial Stability", which appeared in I.M.F., Staff Papers, III (October 1953), pp. 228-253.

usually referred to as "forced savings". A rise in prices which is brought about by the development of inflationary forces tends almost invariably to cause a reduction in general consumption in the country, thereby making possible a greater amount of aggregate savings. Furthermore, since inflation also leads to a redistribution of income in favour of high-income, profit-receiving groups,<sup>1</sup> and since the propensity to consume of such groups is normally lower than that of other groups in an economy, then inflation exercises a favourable influence upon a country's ability to save. Therefore, it is claimed that monetary inflation indirectly accelerates the rate of capital formation.

As it may be seen, the argument rests upon the conviction that higher prices reduce consumption which reduction is propitious to economic development since it accelerates the rate of capital formation. But whether rising prices actually lead to reductions in consumption is dependent on the elasticity of demand and of price expectations. And whereas at its initial stages inflation may result in forced savings and in a consequent acceleration of the rate of capital formation, consumption would tend to increase at a faster rate than that of the increase in monetary income, once the phenomenon of continually rising prices comes to be accepted as a normal

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1. The reasons for this assertion are given below.

situation. Thus, if inflation continues unchecked, there would come a time at which the rise in prices which it entails is no more effective in reducing consumption. And if the rate of increase of prices is not greater than the rate of increase in monetary income, the case for accelerating the rate of capital formation through inflation falls to the ground. It is at its initial stages, and only then, that inflationary rises in prices may result in reduced consumption.

The argument furthermore claims that inflation is favourable to economic development because of the redistribution of income which it gives rise to. Although it is here accepted that inflation redistributes income in the way presented by the argument, it is believed, nonetheless, that the outcome of such redistributive forces would result in unbalanced economic development. It is indeed very unlikely, judging by past experiences, for new investments financed by increased savings which are the result of the redistributive process to be directed into such channels as would result in a balanced process of development. It is more likely for savings thus procured to be invested in such fields as luxury consumption goods, luxury construction and speculation. Accordingly, although it may be granted that the redistributive factors let loose by inflation may increase investment, it is highly doubtful whether development thus financed would be dispersed over the various sectors of the economy in a way conformable with



balanced growth.<sup>1</sup>

Finally, one should question whether in the final analysis inflation actually results in a net increase in the rate of capital formation. As will be shown later, inflation exercises a positive influence in discouraging spontaneous (in contradistinction to forced) savings and in precipitating capital exportation that its net effect might as well be a deceleration rather than an acceleration of the rate of capital formation.

The second argument in favour of inflation as a means of financing economic development revolves around the assumptions that inflation increases production and that economic development is synonymous with increased production. It is argued that by constantly raising the level of monetary incomes, inflation insures a ready market for increased production and as such induces entrepreneurs to increase their production. Entrepreneurs would be induced to take such course of action not only because demand has sufficiently increased to absorb the inflated supply, but also because profit margins tend now to be larger, since inflation in general, and especially in its initial stages, is apt on the whole, to lead to a higher rise in prices than in costs. Accordingly, since inflation increases profit margins and inflates aggregate demand, it stimulates an increase in production which is tantamount - according to the

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1. This will be further explained below.

assumption made by proponents of the argument and given above - to economic development.

It should be admitted, in analysing this argument, that a slow rise in prices may prove to be beneficial to economic development in this respect, provided, however, and this proviso is very important, that sufficient and adequate control over prices is effectively maintained. Nevertheless, the argument is believed to have missed the important point in a consideration of the economic development of underdeveloped countries. Such countries suffer in their development programmes from an insufficiency of capital, of supply, rather than from a deficiency in monetary demand. Their major impediment against rapid development is the low income level and the consequent low level of savings. Thus, the problem is not as much one of deficient monetary demand, so that it may be solved through monetary expansion as it is a problem of lack of capital, or, to put it in another way, of deficient supply, which is very likely expected, when monetary demand is expanded through inflationary measures, to lead to higher prices rather than to increased production. Unlike highly developed countries which suffer a depression, and where monetary expansion may prove effective in animating economic activity in general, underdeveloped countries suffer from a basic shortage of capital. Monetary expansion may prove beneficial in the latter countries, but only to the extent that it brings about into activity otherwise idle productive capacity, and only in

so far as it does not develop into extents at which its social cost outweighs by far its other advantages. This is discussed further below in more detail.

Finally, it is sometimes argued that inflation is often invariably accompanied with exchange and trade controls of all types which are made necessary in order to avert balance of payments deficits and which may be used to protect local production interests from foreign competition. As such, inflation is believed to be conducive to economic development. Aside from questioning the economic viability of exchange and trade controls in this respect, it should be said, in answer to the above argument, that it is not at all necessary that internal inflation should at first obtain in order that protective measures of this type may be subsequently imposed. Furthermore, such trade and exchange controls are apt to create many obstacles and delays to international trade and international movements of capital which would greatly retard economic development. This is more so in view of the underdeveloped countries' dependence on imports of goods and services, and on capital inflows necessary to carry out their development programmes.

( From the above exposition of the three arguments in favour of inflation as a means of financing economic development, it can be seen that financial expansion may prove beneficial in this respect in its early stages only, but that if it is left unchecked, it may lose all its advantages and may in fact

prove to be disruptive of balanced economic development. Accordingly, it becomes imperative upon the authorities concerned to maintain adequate and effective control over internal financial expansion. The need for such control is the more pronounced in view of the tendency of inflationary forces to become cumulative and self-perpetuating once they are started.<sup>1</sup> Considering the prospects for such dangerous developments, currency convertibility presents the advantage of imposing effective limits on financial expansion.

