Multilateralizing Trade and Payments in Postwar Europe

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The liberalization of intra-European trade in the years immediately following World War II offered potentially large welfare gains to European societies. In this period European trade flowed through a network of two hundred bilateral agreements. In the two years after the war intra-European trade increased rapidly within this bilateral framework, but by 1947 the growth had halted.[1] Shifting from this bilateral system to a multilateral clearing union could have provided a first step toward trade expansion. In spite of the potential benefits multilateral clearing offered, however, it was not until September 1950 that European governments established an effective multilateral clearing union, the European Payments Union (EPU).

Once established, the EPU had a dramatic impact on intra-European trade. The clearing union freed trade credit and greatly reduced European governments' need to resort to discriminatory quantitative restrictions for balance-of-payments considerations. Trade liberalization within the framework of the Organization for European Economic Cooperation (OEEC) quickly followed. By 1954 80 percent of intra-European trade had been freed from quantitative restrictions, and governments had begun to consider meaningful tariff reductions as well.[2] Thus, inducing European governments to enter a multilateral clearing union in 1950 marked the critical first step toward nondiscriminatory trade in postwar Europe.

I use the Rational Design framework to explore how the institutional structure supporting the multilateral payments arrangements facilitated Europe's shift to

Earlier versions of this article were presented at the Program on International Politics, Economics, and Security at the University of Chicago, February 1998; the Rational Design conference, Chicago, May 1998; and the 1998 Annual Meeting of the American Political Science Association. For helpful comments, I thank Barbara Koremenos, Charles Lipson, Lisa Martin, Walter Mattli, Tim McKeown, Jim Morrow, Robert Pahre, John Richards, Duncan Snidal, Terry Sullivan, the Comparative Politics Discussion Group at the University of North Carolina at Chapel Hill, and the editors and anonymous reviewers of *IO*.

1. See Eichengreen 1993; and Diebold 1952.
2. Asbeek-Brusse 1997, 83.

International Organization 55, 4, Autumn 2001, pp. 949–969
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https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

multilateralism. This question has received little explicit attention in the existing literature. Standard accounts of the Marshall Plan, in which the EPU figures prominently, and the one detailed history of the EPU largely ignore the strategic and institutional aspects of Europe's shift to multilateralism.[3] Barry Eichengreen's work on the EPU is more explicitly institutionalist.[4] Eichengreen suggests that European governments chose the EPU over full convertibility because domestic political considerations—in particular, the need for business and labor agreement on wage moderation and investment levels—made them unwilling to accept the real income losses full convertibility would necessarily entail. What Eichengreen neglects, however, is the fact that the very concerns that made European governments reluctant to adopt full convertibility also made them reluctant to adopt more limited multilateral clearing arrangements like the EPU. Thus, existing work provides little insight into how distributive conflict, uncertainty, and enforcement problems blocked Europe's transition to multilateralism or into how specific elements of the EPU's institutional framework facilitated this transition.

In examining Europe's postwar shift to multilateralism I evaluate six conjectures drawn from the Rational Design project. The specific conjectures relate three dimensions of institutional design—flexibility, centralization, and control—to four of the project's independent variables: distributional problems, enforcement problems, uncertainty about the state of the world, and asymmetry of contributions. To evaluate the conjectures linking these variables, I first demonstrate that the independent variable did in fact frustrate European governments' transition to multilateralism. I then examine the degree to which the institutions that governments designed in response to these characteristics of the bargaining environment are consistent with the expectations of the Rational Design framework. The results are quite encouraging. Five of the six conjectures I examine receive very strong support. The sixth conjecture receives only moderate support, but this is more a result of idiosyncratic features of the Marshall Plan than of a weakness in the Rational Design framework.

The article proceeds as follows. I first describe the postwar bilateral trade system in western Europe and explain how multilateral clearing arrangements would work. In the second section I focus on distributional problems and uncertainty about the state of the world. I explain how distributive conflict and uncertainty about the state of the world made European governments reluctant to adopt multilateral arrangements; I then elaborate how the flexibility and centralization imparted to EPU institutions reduced the severity of these problems and thereby facilitated the transition. In the third section I focus on enforcement problems. I explain how the enforcement problem made U.S. officials reluctant to capitalize the payments union and how U.S. policymakers responded by designing centralized institutions that helped limit the kind of behavior they feared. In the final section I summarize the

3. See Hogan 1987; Kaplan and Schleiminger 1989; and Milward 1984.
4. Eichengreen 1993.

https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

degree to which the case supports the Rational Design conjectures and offer some concluding comments.

Bilateralism and Multilateralism in Postwar European Trade

Bilateral agreements in postwar European trade were necessitated by the inconvertibility of European currencies and designed to ensure that imports from particular trading partners were paid for by exports to the same partner.[5] Each bilateral agreement established a list of commodities that the contracting governments agreed to import from each other in specified amounts. Many of these agreements also predetermined prices for these commodities. While bilateral agreements were oriented toward bilateral trade balance, most also contained short-term "swing" credit arrangements that allowed temporary departures from balanced bilateral trade. Bilateral deficits larger than the credit lines offered in the agreement often required settlement in 100 percent hard currency.

While the bilateral system allowed intra-European trade to reemerge in the immediate postwar period, by 1947 bilateralism had reached the limits of its usefulness. The assumption on which bilateral agreements were based, that bilateral trade would be balanced, proved incorrect. Intra-European trade was in disequilibrium. As Table 1 shows, Belgium, Italy, France, Sweden, and Switzerland ran net surpluses on their European trade, while the other countries ran net deficits.[6] These persistent imbalances exhausted available credit, and as a result "downward pressure was placed on the entire network of Europe's trade."[7] When the credit lines available in a bilateral agreement were exhausted, governments either used quotas to restrict their imports from specific countries or in extreme cases stopped trading with some partners altogether. France, for example, ceased importing entirely from Belgium in late 1947, as did Sweden in March 1948. The persistent imbalances and limited credit that characterized postwar bilateralism, therefore, constrained the expansion of trade. Moreover, heavy reliance on quotas to restrict trade when credit limits were reached introduced considerable distortions into European trade, as governments purchased goods from countries with which they had a bilateral surplus or that were willing to grant credit rather than making purchases from producers offering the lowest price.

A multilateral clearing union offered a solution to the problems posed by bilateralism. While the specific elements of clearing mechanisms can be complex,

5. For a description of this system see Patterson and Polk 1947; and Diebold 1952.

6. The British trade deficit in 1949 is, to some extent, misleading. This large deficit reflected the overvaluation of sterling. After the 1949 devaluation, the United Kingdom moved into surplus on its European trade. However, because of the problem of sterling balances, the British bargaining position shared more in common with the other European debtor governments than with the other European creditors.

7. Eichengreen 1993, 16–17.

https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

TABLE 1. *Net balances on European trade, 1949 (in thousands of $US)*

Country	*Net trade balance*
Austria	−107,756
Belgium-Luxembourg	277,550
Denmark	39,851
France	49,350
Greece	−134,250
Italy	243,214
Netherlands	−120,037
Norway	−108,284
Portugal	−53,783
Sweden	113,783
Switzerland	93,817
Turkey	18,597
United Kingdom	−297,127
West Germany	−14,925

Source: The Operation of the Clearing Union, 20 February 1950, in File: Finance, P.; Finance and Trade Division, 1949–52; RG469.2.2, NACP.

the underlying principle is simple. Under a bilateral system each government has multiple bilateral balances; some of these bilateral balances will be in deficit, and others will be in surplus. Under a multilateral clearing arrangement the credits available in surplus bilateral accounts are used to settle the debts owed in the deficit bilateral accounts. A stylized example can illustrate. Suppose that Britain has a $6 million deficit with Italy, Italy has a $6 million deficit with Belgium, and Belgium has a $5 million surplus with Britain. Under a multilateral clearing system Italy could use its credit with Britain to settle its debt to Belgium.

Multilateral clearing offered two advantages to bilateralism. First, clearing would reduce total outstanding credit obligations. In the stylized example, multilateral clearing would reduce outstanding obligations from $17 million to $11 million.[8] The $6 million of cleared credit could then be used to finance additional trade. In the real world, it was estimated in 1948 that full multilateral clearing could cancel $278.9 million of an existing $762.1 million debt in the European trade system. Second, multilateral clearing would allow governments to focus on their net position against the OEEC as a whole rather than on individual bilateral positions. This in turn would allow governments to remove the discriminatory quantitative restrictions they had

8. Under the bilateral agreements, Britain owes Belgium $5 million, Italy owes Belgium $6 million, and Britain owes Italy $6 million, for a total debt of $17 million. Under multilateral clearing, Italy transfers its $6 million credit with Britain to Belgium, thereby paying its debt. The only remaining debt is Britain's $11 billion debt to Belgium (the $5 million of its own deficit and the $6 million arising from the Italian transfer).

https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

relied on to balance bilateral trade, thereby reducing the distortions that characterized European trade.

In spite of the apparent benefits to be realized from multilateral clearing, however, European governments were extremely reluctant to relinquish the system of bilateral agreements in favor of multilateral arrangements. The Council for European Economic Cooperation (CEEC) proposed multilateral clearing in 1947–48, but European governments showed little interest in the proposed multilateral scheme. The first clearing under this system, undertaken in 1948, eliminated only $1.7 million of the possible $278.9 million that could have been cleared, and total clearings throughout the agreement's lifetime amounted to only $51.6 million.[9] European governments' resistance to full multilateral clearing persisted throughout 1948 and 1949. U.S. officials consistently pressed Europe to move toward multilateral clearing arrangements, but met little success. As a consequence, multilateral clearing had little effect on European trade. Robert Triffin estimated that between 1947 and June 1950, the effective starting point of the EPU, multilateral arrangements "cleared only about 4 percent of the positions which would have been cleared under a system of full and automatic multilateral compensation such as was adopted later under the EPU agreements."[10]

Uncertainty, Distributive Conflict, and Europe's Shift to Multilateralism

European governments' reluctance to move toward multilateral clearing arrangements during the late 1940s was caused by the interaction between governments' uncertainty about how multilateral clearing would affect their hard-currency receipts and obligations and an underlying distributive conflict. Distributive conflict in an environment of hard-currency scarcity made European governments unwilling to cede even partial control over their external payments obligations to a centralized clearing union. Rational Design conjecture F2, FLEXIBILITY increases with DISTRIBUTION problems, and conjecture C2, CENTRALIZATION increases with UNCERTAINTY ABOUT THE STATE OF THE WORLD, suggest that in such circumstances governments should seek to create centralized institutions to reduce uncertainty and flexible institutions to reduce the severity of the distributive conflict. The institutions created in 1950 strongly support both conjectures. A U.S. decision to capitalize the payments union relaxed Europe's hard-currency constraint and made possible a centralized clearing union based on a set of clearing rules that imparted considerable flexibility into creditor-debtor relations. This institutional framework enabled European governments to adopt multilateral clearing arrangements.

9. Bean 1948, 408.
10. Triffin 1957, 149.

https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

TABLE 2. *Gold and dollar reserves, 1951 and 1938 (in millions of $US)*

	1951		*1938*	
	Gold and dollar reserves	*Months of imports covered*	*Gold and dollar reserves*	*Months of imports covered*
Belgium	897	4.3	828	12.7
France	899	2.3	2,944	26.8
Italy	635	3.6	193	3.9
Netherlands	524	2.5	1,100	16.7
Switzerland	1,973	17.4	920	30.1
United Kingdom	2,335	2.6	3,313	8.8

Source: OEEC 1952, 60.

Uncertainty, Distributive Conflict, and Europe's Reluctance to Multilateralize

Uncertainty about the state of the world arose from European governments' inability to predict how multilateral clearing would affect their hard-currency payments and receipts. European governments held little hard currency in the immediate postwar period. The severity of the hard-currency constraint is shown in Table 2, which compares gold reserves in 1951 with prewar holdings. Before the war, European governments (excluding Switzerland) held, on average, reserves sufficient to cover almost fourteen months of imports. In contrast average reserves in 1951 (excluding those in Switzerland) were only about three months of imports.