The first argument against inflation as a means of financing economic development is the claim that it often leads to unbalanced development as regards the various sectors of the economy. Broadly speaking, investment is considered to consist of two major types. On the one hand there is that type of investment which increases demand for labour and supply of consumption goods, especially of such consumption goods as are normally in demand by the lower-income groups of the economy; on the other hand, there is the type of investment which promises high profits and high capital gains. The former is usually said to command high "use" or "social" benefits, and the latter high "ownership" or "private" benefits. Since businessmen are primarily prompted by profit motives, and since inflation accentuates the difference in profit margins obtaining in the two above mentioned types of investment, and

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1. The reasons for which inflation tends to become cumulative and self-perpetuating are discussed below in presenting the arguments against the use of inflation as a means of financing economic development.

since the effect of inflation is to redistribute income and wealth in such a way as to render them more concentrated in favour of profit receivers, inflation tends to direct investment into channels that promise the highest ownership or private benefits such as luxury consumption industries, luxury construction and speculation, rather than into outlets which involve higher social benefits, such as industry and agriculture in general. Upon this basis inflation is often accused of diverting the resources of the economy into socially less productive uses, thereby encouraging the development of certain given sectors of the economy at the expense of others.

The second argument against inflation in this connection consists of the high social cost involved in inflationary financing of economic development. Inflation, it is claimed, reduces the real income and wealth of the poorer classes of society and increases those of the richer classes. A shift in income in this way is effected because inflation tends to increase prices in general (and especially prices of consumers' goods in great demand) while costs on the whole, and wages and salaries more specifically, tend usually to lag behind. As such the distribution of income is apt to become more concentrated. Furthermore, inflation reduces the savings of those whose incomes are reduced, as well as it increases the savings of those in whose favour income has been redistributed. That part of the said increase in savings which is equivalent to

the reduction in the savings brought about by the interplay of inflationary forces should be regarded as a shift in the ownership of wealth from low-income to high-income classes. As such, inflation is considered to lead to a redistribution of wealth as well as to a redistribution of income, and in the same direction also. Such a redistribution of income and wealth is here considered to involve a high social cost which may endanger the political and social stability of the country concerned. This is more so in underdeveloped countries where differences in income and wealth among the various classes of society are normally more pronounced. The smaller is the shift in income and wealth the less would the social cost involved in inflationary financing of development tend to be.

Inflation is also attacked on the basis that it discourages spontaneous savings not only by those whose income is reduced but also aggregately because it involves a continuous depreciation (so long as prices are rising) of the value of money and monetary assets. In view of such depreciation, and in view of the expectation which it creates as to the probability of further depreciation, monetary savings and savings in common stocks would tend to be discouraged because of the risk of loss in value involved, and an increase in the amount of savings held in the form of real estate would tend to appear. It is believed that if inflation reaches the point at which confidence in the future purchasing power of money is basically shaken, then aggregate savings are almost certain to show a net



decrease. Furthermore, the fall in the value of money and monetary assets which inflation entails encourages the export of capital for investment abroad or simply for the purpose of being held abroad in gold or in other more stable currencies. As such, inflation reduces further the amount of local savings available for investment in the country concerned.

The decline in the value of money and monetary assets involved in inflationary expansion and the ultimate consequent loss of confidence in the internal and external purchasing power of local currency set a further impediment to economic development in so far as they make difficult, or even almost impossible, long-term financing at fixed interest rates. Government obligations extending over a relatively long period would lose their attractiveness for investors, thereby making the mobilization of private savings for development purposes more difficult. Such difficulty presents a greater impediment to economic development in underdeveloped countries where a greater share of development programmes is normally the responsibility of governments rather than of private entrepreneurs.

Finally, inflation is attacked on the basis that it tends to become cumulative and self-perpetuating. In so far as governments cannot raise adequate funds for financing development by calling on private savings, and considering the usual urgency of and priority given to development projects, governments would be tempted, and often are so tempted, to resort



to their issue agencies for financing development, thereby accentuating already existent inflationary pressures. Once inflation has been established in an economy, it is very difficult to stop it without causing basic disturbances. Hence the primary necessity for an effective tool to check undue inflationary developments at their initial stages. Currency convertibility represents such a tool for preventing undue financial expansion.

The second advantage which Lebanon stands to gain if the convertibility of its currency is undertaken is the ensuing stability and growth of capital movements in its balance of payments. It is to be recalled in this connection that capital movements constitute a major weakness of the Lebanese balance of payments. It was said in Chapter III above that one of the weaknesses of the Lebanese balance of payments derives from its dependence on capital movements, which caused, during the period 1951-1954 inclusive, net inflows ranging from approximately LL 40 to approximately LL 50 million annually. Considering that during the period under consideration annual balance of payments surpluses averaged around LL 34 million, a reversed movement of the same order at which capital was annually incoming would probably wipe away the annual surplus and may even precipitate a deficit in the balance of payments. Whether such a reversed movement is to be expected or not depends to a great extent on such factors as the nature of incoming capital funds and the future prospects of the country's economic and political stability.

It should be admitted at the beginning that not much is known about the sources and ultimate destinations of capital movements so that what will be said here should be taken to represent probably no more than informed impressions. Considering the motives behind them, foreign capital movements into Lebanon may, broadly speaking, be divided into three types. The first one includes foreign capital which is brought into the country in order to be invested in various outlets, and especially in real estate and in setting up business establishments whether in banking, trade or industry. The second type of foreign capital movements consists of funds which may most conveniently be referred to as "refugee" capital. Such funds are attracted into Lebanon primarily because of such factors as the country's relative political stability, and the free economic policy which it follows in general and the complete absence of exchange restrictions on capital transactions (as well as on all other transactions) in particular. Capital of this type is here referred to as refugee capital because it normally comes into Lebanon as a result of the political instability, the fear of inflation, or generally the unfavourable conditions in the country of origin, or because it manages to escape exchange and other controls there. It usually remains in the country of refuge (Lebanon in this case) under the form of bank current accounts until it is withdrawn either because the reasons which originally led to its flight from the country of origin no more prevail or

because more secure and generally more profitable places of refuge are found. Finally there are those capital movements which consist of what may here be called "transient" capital, which is normally handled by banks operating in Lebanon for ultimate investment abroad (mainly in the United States and Switzerland).<sup>1</sup> For such capital funds, Beirut serves the role of an intermediary and of a point of departure. However, nothing certain can be known about the period which such capital normally spends in Lebanon before it is ultimately<sup>2</sup> withdrawn.