The shortage of hard currency created problems for European governments. Postwar reconstruction depended on imports from the dollar area that had to be paid for with hard currency, while European exports to the dollar area were quite limited. European countries therefore ran deficits with the dollar area. The scarcity of hard currency coupled with the need to import from the dollar area to achieve reconstruction objectives made European governments extremely concerned about how intra-European trade would affect their hard-currency reserves. Bilateralism was adopted as the safest way to manage European trade in this environment. Bilateral agreements allowed governments to tightly control the amount of hard currency they expended through trade within Europe. By balancing trade on a bilateral basis, imports from a given trading partner could be paid for with exports to the same partner and no hard currency would need to change hands. Bilateral agreements also enabled European governments to shut off imports from a given country if the bilateral balance became unfavorable and threatened to impose hard-currency obligations. In other words, in an environment of hard-currency scarcity bilateral agreements allowed European governments to manage their external balance and conserve hard currency.

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The problem with multilateral arrangements, given the scarcity and importance of hard currency, was that governments could not easily predict how multilateral clearing would affect their total hard-currency receipts and obligations. This is clear in creditor and debtor governments' reactions to a multilateral clearing arrangement proposed by the CEEC in 1947–48. The CEEC proposed that each government's bilateral credits and debits be pooled to produce a single net position against the entire CEEC. Debtors' total obligations to the system's creditors would be allocated across all creditor governments in proportion to each creditor's share of the system's total credit. Debtor governments would then settle in hard currency any debts above the credit lines established in the relevant bilateral agreement.

Uncertainty about how the proposed arrangement would affect hard-currency payments caused creditor and debtor governments to object to the proposal. Creditor governments objected to the proposed arrangement because the CEEC plan could reduce the amount of hard currency they earned from European trade. Pooling under the CEEC plan would distribute each creditor government's credits across all of the system's debtor governments. Belgium, for example, which under its bilateral arrangements might have a total hard-currency claim of 100 against Britain, France, and the Netherlands, might find that in the multilateral system it had a total hard-currency claim of 80 distributed across a large number of debtors.[11] By reducing the total claim and by distributing this claim across a larger number of debtor governments, Belgium might find that its intra-European trade surpluses were generating less hard currency under the multilateral arrangement than they would under bilateral agreements. Moreover, some of the governments against which Belgium gained claims as a result of pooling might not have the hard currency required to settle.

Debtor governments objected to the proposed system because it reduced their ability to control their gold obligations.[12] Under the bilateral system, debtor governments could avoid external demands for hard currency by shifting the source of their imports. If they reached the hard-currency payment point in one bilateral agreement, they could stop imports from that country and begin to import from a country with which they had a surplus or that was willing to offer credit. Under a multilateral system these techniques would no longer be effective. Because debts would be distributed across all of the system's creditor countries, shifting imports from one country to another would do little to economize on hard-currency obligations. Thus, debtor governments faced potentially larger gold demands under multilateral clearing than they would face under the bilateral system.

Creditor and debtor governments both preferred the certainty of existing bilateral arrangements to the uncertainty of the CEEC proposal. Instead of adopting the CEEC plan, European governments adopted a multilateral system that provided each government full control over its hard-currency receipts and obligations. The

11. This example comes from Bean 1948, 410.
12. See Hogan 1987, 119–21; and Diebold 1952.

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First Agreement on Multilateral Monetary Compensation, as this system was called, distinguished between two categories of clearing. First category clearings were those that did not increase any bilateral balances. For example, if France owed Norway $3 million, Norway owed Britain $5 million, and Britain owed France $4 million, multilateral clearing would eliminate the French debt to Norway, reduce Norway's debt to the United Kingdom to $2 million, and Britain's debt to France to $1 million. Because these clearings did not increase any bilateral balances, they were to be conducted automatically among the system's full members. Second category compensations were those that did increase a bilateral balance. Because second category clearings would increase balances in certain bilateral trade accounts, they could occur only if all the parties involved—the primary debtor, the primary creditor, and the government whose currency was being transferred—agreed. In other words, rather than accept full automatic multilateral clearing, European governments created a multilateral clearing system in which they retained a veto over any clearings that would alter their hard-currency receipts or payments. But even with this veto, multilateral clearing proved too large a step. Only five governments joined the system as full members. Eight other governments joined as "occasional members" who reserved the right to veto even first category clearings. As a result, the First Agreement had a negligible effect on European payments arrangements, clearing only $56 million of the total debt in the system.[13]

An injection of hard currency into Europe could reduce European governments' resistance to multilateral clearing arrangements, and as we will see such an injection was an important part of the solution. A permanent shift to multilateralism, however, would require a solution to an underlying distributive conflict. This distributive conflict pitted European debtor governments against European creditor governments and revolved around one basic question: who would bear the costs arising from the existing imbalance in intra-European trade? Would creditor governments with current account surpluses have to reduce the size of their surpluses by importing more, or would debtor governments with current account deficits have to reduce the size of their deficits by importing less? This distributive conflict focused on two distinct, though intrinsically linked, sets of issues: financial arrangements and macroeconomic policy.

Distributive conflict over financial arrangements revolved around the role hard currency and credit facilities would play in any multilateral clearing system. Led by the Belgians, creditor governments saw that their surpluses in European trade could be a potential source of hard currency that could be used to cover their deficits with the dollar area. Creditor governments therefore sought to maximize the amount of hard currency used in settling debts with the clearing union and to minimize the degree to which these imbalances would be settled through credit. Led by the British, debtor governments saw that their deficits in European trade represented a potential claim on their hard-currency reserves, and this potential claim competed

13. Bean 1948, 408.

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with their need to import goods from the dollar area. The more that debtor governments were required to use hard currency to settle intra-European deficits, the less hard currency they would have available to make necessary purchases from the dollar area. Debtor governments therefore sought to maximize the amount of credit available to finance trade with Europe and to minimize the amount of hard currency used to settle their European accounts. In short, creditor governments wanted to draw more hard currency from any clearing union that was created than debtor governments were willing to pay.

Distributive conflict over macroeconomic issues arose from different macroeconomic priorities. Debtor governments, the Scandinavians and British in particular, were putting the greatest emphasis on achieving full employment, whereas creditor governments, the Belgians and Italians in particular, were putting the greatest emphasis on domestic price stabilization. The combination of domestic demand stimulus in one set of countries and restrictive monetary policies in a second set of countries was one of the primary causes of the imbalance in European trade.[14] Liberal multilateral trade in Europe, therefore, would force either creditor or debtor governments to alter their macroeconomic policies.

The recognition that full multilateral trade would require macroeconomic adjustment predictably generated conflict. Creditor governments argued that the imbalance in European trade was due to the overly expansionary macroeconomic policies being pursued by governments in the deficit countries. Balanced European trade could be attained only if these governments concentrated on domestic stabilization. Governments in the debtor countries argued that their commitment to full employment and expansionary macroeconomic policies was defensible. The imbalance, they argued, was due to the zealous manner in which governments in the creditor countries pursued orthodox policies. For the debtors, the imbalance should be corrected by relaxing macroeconomic policies in creditor countries.

The distributive conflicts over gold and macroeconomic adjustment were intrinsically connected. In a fully automatic multilateral clearing union, hard settlement rules, that is, rules under which hard-currency payments played a large role and credit a small role, would produce creditor-favorable macroeconomic adjustment. As hard currency flowed from deficit countries in payment of their debts, deficit governments would exhaust their hard-currency reserves and be forced to adopt restrictive policies to balance their external account. Thus, under hard settlement rules debtor governments would bear the costs of multilateral arrangements by being forced to reduce their commitment to Keynesian strategies in favor of more orthodox policies. As Sir George Bolton, Governor of the Bank of England, told one

14. See Disadvantages of Pro-Debtor Proposals—Clearing Union—Full Employment, 24 January 1950; and Disadvantages of Pro-Creditor Proposals—Clearing Union, PS/AAP(50)14 AAP Policy Series, 24 January 1950; File: European Cooperation; Records of Special Assistant for Staff Planning Henry J. Tasca, 1949–51 (Tasca Papers 1949–52); Records of the Office of the United States Special Representative in Europe, Record Group 469.2.2 (RG469.2.2); National Archives at College Park, Md. (NACP).

https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

U.S. policymaker, hard settlement rules would represent "a return to the old gold standard. [They] would cause extreme difficulties in the UK and the sterling area, a 4 percent decrease in European trade, and millions of unemployed in the UK."[15] A multilateral clearing union based on soft settlement rules, that is, rules in which hard-currency payments were minimized and credit facilities were maximized, would produce debtor-favorable macroeconomic adjustment. As credit expanded in surplus countries, domestic demand would increase, and domestic prices would rise. Expanded demand and rising prices would tend to reduce surpluses in the external account. Thus, under soft settlement rules creditor governments would bear the costs of multilateral arrangements by being forced to reduce their commitment to price stability in favor of more rapid credit creation.

In summary, uncertainty about the state of the world and distributional problems made European governments unwilling to abandon bilateralism in favor of multilateral clearing arrangements. Uncertainty about the state of the world, specifically about how multilateral clearing would affect their hard-currency receipts and payments, made governments cling to the certainty that bilateral agreements provided. And even with an increase in hard currency, European governments would need to solve two connected distributive conflicts arising from the existing imbalance in European trade: how much credit should be made available and who, the creditors or the debtors, should bear the costs of adjustment?

Flexibility, Centralization, and Europe's Shift to Multilateralism

The Rational Design project suggests three conjectures relevant to the problems that European governments faced. First, conjecture C2, CENTRALIZATION increases with UNCERTAINTY ABOUT THE STATE OF THE WORLD, suggests that European governments should have sought centralization as a solution to their uncertainty about the state of the world. Second, conjecture F2, FLEXIBILITY increases with DISTRIBUTION problems, suggests that European governments should have sought flexible institutions to solve their distributive conflict. Third, conjecture F1, FLEXIBILITY increases with UNCERTAINTY ABOUT THE STATE OF THE WORLD, suggests that European governments should have sought flexible institutions as a solution to their uncertainty about the state of the world. As these three conjectures suggest, the institutional framework that allowed European governments to make the transition to multilateral trade combined centralization and flexibility.

A U.S. decision to capitalize the clearing union (a decision examined in greater detail in the next section) yielded a highly centralized clearing union that substantially reduced creditor and debtor governments' uncertainty about how multilateral clearing would affect their hard-currency holdings. As discussed earlier creditor governments had objected to the multilateral system proposed by the CEEC in

15. Memorandum of Conversation, Hebbard and Bolton, 24 January 1950; File: Finebel-Fritalux; Tasca Papers 1949–52; RG469.2.2; NACP.

https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

1947–48 in part because under this plan the credits that they had offered initially on the basis of the credit-worthiness of the individual borrower government would be transformed into claims against all debtor governments with little or no account taken of their individual credit-worthiness. Pooling in the CEEC proposal, therefore, could potentially transform *ex ante* hard-currency claims into worthless paper claims. Creditor governments were highly uncertain, in other words, about how decentralized pooling would affect the value of their credits.

The U.S. capitalization of the EPU allowed pooling to be highly centralized. Under the EPU, pooling generated claims against the clearing union rather than individual governments. Moreover, U.S. capitalization allowed the clearing union to hold sufficient hard currency to ensure payment of claims against it. Pooling under the EPU, therefore, protected the hard-currency value of credits in a way that the CEEC proposal had not.[16] Centralizing pooling and capitalizing the EPU therefore eliminated creditor governments' uncertainty about the *ex post* value of their credits. Once they were assured that any credit they advanced through a multilateral clearing union would not be transformed into claims against nonexistent hard-currency reserves of weak-currency governments, creditor governments became willing to extend credit on a multilateral basis.

Centralization also reduced debtor governments' resistance to multilateral clearing. By creating debts to a centralized clearing union rather than to individual governments, and by writing explicit rules (discussed later) about how much hard currency would be required to settle debts to the union, debtor governments became less uncertain about how multilateral clearing would affect the hard-currency obligations generated by a given set of bilateral balances. At the same time, creditor governments' willingness to extend multilateral credit through the EPU allowed debtor governments to balance their trade with OEEC members over a medium term.[17] Normal seasonal fluctuations in exports alongside a constant import stream, for example, could generate a large deficit in one month and a large surplus the next. Without credit mechanisms, governments facing deficits would be forced to choose between making hard-currency payments or tightening quantitative restrictions to limit imports to the level of exports. Given the scarcity of hard currency, European governments were likely to prefer the latter solution to the former. The clearing union's credit mechanisms relaxed this short-term constraint by allowing governments to borrow from the union against future export revenues to pay for current imports. The credit made possible by centralized pooling therefore made deficit governments more willing to expose their economies to the fluctuations inherent in liberal international trade than they would have been otherwise.