From what has been said about the nature of capital movements into Lebanon it may be seen that the first type, that which is originally brought into the country for investment purposes, cannot be withdrawn in a short period of time except perhaps at a loss. But the other remaining two types of capital movements may be withdrawn in a hurry to the possible detriment of the country's banking liquidity and balance of payments position. It is the ease with which such capital funds may be withdrawn from the country at short periods that constitutes the greatest weakness of Lebanon's balance of payments. Although nothing certain is known about the size of

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1. Keesing, op.cit.

2. The division of incoming capital movements into the above three types is highly arbitrary and is not claimed to be clear-cut: e.g., it may very well happen that what is termed as "refugee" capital may in fact come to be invested in Lebanon in long-term investments.

such funds, it is believed that they constitute a sizable part of the total annual capital movements, and that they represent, as such, a real threat to the so far favourable balance of payments situation.

As mentioned above, convertibility in Lebanon would essentially entail the official stabilization of the exchange rate of the Lebanese pound. The advantage now under discussion that is expected to be derived from such a step is the increased confidence in the strength of the currency, which confidence has so far been materially contributive in attracting capital funds into the country. The reasons for the present confidence in the strength of the Lebanese currency are primarily due to the increase in the percentage of gold in the note cover, as well as to the relative stability of the exchange rate of the Lebanese pound vis-a-vis the US dollar. To declare the Lebanese currency convertible (thereby placing it in the category of the few currencies in the world which are de jure convertible) would add to its prestige and would thus certainly bring into interplay important psychological factors the effects of which would be expressed in increased confidence not only in the strength of the currency specifically, but also in the viability of the economy at large. Convertibility spells strength and as such it breeds confidence. Such added confidence as is expected from convertibility in Lebanon would have the welcome effects of materially contributing to the stability and growth of capital movements. Part of what is above referred to as refugee and

transient capital would now be tempted to remain in the country, and additional funds would also be attracted. The prospects of dangerous massive capital withdrawals would be highly weakened, thereby strengthening the general balance of payments position.<sup>1</sup> But this is not all. Convertibility would also exercise a favourable influence over the type of capital funds which are imported into the country to be invested. Because convertibility reflects the viability of the whole economy, increasingly more capital funds would be attracted into the country for investment purposes. As such, convertibility in Lebanon would make the country a more attractive recipient of foreign medium-and long-term capital funds (the present lack of which exercises an effective impediment to economic development) and would thus contribute to speed up the process of economic development. Finally, because of the above effects of convertibility, Lebanon's position as the financial centre of the Arab Middle East would be bolstered up, thereby increasing the revenue which the country annually derives from enjoying such a central financial position. For all these effects which convertibility is expected to produce, Lebanon stands to gain if it establishes the convertibility of its currency;

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1. This is not to say that convertibility is the sole factor implied in a programme for stabilizing the said two types of capital movements. Nonetheless, it is considered to be one of the most important factors in this respect.

the gain thus procured is in fact a very vital one in view of the importance of capital movements in the country's balance of payments and in view of their present vulnerability.

Finally, a third advantage of convertibility may here be registered. This refers to the contribution which the establishment of convertibility in Lebanon is expected to give towards the stability and growth of certain service items in the Lebanese balance of payments. With the exchange rates of the currency now officially stabilized, and with the freedom of exchange transactions for all purposes officially guaranteed, revenue from such services as tourism (including estivage), banking transactions and entreposage would be expected to become more steady and uniform, and it would also be expected to grow in size. With the increased confidence in the future strength of the currency, and with the further increased confidence in the continuing freedom and viability of the economy as a whole, a larger part of Middle Eastern trade would be effected through Lebanon, and especially through Beirut, (thereby contributing towards an increase in financial transactions which banks and other financial institutions situated in Lebanon handle on behalf of foreigners), as well as a larger number of tourists and estiveurs would annually be attracted to the country. Accordingly, the establishment of convertibility may be considered to

exercise, in this respect, a positive favourable influence towards making the country occupy the position of a financial, trade and entrepot center in the Middle East, and to represent an important step forward towards the integration of the Lebanese economy into an Arab and, more generally, Middle Eastern regionalism, both of which objectives are highly coveted by the authorities in Lebanon. In view of what was said in Chapter III above about the importance to Lebanon of both of these objectives, convertibility in this connection is expected to be vitally advantageous. Lastly, considering the favourable influence which convertibility is expected to exercise towards the integration of the Lebanese economy into an Arab and Middle Eastern regionalism and towards the establishment of Lebanon as the financial and trade center of the area, it may not prove too far fetched to say that convertibility may lead towards rendering the Lebanese currency into a regional, rather than a strictly national, currency. Such a development, if it comes to be materialized, would almost certainly increase Lebanon's annual revenue from service transactions rendered to non-residents and would, thereby, strengthen the general position of its balance of payments.



## CHAPTER V

### CONCLUSION AND RECOMMENDATIONS

The previous four chapters have attempted to give a definition of currency convertibility, to outline its various conditions and to present its advantages to Lebanon in view of the salient features of the Lebanese economy. This final chapter proposes, in way of a conclusion to the whole study, to give a summary of the advantages which Lebanon is expected to draw from convertibility; to inquire into whether Lebanon at present satisfies the four conditions of convertibility outlined in Chapter II, and is thereby able to undertake convertibility; to pass a judgement as to whether Lebanon should undertake to establish the convertibility of its currency now (in case it is found out that it can); and, finally, to indicate the presently most urgent prerequisites which must first be met if Lebanon is to establish convertibility.