Of course, creditor governments were not willing to extend credit without limit, nor were debtor governments willing to enter into a clearing union irrespective of how much credit was made available. Thus, credit mechanisms were themselves the

16. Triffin 1957, 172–74.

17. Joel Bernstein to Henry Tasca, The Reconciliation of Intra-European Payments Objectives, 14 March 1950; File: Finance, P; Finance and Trade Division 1949–52; RG469.2.2, NACP.

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object of considerable distributive conflict between creditors and debtors. The important point here, however, is that centralization reduced creditor and debtor governments' uncertainty about how multilateral clearing would affect their hard-currency receipts and obligations. The reduction of this uncertainty made governments more willing to enter into multilateral arrangements.

EPU institutions also provided substantial flexibility to creditor-debtor relations. The Rational Design framers conceptualize flexibility in two ways. First, institutions can allow governments to temporarily opt out of existing commitments by invoking escape clauses. Second, flexibility can be provided by substituting a series of short-term agreements for one permanent agreement. To these two types of flexibility, I add a third: flexibility as pliability. Pliable institutions are based on rules that have been designed to impart slack to what otherwise would be tightly binding constraints.

All three types of flexibility were evident in the design of the EPU. First, an escape clause was incorporated into the OEEC's broader trade liberalization program. In this regard it is important to recognize that the over-arching purpose of the multilateral payments system was to facilitate the liberalization of intra-European trade. To achieve this objective the OEEC Code of Liberalization was implemented in conjunction with the EPU.[18] The first step in the liberalization process was to eliminate quotas. While multilateral clearing would eliminate the need for discriminatory quotas—because gold obligations would arise from the deficit with the EPU as a whole rather than through bilateral debts—the possibility remained that a country developing a deficit with the union that it would be unwilling to settle with hard currency might find it necessary to resort to quotas to conserve hard currency. The OEEC trade liberalization program, therefore, allowed governments to suspend temporarily their liberalization programs and reimpose nondiscriminatory quantitative restrictions under a set of broadly defined events. This escape clause was embodied in Article III of the OEEC Code of Liberalization. This article gave governments the right to suspend or only partially implement the required liberalization measures if, "its economic and financial situation justifies such a course"; "any measures of liberalisation of trade ... result in serious economic disturbance"; and "despite any recommendations made [by the OEEC Council] the deficit of a member country with the Union is increasing at a rate which it considers serious in view of the state of its reserves."[19] Thus, governments were allowed to opt out temporarily of the trade liberalization if this process proved too disruptive to a government's general economic objectives or to its narrower balance-of-payments objectives.[20] The flexibility that the escape clause provided

18. On trade liberalization, see Diebold 1952; and Asbeek-Brusse 1997.

19. *OEEC Code of Liberalization*, 1948.

20. While Article III did lay out the general conditions under which governments could opt out of the trade liberalization program, the article contained no explicit constraint on governments' ability to invoke these clauses. Determining whether opting out was necessary appears to have been left to the discretion of the government. Also not imposed were explicit penalties for invoking Article III or explicit

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reduced the degree to which European governments' uncertainty about the state of the world—particularly their concerns that future shocks could create balance-of-payments problems—made them reluctant to embark on trade and payments liberalization.

Flexibility as pliability was imparted through the system's settlement rules. The U.S. decision to capitalize the EPU made it possible to write settlement rules that explicitly allowed creditor governments to withdraw gold from the union at a faster rate than debtor governments were required to pay gold in. The EPU's settlement mechanism worked in the following way. Each government's quota was broken into five tranches of equal size. In the first tranche settlement was entirely in credit and no hard currency changed hands. For all credits above the first tranche the clearing union's obligations to net creditors were settled in 50 percent hard currency and 50 percent credit. Debtors, however, faced a less steep escalation of gold payments. Twenty percent gold payment was required in the second tranche, 40 percent in the third tranche, 60 percent in the fourth tranche, 80 percent in the fifth tranche, and 100 percent once the quota was exhausted.[21] Consequently, in the second and third tranches debtors paid less gold into the clearing union than creditors withdrew. The impact of these settlement rules on intra-European gold flows can be best illustrated by comparing actual gold payments between creditors and debtors in the period October 1948 through March 1950 with the gold payments that would have occurred had the EPU's settlement rules been in operation during this period. According to calculations by the Economic Cooperation Administration, creditor governments would have received $535.5 million under EPU settlement rules compared with the $152 million they did receive. Debtors, in turn, would have paid less: a total of $106 million under EPU rules compared with actual payments of $152 million.[22] The gap between the EPU's hard-currency payments and receipts would be covered by the U.S. funds that capitalized the union.

This settlement mechanism had two effects on the distributive conflict. First, and most obvious, it broke the tight link between creditor hard-currency receipts and debtor hard-currency payments. As a result, the hard-currency consequences of multilateralism were acceptable to both groups. Second, loosening the link between hard-currency payments and receipts weakened the pressure for macroeconomic

requirements that the government doing so engage in some costly signal, as Rosendorff and Milner suggest one should see. Rosendorff and Milner, this volume. Rather than explicit penalties, an informal process does seem to have emerged, driven largely by the handling of the German crisis in 1950–51. See Kaplan and Schleiminger 1989, chap. 6.

21. Diebold 1952, 92–95.

22. See Gold Settlements Under EPU, April 1950; and Gold Payments Under EPU Compared with Actual Intra-European Gold Payments Since October 1948, 20 June 1950; both in File: Finance, P; Finance and Trade Division 1949–52; RG469.2.2; NACP. U.S. policymakers also reduced British concerns about sterling balances being cleared through the EPU by insuring British gold against this risk: "In the event that EPU operations should unexpectedly result in British dollar payment obligations beyond some agreed danger point, ECA would be prepared to consider the allotment of special dollar aid to the United Kingdom." Secretary of State to the British Secretary of State for Foreign Affairs, Aide Memoire, EPU, 11 May 1950. U.S. Department of State 1950, 3:655–56.