It was seen in Chapter IV that there are, broadly speaking, three advantages to which the maintenance of convertibility is expected to lead. The first one consists of the definite limits which currency convertibility imposes upon the extent to which internal financial expansion may be allowed to develop. In the second place, convertibility is expected

to have the welcome effects of stabilizing (and probably increasing) annual foreign capital flows into Lebanon. Finally, the maintenance of convertibility entails the favourable contribution to the stability and growth of Lebanon's revenue from certain services which the country is currently rendering to non-residents. The first advantage constitutes a brake against excessive internal financial expansion, thereby preserving the country's internal financial situation. The other two advantages which are here claimed to accrue to Lebanon if it maintains convertibility are essentially concerned with the external accounts of the country. Both advantages, if they materialize, would prove instrumental in placing the balance of payments position upon more solid and secure bases, and would, thereby, increase confidence in the financial stability of the country. The importance of all three advantages to the Lebanese economy is perhaps better understood when it is remembered that the foreign trade sector currently accounts for about 24 percent of total national income of the country.

"The importance of convertibility lies not so much in what it is as in what it does and in the basic policies implied in its adoption. When national policies in harmony with the requirements of convertibility are adopted, all countries can share more fully the benefits of expanding world trade. Convertibility then becomes a powerful instrument for achieving internal stability, external balance, increased production and

trade, and higher standards of living."<sup>1</sup>

It is now proposed to investigate whether, in view of its four conditions presented in Chapter II above, convertibility can be established by Lebanon or not. It may be recalled that the four conditions of convertibility are the following: balanced international accounts, proper internal financial situation, satisfactory world payment situation and, finally, adequate international liquidity.

The first condition of convertibility is the realization, over a period of time, of equilibrium in the balance of payments without the need to resort, for the special purpose of achieving such an equilibrium, either to inflation or deflation at home, or to trade or exchange restrictions (including exchange rate fluctuations beyond one percent of a given rate). As shown in Chapter III above, Lebanon has enjoyed since 1951 (inclusive) a continuing annual surplus in its balance of payments, which amounted to about LL 57 million in 1954.<sup>2</sup> Such a surplus had for the most been achieved without resort to inflationary or deflationary developments in the country and, furthermore, without the

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1. Address by Ivar Rooth, Managing Director of the Fund, at the Ninth Annual Meetings of the Fund and the International Bank, op.cit., p. 109.

2. Although no estimates of the various components of the balance of payments for 1955 are available, it is nonetheless estimated that in the said year a surplus of about LL 43 million was registered. See Commerce du Levant, op.cit.

need for exchange or trade controls. For it is recalled that in November 1948 the open exchange market in the country was legalized, and the last exchange restriction was officially abolished in May 1952; that exchange rates have been relatively stable since August 1953; and, finally, that the liberalization of trade had enjoyed an almost parallel development to that of exchange liberalization; what still remains of trade restrictions cannot be attributed to a desire to prevent a deterioration in the external accounts situation: prior import licences are imposed for protective purposes and customs policy is essentially geared towards the objective of raising public revenues. Whether such a situation meets the first condition of convertibility or not depends upon whether the period over which the said situation has prevailed is regarded as sufficient or not. In discussing the requirements for balanced international accounts in Chapter II, it was said that the period over which equilibrium in the balance of payments prevails should be long enough to give time for reversible items in the balance of payments to consume themselves. It was further mentioned that it is normally preferable to take a period which is believed to cover a whole cycle, especially when the exports of the country under consideration are subject to cyclical fluctuations (such as is normally the case with primary commodities). However, it is very difficult, if not impossible, to determine exactly the length of the cycle (if any) which the Lebanese balance of payments is subject to. In

view of such difficulty, and in view of the comparative unimportance of primary commodities in Lebanon's total exports, it is believed that the period 1951-1955, over which the Lebanese balance of payments has shown continuous annual surpluses, constitutes, for the present purpose, enough evidence that Lebanon satisfies the first condition of convertibility. To claim that balance of payments surpluses which obtained during the first two or three years of the period 1951-1955 would have not been achieved had trade and exchange restrictions not been maintained is not tenable, for all during the said period Lebanon's foreign trade was essentially free, and whatever exchange restrictions existed between 1951 and May 1952 affected an insignificant portion of total exchange transactions; furthermore, the exchange rate of the Lebanese pound vis-a-vis the US dollar, though not stable, had actually risen (as a reflection of balance of payments surpluses) from an annual average of LL 3.73 in 1951 to LL 3.66 in 1952, LL 3.42 in 1953 and LL 3.20 in 1954.<sup>1</sup> Accordingly, balance of payments surpluses during 1951-1955 inclusive were not achieved because of the country's resort to trade or exchange restriction. And since during the said period the country did not witness any internal deflation of importance, it may be concluded that Lebanon does actually

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1. Since August 1953, it has been relatively stable moving between LL 3.20 and LL 3.25 only.

satisfy the first condition of convertibility.<sup>1</sup>

The second condition of convertibility is the maintenance of a proper internal financial situation, more specifically, the prevention of undue financial expansion. As for Lebanon, it may be easily seen from Table 9 above that wholesale prices and cost of living indices have appreciably fallen between 1948 and 1954, and that, accordingly, no undue financial expansion occurred during the said period. However, it is worthwhile in this connection to mention that both indices of prices have shown a tendency to rise beginning with the early months of 1955. Thus, taking prices in March 1955 as a base, the indices of wholesale prices and of cost of living were 109 and 110 respectively. It may be too early now to pass a judgement about the causes of such a rise in prices or about its prospective developments and effects on the external payment position of the country. Nonetheless, it may be mentioned that wholesale price rises in France, the United Kingdom and the United States rose by much less than this amount during the same period (i.e., by 2% in France, 3% in the United Kingdom and 2% in the United States). Since these three countries are among the most important trade partners of Lebanon, the reasons for price rises in Lebanon should be

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1. The fall in wholesale prices and cost of living indices shown in Table 9 above are not the result of internal deflationary forces generated by an attempt to restrict importation, but are rather a reflection of the worldwide force of a general postwar fall in prices.



sought locally. It is believed that the recent devastation caused by the flood of the River Abu Ali in North Lebanon and by the earthquake, alongside the embargo imposed by Syria on the export of livestock and the bad local olive crop may partially account for such rises. A tendency for overstocking initiated by the recent heightened political tension between the Arab States and Israel and the fear of an Arab-Israeli war, is also believed to have had the same effect. More important than all that, however, is the large increase in money supply witnessed during the last two years. Currency circulation increased from LL 205 million at the beginning of 1954 to LL 266 million at the end of 1955, whereas private demand deposits increased from LL 189 million to LL 299 million during the same period, thereby leading to a total increase in money supply of about LL 171 million (or an increase of almost 44 percent). The reasons for such a large increase in money supply are twofold: <sup>1</sup> the policy followed by BSL (in line with the government's instructions) in buying US dollars in the local open market to prevent a decline of the dollar-pound rate below LL 3.20/US\$ 1; and the sizable expansion in bank credit. Although no exact figures are available, it is believed that large amounts of US dollars were purchased during 1954 and 1955,

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1. The above increase in money supply is not believed to have been initiated by the government's expenditure policy, because budget results for 1954 showed a net surplus of about LL 32 million, and, although its closed account has not yet been published, the budget for 1955 is also expected to show a net surplus.



because the gold cover increased by about LL 126 million during the same period. (It is recalled that BSL normally buys gold with the dollars thus purchased and places it in the note cover.) As for the bank credit expansion, it is believed that a general increase in economic activity and a large inflow of foreign capital funds go far in explaining it.

The question to be investigated here is to see whether recent price rises constitute an impediment in the face of establishing convertibility or not. It was seen that up to the end of 1954, prices in Lebanon were generally falling,<sup>1</sup> and, as such, it is believed that Lebanon satisfied the second condition of convertibility. It is, furthermore believed that Lebanon still satisfies this condition of convertibility; because, despite the price rise which began a year ago, there has not been recorded any strain in the foreign sector of the economy: the US dollar rate vis-a-vis the Lebanese pound remained relatively stable at its previous level<sup>2</sup> and would have almost certainly fallen had not BSL bought dollars in the open market. Price rises constitute a difficulty in the face of maintaining convertibility in so far as they are reflected in a tendency of the external value of the currency concerned to fall. Thus, since recent price

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1. Refer to Table 9, Chapter III, supra.

2. The said rate has lately fallen to LL 3.22/US\$1.

rises in Lebanon have not, so far, unfavourably affected the exchange rate of the Lebanese pound, they cannot be considered as constituting a threat to the country's ability to maintain convertibility. As such, Lebanon continues to satisfy the second condition of convertibility, despite the recent internal price rises.

The third condition of convertibility is the prevalence of a satisfactory world payment situation because of the danger of discrimination by non-convertible countries, which convertibility entails in case the external payment position of major trading countries continues to be difficult. Since the establishment of convertibility normally opens the economy concerned to a greater extent of foreign competition, and since it may involve discrimination by non-convertible currencies as mentioned in Chapter II, it is necessary that the world's payment situation be somewhat eased before a country undertakes to establish convertibility alone and by itself. However, such an argument does not apply to the particulars of the case of Lebanon, because the establishment of the convertibility of the Lebanese currency would not probably imply an increase in the extent of foreign competition, because Lebanon's foreign trade is already essentially free; and because no significant increase in foreign discrimination (if any exists today) would be expected since, as mentioned above, the Lebanese pound already enjoys a de facto convertibility. If even with an essentially open economy and a de facto convertible currency balance of payments surpluses

are being accumulated, a reversal of the present order of things is not normally expected to follow as an outcome of the de jure establishment of convertibility. However, notwithstanding the faint prospects of increased foreign competition and discrimination which may develop following the establishment of convertibility by Lebanon (and which may impose new drains on the balance of payments of the country thereby making the task of maintaining convertibility more difficult), it may be repeated here that the international economic climate is getting increasingly propitious and that the dollar gap has essentially disappeared. The recent reduction in the discounts at which various major inconvertible currencies of the world are being quoted in free exchange markets bears witness to these developments. Accordingly, it is believed that Lebanon satisfies the third condition of convertibility also. The establishment of de facto convertibility has been invaluable in rendering the task of establishing de jure convertibility easier.

Finally, there remains the fourth condition of convertibility which is the adequacy of international liquidity. Chapter II above defines international liquidity and presents various standards for measuring its adequacy. However, in a country like Lebanon where de facto convertibility of the currency is maintained and where practically no exchange controls exist, official holdings of gold and convertible currencies highly underestimate the country's actual international liquidity,

because they do not include private holdings of international liquidity. Since no exchange controls in this connection exist in Lebanon (as well as no legal requirements upon private banks to give the amount of their holdings of international liquidity to the authorities concerned), it becomes very difficult to estimate the value of the country's international liquidity and to subsequently determine whether it is adequate for the purpose of maintaining convertibility or not. However, even though an exact calculation of the country's international liquidity cannot be undertaken under present conditions, it is nonetheless believed that the country has enough international liquidity to enable it to establish and maintain the convertibility of its currency. Thus Professor Klat of the American University of Beirut states that Lebanon's reserves of international liquidity are today (1955) sufficient to face large future deficits in the balance of payments.<sup>1</sup> It should be mentioned in this connection that Lebanon's private reserves of international liquidity would serve to cushion unfavourable balance of payments developments before the need to resort to official reserves manifests itself.