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policy adjustments that multilateral trade would otherwise produce. Under these settlement rules, a balance-of-payments deficit of a given size would be less costly in terms of hard currency than under rules calling for 100 percent hard-currency payment. Deficit governments would therefore face a less-binding reserve constraint when pursuing expansionary macroeconomic policies.

Finally, the EPU was a short-term agreement that had legal standing for only two years. Of course, the short-term nature of the clearing union was due largely to the system's role as a stepping-stone to full currency convertibility. But it is precisely the longer-term goal of full currency convertibility that makes the EPU's evolutionary approach significant. With European governments unwilling to move directly from bilateralism to full convertibility, the EPU provided an evolutionary path toward this final objective. As originally designed, the system's settlement mechanism was to be gradually hardened over time. If any credit was to survive in the system, this was to take the form of strict swing credits that would be repayable in gold after twelve months.[23] Moreover, European governments were to be pressed during the two-year period of the first agreement's lifetime to move to general convertibility, that is, to 100 percent gold settlements for net deficits. Thus, over a medium-term period the flexibility provided in the short term was to be gradually eliminated from the system, thereby tightening the constraints European governments faced and pushing them gradually toward full convertibility.[24]

In summary, the institutions created to promote multilateral clearing in postwar Europe both centralized and imparted considerable flexibility to creditor-debtor relations. The combination of centralization and flexibility reduced uncertainty over the state of the world and distributional problems, thereby greatly reducing European governments' reluctance to abandon bilateralism in favor of multilateralism. Centralization was achieved by using a U.S. capitalization to create country positions against a gold-backed clearing union. Centralization reduced creditor and debtor uncertainty about how multilateral clearing would affect their hard-currency receipts and obligations. Flexibility was provided through temporary opt outs that allowed governments to conserve hard-currency reserves, by relaxing the constraints that multilateral trade and payments would otherwise impose on creditor-debtor relations, and by an evolutionary hardening of settlement terms. Flexibility reduced the severity of the problems caused by hard-currency scarcity, distributive conflict, and uncertainty about the state of the world, and made European governments willing to enter a multilateral clearing arrangement.

23. See Intra-European Credits in EPU, 8 May 1950, RG469.2.2, NACP; and National Advisory Council (NAC) Minutes, meeting no. 158, 29 June 1950; Minutes of Council Meetings 1945–70 (Minutes); Records of the NAC on International Monetary and Financial Problems and the NAC on International Monetary and Financial Policies, Record Group 56.12.1 (RG56.12.1); NACP.

24. In the event, these expectations proved optimistic. The EPU was renewed every two years until finally dismantled in 1959. Settlement mechanisms were not greatly hardened until the 1954 renewal, at which point all debts and all surpluses were settled in 50 percent gold and 50 percent credit. See Kaplan and Schleiminger 1989.

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And while it is true that the central aspects of these institutions, the creation of the system's credit mechanism and the asymmetric settlement terms, were made possible by the United States' willingness to capitalize the clearing union, it is important to recognize how this U.S. contribution affected the outcome in Europe. U.S. assistance was not used as a simple side payment, that is, as cash payments to induce cooperation. Instead, the capitalization was used to create a centralized payments union and to write a set of rules that imparted flexibility to this system in a manner that allowed creditor and debtor governments to see clear benefits from participation. In other words, U.S. assistance made a difference through the institutional design that it made possible.

Enforcement Problems and the U.S. Capitalization of the EPU

The creation of the multilateral clearing union in 1950 suggests a puzzle I explore here. The U.S. decision to capitalize the EPU made it possible to create institutions that reduced uncertainty and softened distributive conflict between debtor and creditor governments and thereby allowed Europe to begin the transition to multilateralism. Yet not until two years after the Marshall Plan was adopted were U.S. policymakers willing to devote Marshall aid funds to a clearing union. It was not that U.S. officials were unaware of the problems blocking the adoption of multilateral clearing arrangements. As early as fall 1947, during the preliminary discussions over Marshall aid, European governments had made it clear to U.S. policymakers that distributive conflict and hard-currency scarcity would block their transition to multilateralism. Moreover, European governments requested at that time that a portion of U.S. aid be used to capitalize a clearing union. Without such a contribution, they told U.S. officials, the transition to multilateral arrangements would be delayed significantly.[25]

Why were U.S. policymakers reluctant to capitalize a clearing union between 1947 and 1950, and how did the institutions created in 1950 alleviate theses concerns? U.S. policymakers were reluctant to capitalize the clearing union because they faced an enforcement problem: they feared that using Marshall aid to finance European trade would lead to a multilateral system that could be sustained only through continued European discrimination against U.S. goods and continued injections of U.S. aid. The Rational Design framers offer two conjectures relevant to the U.S. role in Europe's transition to multilateralism. Conjecture C4, CENTRALIZATION increases with ENFORCEMENT problems, and conjecture V2, asymmetry of

25. See Memorandum of Conversation, Meeting of the Representatives of the U.S. Advisory Steering Committee with the CEEC Delegation, 3:30–6:00 p.m., 22 October, 1947; File: Memoranda of Conversation and Questions for Discussion; Lot 123; Formulation of the European Recovery Program; General Records of the Department of State, Record Group 59; NACP.

https://doi.org/10.1162/002081801317193655 Published online by Cambridge University Press

CONTROL increases with asymmetry of contributors (NUMBER), receive some degree of support here, though conjecture V2 receives weaker support than conjecture C4.

The Enforcement Problem: Moral Hazard and the Financing of European Trade

In contemplating the use of Marshall Plan aid to finance intra-European trade U.S. policymakers faced a moral hazard problem. The nature of this problem was straightforward: using dollars to finance intra-European trade could alter European governments' behavior and make it more difficult to achieve the Marshall Plan's broader objective of returning Europe to full convertibility and nondiscriminatory trade.