From the above exposition of whether Lebanon currently satisfies or not the general four conditions of currency convertibility has emerged the conclusion that all four conditions are satisfied by the Lebanese economy. However, this is not

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1. Klat, "Le Commerce et Ses Incidences Sociales,"  
op.cit., p. 96.

to say that convertibility must be established instantly. There still exist certain minor conditions of convertibility which are implied in the more general ones and which Lebanon should first satisfy in order that the establishment of convertibility may be undertaken. Chief among these are the declaration of a new and more realistic par value of the Lebanese pound, and the need for an effective financial (and especially monetary) policy to prevent undue financial expansion. These two requirements will now be discussed in a presentation of the various factors claimed to constitute practical impediments against the establishment of convertibility by Lebanon today.

Although it is admitted that convertibility for Lebanon may prove advantageous by itself, yet it is sometimes claimed that the task of establishing and maintaining convertibility may be faced with various practical difficulties the existence of which may render it preferable not to establish convertibility at all, or, at least, to defer its establishment to a more favourable time in the future.

The first practical difficulty to be faced concerns the obligations of Lebanon vis-a-vis the International Monetary Fund; more specifically, it consists of the various implications which are involved in case Lebanon accepts the provisions of

Article VIII instead of those of Article XIV of the Fund's Articles of Agreement (i.e., in case it establishes the de jure convertibility of its currency). It is recalled here that a country which avails itself of the transitional arrangements implied in Article XIV, Section 2, may impose new restrictions on exchange transactions for current payments without the prior approval of the Fund whereas it may not do so once it accepts to undertake the obligations implied in Article VIII. Thus, it is argued that if Lebanon establishes the de jure convertibility of its currency, then the implementation of an effective policy to check the effects of unfavourable balance of payments developments once the need manifests itself would be retarded; whereas, under Article XIV, a member country would be free to act at a much earlier moment. Such line of reasoning, however, begs the question of the adequacy of Lebanon's international liquidity for the purpose of maintaining convertibility, and as such, in view of what was mentioned above, is not believed to fit the actualities of the situation. So long as it satisfies the general four conditions of convertibility, Lebanon is not expected, under normal situations, to find itself in need to impose restrictions. If, however, a major and sudden unfavourable balance of payments factor develops, it is believed that the Fund would not hesitate in permitting the imposition of those exchange restrictions on current account which are



thought to be necessary to handle the new situation or, alternatively, in authorizing drawings on the Fund's resources. Thus, in a memorandum prepared by the Exchange Restrictions Department of the Fund it is stated, with regard to the Fund's policy attitudes concerning countries coming under Article VIII, that, "The Articles of Agreement do not differentiate between various types of restrictions, designating some as more acceptable to the Fund than others, and the Fund's basic position must be to encourage the removal of all exchange restrictions which include restrictions on current payments, discriminatory currency arrangements and multiple currency practices. This does not mean, however, that the Fund would be unable to approve on a temporary basis certain restrictions, which a country feels are suited to its circumstances than possible alternative restrictions, and for whose maintenance a good case could be made".<sup>1</sup> Furthermore, the Fund stands ready, as shown in Chapter II, to enter into stand-by arrangements with member countries contemplating to establish the de jure convertibility of their currencies. Notwithstanding this, however, Lebanon would still be able, if the need arises, to impose certain exchange restrictions without the prior approval of the Fund. Such restrictions concern those imposed on exchange transactions

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1. International Monetary Fund, Policy Aspects of the Article VIII and Article XIV Problem, SM/54/107, Washington, D.C., October 21, 1954, p. 4. (Typescript.)



for capital transfers. (However, it should be mentioned that, as pointed out above, it might not prove easy for the Lebanese authorities to effectively impose exchange restrictions on transactions for capital transfers.)

Accordingly, since the need to resort to exchange restrictions in general after convertibility has been established in Lebanon (let alone the need to resort to restrictions on current payments) is not expected to prove to be of pressing importance, especially in view of the present de facto convertibility of the Lebanese pound, the claim that the establishment of de jure convertibility involves the difficulty of retarding the resort to exchange restrictions on current payments is not apt to carry great practical significance.

There is, however, another difficulty which is normally claimed to be implied in the transition from Article XIV to Article VIII. It is argued that in case a country declares the de jure convertibility of its currency, other member countries would tend to become interested in buying the new convertible currency from the Fund. This might turn the non-interest-bearing bonds, which represent the said country's subscription to the Fund made in its local currency, into active internal purchasing power, thereby generating new inflationary pressures. A danger of this kind is very unlikely to materialize in Lebanon, since all of its subscription in

Lebanese pounds (equivalent to US\$ 3.375 million) amounts only to about 2 percent of total money supply at the end of 1955 and 0.8 percent of national income in 1954.<sup>1</sup> On this basis, the claim that convertibility might thus entail the generation of inflationary pressures is grossly exaggerated.