Moral hazard arose in two distinct ways. First, financing intra-European trade with U.S. funds could give European governments an incentive to expand their consumption by the amount of the U.S. contribution. Thomas Schelling, who worked for the ECA in Paris at the time, noted that "if [recipients] were to believe that their own . . . shortfalls would be made up by U.S. expenditure, those deficits would be enlarged by the very evidence of American willingness to fill the gap."[26] This concern was explicitly discussed in the October 1947 Washington conversations between European and U.S. representatives. In these discussions Frank Southard (U.S. Department of the Treasury) asked the European CEEC delegates, "Suppose that one of the CEEC countries were to import from others some relatively less essential items . . . through reliance on settlement in dollars. Suppose further that you got a fair degree of freedom of trade. Would it, then, possibly be the case that the country would be piling up, or running the risk of piling up, a debit in the account, while the country which was supplying the relatively less-essential commodities would be, in a sense, earning dollars which have come in through the United States?"[27] Were this to come to pass, any shift to multilateralism could persist only for as long as the United States continued to inject hard currency into European trade. The reasoning behind this concern was straightforward. If U.S. funds allowed consumption to expand, imports would expand. These additional imports could be paid for in hard currency, however, only as long as dollars were injected into the system. Once dollar inflows stopped, imports would drain hard-currency reserves, causing governments to resort once again to trade restrictions to limit their imbalances and conserve hard currency. As one U.S. Treasury official commented, a European payments plan "can't work after U.S. dollars cease to be put in."[28]

26. Schelling 1955, 609.

27. See Memorandum of Conversation, Meeting of the Representatives of the U.S. Advisory Steering Committee with the CEEC Delegation, 3:30–6:00 p.m., 22 October 1947; File: Memoranda of Conversation and Questions for Discussion; Lot 123; RG59 Lot 123; NACP.

28. NAC Minutes, 14, 19, and 23 January 1950; File: Minutes, 21 August 1945–25 October 1968; Minutes; RG56.12.1; NACP.

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Second, a U.S. hard-currency contribution might reduce European governments' incentives to become competitive in the dollar area.[29] The dollar gap was the primary problem that Marshall aid had been created to solve, and the solution to this problem lay in generating the productivity improvements necessary to allow European governments to export enough goods to the dollar area to earn the hard currency they needed to pay for their imports from the dollar area. If European governments were suddenly allowed to earn dollars by exporting to other European countries, they would have less incentive to make the economic adjustments necessary to become competitive against U.S. goods. At the extreme, allowing European governments to earn dollars by exporting to Europe might, according to one Treasury official, "make it impossible for the European countries to earn dollars from exports to the dollar area. . . . After the initial stages, [a European clearing union] would be used as a device to discriminate against American trade and would defeat the entire objective of the ECA program."[30]

Confronted with this moral hazard problem, U.S. policymakers initially opted to maintain tight control over all Marshall Plan resources used to finance intra-European trade. In the first two years of the Marshall Plan, the United States allocated only a small amount of aid to intra-European trade and maintained tight control of these resources through the offshore procurement program.[31] Under the offshore procurement system, each European dyad forecast its net bilateral trade balance for the forthcoming fiscal year, and the government expected to be in surplus offered a drawing right in local currency to the other government equal to the expected imbalance. The grantee then used these drawing rights to purchase goods from the grantor, who was then compensated with ECA dollar aid. As the State Department noted, financing intra-European trade through offshore procurement rather than through free dollars provided "greater control over any United States contribution to European multilateral clearing than would be the case if dollars were made directly available to settle these accounts."[32]

Limiting Moral Hazard: Centralized Institutions

The Rational Design framers suggest that U.S. policymakers should have responded to the problems they confronted in their decision to capitalize a European clearing union in two ways. First, conjecture C4, CENTRALIZATION increases with ENFORCEMENT problems, suggests that U.S. policymakers should have sought a highly centralized institution to mitigate the enforcement problem they faced. Second, conjecture V2, asymmetry of CONTROL increases with asymmetry of contributors (NUMBER), suggests

29. NAC Minutes, 14 January 1950; File: Minutes, 21 August 1945–25 October 1968; Minutes; RG56.12.1; NACP.

30. NAC Minutes, 19 January 1950; File: Minutes, 21 August 1945–25 October 1968; Minutes; RG56.12.1; NACP.

31. For State Department views on free dollars, see The Acting Secretary of State to the Embassy in France, 26 August 1947, in U.S. Department of State 1947, 3:386–87.

32. U.S. Department of State 1948, 50.

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that given the asymmetric contribution made by the United States, U.S. policymakers should have sought greater control over EPU decision making.

U.S. policymakers did push for an institutional framework that combined a high degree of centralization with majority rule decision making in order to promote macroeconomic policy coordination among European governments.[33] The payment union's decision-making powers were vested in a managing board rather than in national governments. Thus European governments would not directly participate in the system's operation. The managing board was given the role of encouraging governments to adopt macroeconomic policies that minimized their trade imbalances with the union. Governments with large credits or debits against the EPU were required to justify their macroeconomic policies in front of the EPU's managing board, which could then recommend macroeconomic policy adjustments.[34] Decisions by the board about particular governments' macroeconomic policies were made by majority rule, thus preventing any single actor from blocking action.

The administrative apparatus worked in conjunction with the system's settlement schedule to minimize the moral hazard problem. As shown in the previous section, the EPU's settlement rules were "debtor friendly" in the lower tranches of the quotas because they required zero or small fractional gold payments in the settlement of debts to the union. Thus for relatively small amounts of short-term credit the system provided considerable flexibility. As a debtor government moved into its quota's higher tranches, however, the gold content of payments to the EPU increased. As the gold portion of repayments increased, debtor governments faced increasing pressure from gold outflows to adopt macroeconomic policy adjustments. Thus, while the system easily accommodated short-term deficits, more persistent deficits generated automatic pressure for tighter macroeconomic policies. As Triffin, one of the architects of the system, observed, "the rising schedule of gold payments, on the one hand, would place increasing pressures on persistent debtors to adopt readjustment politics." These pressures would be further reinforced by two factors. First, the administrative authority conferred on the managing board was designed to "foster and support national or mutual policies aiming at the correction of excessive surpluses or deficits."[35] In other words, the managing board would promote a process of macroeconomic policy coordination among European governments oriented toward sustainable trade positions. Second, the evolutionary nature of the EPU was to be used to gradually tighten the settlement terms as the system progressed. Thus, initially soft terms—a lot of credit relative to hard currency—would gradually evolve into sequentially harder terms until the clearing union was functionally equivalent to full convertibility. An explicit process of macroeconomic coordination around relatively conservative policies would place European govern-

33. See, for example, Proposal for the Establishment of a European Monetary Authority, PS/AAP(49)10 (draft), AAP Policy Series, 5 December 1949; File: European Cooperation; Tasca Papers 1949–52; RG469.2.2; NACP.