A second difficulty expected to be faced in maintaining the convertibility of the Lebanese currency derives from the alleged sensitivity of the Beirut exchange market. It is claimed that exchange rates in the Beirut market are so sensitive to outside developments of economic, political or other nature that the maintenance of convertibility would prove to be a very difficult task for the local authorities to undertake. However, although it may be here admitted that the local exchange market is particularly sensitive to outside developments, it is not at all necessary to conclude that Lebanon should not undertake the establishment of its currency convertibility. What such sensitivity may go to point out to is the need for a larger amount of international liquidity than may otherwise prove necessary. Under its present external payments situation, and considering the prospective future developments of its balance of payments position, Lebanon today

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1. The US\$3.375 million were converted into Lebanese pounds at the rate of LL 3.23/US\$1, which is about the average exchange rate between the US dollar and the Lebanese pound that obtained during 1954-55 in the free exchange market of Beirut.

is believed to have sufficient public and private international reserves to enable it to embark on the path of convertibility with confidence. "The Lebanese balance of payments, and indeed the whole economy, has shown considerable resilience during the last fifteen years, riding out two crises without grave consequences. The Allied Armies expenditure in Lebanon and Syria ..... dropped suddenly in 1946 and 1947, and yet the balance of payments of the Syrian-Lebanese area, estimated to have shown a surplus before the war under the mandatory regime, recovered very rapidly from that blow. In 1950 the Syrian-Lebanese customs union terminated: traditional outlets for Lebanese exports of goods and services, as well as convenient sources of basic commodities, seemed to be imperiled, yet the surplus in the Lebanese balance of payments increased thereafter."<sup>1</sup> Although the high sensitivity of the local exchange market renders the task of maintaining convertibility more difficult, yet the resilience of the whole economy as well as its relatively large international reserves and its favourable balance of payments position act as a strong shield against unfavourable developments that may threaten the maintenance

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1. I.B.R.D., The Current Economic Position and Prospects of Lebanon, op.cit., p. 23.

of convertibility. The present discussion should not pass without repeating that for the past almost three years, exchange rates in the Beirut market, despite changes in world conditions, had continually been relatively stable.

Lastly, it is sometimes claimed that Lebanon, being a relatively small and unimportant country in world trade, should not establish convertibility before other major countries (especially the United Kingdom and France) undertake such course of action themselves. The reason for this is probably the fear that such major countries may discriminate against Lebanon, thereby rendering the maintenance of convertibility very difficult. In answer to this argument it may be said that there is no reason why a country that satisfies the various conditions of convertibility should not establish it before other countries. As far the fear of discrimination, it was mentioned in the present chapter that such a fear bears little prospects of being actually materialized.

There are two major difficulties, however, that stand in the way of an immediate establishment of convertibility. The first one concerns the declaration of a new parity of the Lebanese pound to the Fund, with all the difficulties that attend such a step. Aside from the implications of a

de jure devaluation of the new parity,<sup>1</sup> there is the difficulty of settling on an exchange rate that would prove to be neither too high nor too low, and as such to be possible to maintain without great difficulty. For although the exchange rate of the Lebanese pound vis-a-vis the US dollar has been stable at around an average of LL 3.23/US\$1 during the past three years, yet this is not believed to constitute conclusive evidence that such a rate would prove to be the most suitable parity for the Lebanese pound. The difficulty of deciding upon a new par value for the Lebanese currency is essentially another aspect of actually determining what is normally referred to as "the equilibrium rate of exchange". For the purpose of the present study, the equilibrium rate of exchange may be defined as that rate which, over a given period of time, maintains equilibrium in the balance of payments.<sup>2</sup> Its criteria are objective and readily discernible. They permit the determination of whether a given rate of exchange is or is not at an equilibrium level. "They do not, however, like purchasing power par, enable us to go further and determine, in the event of

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1. These implications were discussed in Chapter IV.
  2. The terms "period of time" and "equilibrium in the balance of payments" have already been defined; refer to Chapter II, supra.

disequilibrium, what the equilibrium rate actually is."<sup>1</sup> In determining the equilibrium exchange rate such factors as the level of international liquidity, the potential magnitude of prospective balance of payments disturbances, the flexibility of prices and costs as well as the past and prospective movement of prices and costs both at home and in other major trading partners must be taken into consideration. "In brief, what is needed is an estimate, for some years ahead, of the country's balance of international payments, and of the major forces likely to affect it. Though data such as these, where obtainable, cannot be lumped together in any formula which automatically gives the equilibrium exchange rate, they can afford a basis for judging its approximate level."<sup>2</sup> And since there must be given enough time for producers, sellers and buyers to adopt themselves to a given exchange rate, then whether a given rate is at the equilibrium level or not can only be determined after sufficient time had elapsed to allow the course of balance of payments to respond to it.

Another difficulty implied in a declaration of a new parity for the Lebanese pound derives from the procedure presently followed in computing ad valorem import duties. As mentioned in Chapter III, ad valorem duties are calculated by the customs authorities on the basis of official rates of exchange, which are only about two-thirds of the free rates actually paid by

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1. P.T. Ellsworth, The International Economy, (New York: The MacMillan Company, 1952), p. 608.

2. Ibid., p. 609.

importers. As such, the declaration of a new parity which would more or less coincide with present free market rates would automatically raise all ad valorem custom duties by about one-third<sup>half</sup> of their present level. However, although this may somewhat complicate the task of establishing convertibility it is not expected to prove a serious impediment on the road to convertibility. More serious is the difficulty concerning the choice of a proper new parity.

The second difficulty in the way of the immediate establishment of convertibility is the non-existence of various prerequisites for an effective financial policy in general and for monetary policy in particular. Of special importance in this connection are "the present lack of information about the position of the banking system and about the role played by foreign capital" and "the poor coordination existing between the BSL and the private banks on the one hand, and between the government and the BSL on the other hand"<sup>1</sup>. As mentioned in Chapter III and IV of the present dissertation, there is no banking law in Lebanon which defines banking institutions and outlines their functions and obligations, and, as such, information about the banking system in general is inadequate for the purpose of drawing an appropriate bank credit policy for the country; it was also mentioned that despite the fact that BSL sometimes acts as a banker of last resort to certain banks, yet many of the banks operating in the country are

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1. Keesing, op.cit.



usually reluctant to resort to it because they regard it as a strong and privileged competitor; that BSL has no legal authority to supervise the activities of other banks; that present legislation gives the government the authority to supervise the proper application of rules concerning the note issue only but not the other activities of BSL (which today can expand the note circulation by about 100% of its present volume); and, finally, that little is known about the sources and ultimate destinations of inflows of foreign capital funds. All this goes to show that a proper and effective monetary policy can be implemented only with great difficulty. In view of the important role which the internal monetary (and financial) situation plays in the maintenance of currency convertibility, it would be rash to establish convertibility without first providing for the above mentioned deficiencies. If the establishment of convertibility is not to prove a step in the darkness, a constantly vigilant monetary policy should always be at work. "The primary risks of convertibility derive, not from the policies which must be followed if convertibility is to be maintained, but from the possibility that these policies will not in fact be followed: either because of the lack of understanding or determination of those who should be determining policy; or because knowing what policies should be followed,

they do not possess the instruments necessary to carry out these policies; or because they are prevented from carrying out these policies by interference from others." <sup>1</sup> In view of the various advantages of convertibility to Lebanon, and considering the importance of the foreign sector in the country's economy, convertibility should be established as soon as possible. It is on the basis of this conviction that a presentation of the immediate steps which the government should take before an attempt at establishing convertibility is made will now be undertaken.

It was mentioned above that the two impediments in the way of the immediate establishment of convertibility in Lebanon are first, the difficulty concerning the declaration of a new par value of the currency and second, the non-existence of various prerequisites for a proper and effective monetary policy. As such, the first requirement that should be fulfilled by the competent Lebanese authorities would be to undertake a serious study for the purpose of deciding upon a new and proper par value of the Lebanese pound. And the second would be to undertake such steps as are necessary to render easier the task of devising and effectively implementing a proper monetary policy. Under this second requirement

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1. A. Marget, Director of the Division of International Finance, Board of Governors of the Federal Reserve System, International Financial News Survey, VII (June 24, 1955), p. 397.

three principal conditions are believed to prove of invaluable importance.

The first condition is the availability of adequate and reliable statistical data in general and data concerning the monetary situation and banking system in particular. Among the first type of required data would be included, without limitation, statistics about the national income and its distribution among the various sectors of the economy and among population groups; about the balance of payments (and especially about the role played by inflows of foreign capital funds); about price movements including movements of factor costs and wages and salaries; about population and its net rate of growth (or decline); about the level of employment and the working population and its distribution among the various sectors of the economy; etc. The second type of data would include, among other things, such information as money supply - divided between currency in circulation and demand deposits -; currency cover; total bank credit by type, duration and collateral offered; bank discounts and their types; value and types of discountable commercial and Treasury paper outstanding; yearly balance sheets and monthly (or bi-monthly) statements of the activities of banks and other financial institutions in the country; etc. Such statistical data, it should be repeated, is invaluable for the purpose of devising the proper monetary policy which the objective of maintaining currency convertibility

renders imperative and for the purpose of providing an objective criterion with which to measure the effectiveness of such policy.

The second condition is the enactment of a comprehensive banking law which would include such provisions as the clear definition of banking institutions and of banking transactions; the imposition of a minimum reserve requirement and liquidity ratio; the determination of minimum capital requirements; and the stipulation for governmental control over and investigation of the activities of banking institutions as well as the determination of the conditions of such control and investigation.

Finally, since it is believed that BSL should not, under present circumstances, be asked to devise and supervise the implementation of monetary policy,<sup>1</sup> and since the preparation of the annual budget of the state and the supervision of fiscal operations within the other ministries presently occupy all the time of the Ministry of Finance, it is here suggested that a new agency (probably under the name of Money and Credit Board) be established by the responsible authorities. Among the functions of the said Board would be to study the present banking and monetary situation in the country and to collect the required information upon the basis of which it

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1. Refer to Chapter III, Currency and Banking, supra.

would devise a proper monetary and credit policy in general; to advise the Minister of Finance as to the means and ways of implementing monetary and credit policies and to supervise their actual implementation; to draw up the comprehensive banking law referred to above; to help organize a sort of bankers' association for the purpose of increasing cooperation among banks, thereby reducing the relative high degree of individualism which presently characterizes the banking system; to undertake the study concerning the declaration of a new and proper par value of the currency; and, finally, to exercise a strict control over the activities of the Issue Department of BSL as well as over the other central banking activities which BSL is presently undertaking. Such control would prevent any change in currency circulation before it is first approved by the Board itself, thereby putting an end to BSL's present ability to increase the note circulation at its discretion. Furthermore, when the other central banking activities of BSL (especially the rediscounting of commercial paper and the extension of credit to other banks) are also controlled by the new agency, it is expected that a larger number of local banks would tend to resort to BSL in case of need than they would otherwise do, thereby also helping in increasing the coordination between the other banks and BSL. As for its organization, it is believed that the Board should not be exclusively governmental, but rather that it should include certain bankers' representatives,

probably appointed through the bankers association referred to above. Needless to say, the effectiveness of the said Board would highly depend on the availability of trained personnel, and serious efforts should be made in order not to create a new impediment in this respect.

In concluding, it may be said that convertibility is apt to prove very advantageous to Lebanon, and as such, it should be established and subsequently maintained. However, two requirements must first be fulfilled before convertibility is attempted. The first one is the creation of a Money and Credit Board in the Ministry of Finance which would be entrusted with the function of devising and implementing the monetary and credit policy which the maintenance of convertibility would call for; and the second is the declaration of a new and proper par value of the Lebanese pound after a serious study of the problem had been made. The provision for monetary policy is not believed to be contradictory to the principle of economic liberalism which is followed in the other fields of economic activity in Lebanon and which has proven to be very beneficial to the Lebanese economy. There is a great deal of difference between monetary policy as recommended here and the complete lack of government intervention: it is the difference between liberty and licence, between order and chaos.

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