34. See Hogan 1987, 295–96; and Van der Beugel 1966, 203.

35. Triffin 1957, 170–71.

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ments on the path to an early return to full convertibility and nondiscriminatory multilateral trade.[36]

European governments were reluctant to accept the degree of centralization the United States desired, resisting in particular a managing board empowered to make binding decisions through majority rule. Another Rational Design conjecture helps explain this behavior: conjecture V3, CONTROL increases with UNCERTAINTY ABOUT THE STATE OF THE WORLD. As Koremenos, Lipson, and Snidal observe in the volume's introduction, "because states are risk-averse with respect to distributional issues, they design institutions that protect them from unforeseen circumstances."[37] It was precisely this concern that motivated European bargaining positions during negotiations over the EPU's decision-making procedures. Given the underlying distributive conflict over the costs of adjustment and uncertainty about who would control a majority of the EPU's managing board, creditor and debtor governments both preferred the certainty of unanimity rule.[38] The most that debtor governments were willing to grant to the managing board was the authority to demand policy changes in connection with "special assistance" extended above the EPU's regular quotas. Creditor governments did see some advantage to decision-making procedures that would force debtor governments to adopt the policies necessary to service their debt. Yet creditor governments feared that a majority rule managing board could force them to adopt more expansionary policies. Uncertainty about who would control the majority on the managing board in conjunction with the underlying distributive conflict caused European governments to prefer the certainty provided by a veto to the uncertainty implied by majority rule.

While the Europeans were unsuccessful in blocking majority rule in the managing board, they were able to require that all board decisions would be adopted by the OEEC Joint Trade and Payments Committee and Executive Committee, where decisions were taken through unanimity rule. Thus European governments maintained veto power over board decisions through the wider OEEC.[39] In addition, the board was given limited authority. The original agreement did not give the board the right to "initiate proposals about economic and financial policies," nor did it give the board explicit authority to make proposals addressed to governments that generated substantial trade deficits.

U.S. policymakers did not gain greater influence over EPU operations than the European governments, an outcome that is inconsistent with conjecture V2, asymmetry of CONTROL increases with asymmetry of contributors (NUMBER). The lack of support for this conjecture in this case owes more to the idiosyncrasies of the OEEC

36. See, for example, OSR to Secretary of State, Relations EPU with International Monetary Fund, (draft) 23 January 1950; and Answer to Treasury Paper to NAC, 23 January 1950; File: Finance; Finance and Trade Division, 1949–52; RG469.2.2; NACP.

37. Koremenos, Lipson, and Snidal, this volume.

38. For creditor and debtor government positions, see Experts' Report on EPU—Suggested OSR Position; and The Reconciliation of Intra-European Payments Objectives, 14 March 1950; File: Finance; Finance and Trade Division, 1949–52; RG469.2.2; NACP. See also Diebold 1952.

39. See Van der Beugel 1966, 202; and Diebold 1952.

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than to a problem with the conjecture's logic. The EPU was a part of the OEEC, and thus formal rights of participation were restricted to those governments that were members of this broader organization. The OEEC was created by European governments for the purpose of coordinating the administration of Marshall Plan assistance, and the United States was not an official member; therefore it could not acquire a larger share of the control over EPU decisions.

In summary, the institutions that facilitated Europe's move to multilateral payment arrangements combined centralization and control to reduce the severity of the underlying enforcement problems. U.S. policymakers were reluctant to use Marshall aid dollars to finance European trade because of an enforcement problem arising from moral hazard. Financing intra-European trade with U.S. dollars could create a European soft-currency area that could be sustained only through additional U.S. aid and continued European discrimination against U.S. goods. As the Rational Design conjectures suggest, U.S. policymakers responded to this enforcement problem by seeking institutions that combined centralized institutions and a relatively autonomous managing board empowered to make decisions with majority rule. Their ability to achieve this objective was limited, however, by European governments' responses to concerns arising from uncertainty about the state of the world. Uncertain who would control a majority of the managing board, creditor and debtor governments both preferred the certainty of unanimity rule.

Conclusion

Interaction between distributional problems, uncertainty about the state of the world, and enforcement problems complicated Europe's movement toward multilateralism in the immediate postwar period. Distributive conflict accentuated by uncertainty about the state of the world generated by hard-currency scarcity made European governments reluctant to adopt multilateral arrangements without substantial financial support from the United States. Concern about moral hazard made U.S. officials reluctant to provide the necessary support. European governments' shift to multilateral arrangements was greatly facilitated by the EPU's institutional framework. This institutional framework allowed U.S. policymakers to reduce the severity of the moral hazard problem, thereby making them willing to capitalize a clearing union. The U.S. capitalization relaxed Europe's liquidity constraint and made it possible to write a set of rules that imparted considerable flexibility to intra-European payments relations, thereby reducing European governments' concerns arising from distributive conflict.

In examining Europe's shift to multilateral payments arrangements, I have focused on six conjectures linking four characteristics of the bargaining environment to three dimensions of EPU institutions. I conclude with a brief discussion of the case's principal findings organized along the three institutional dimensions the case examined: flexibility, centralization, and control. The Rational Design project suggested that the degree of flexibility in the EPU should have been influenced by

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the severity of the underlying distributional problem (conjecture F2) and by uncertainty about the state of the world (conjecture F1). The case provided strong support for the conjectures as well as for their underlying rationales. Distributional problems and uncertainty about the state of the world did make European governments reluctant to engage in multilateral trade and payments cooperation, in spite of the large benefits such cooperation offered. Flexibility, provided by an escape clause, by the use of credit mechanisms and settlement rules to relax the constraints multilateral clearing would otherwise impose, and by the evolutionary nature of the EPU mitigated both of these obstacles to cooperation. Credit mechanisms, settlement rules, and the evolutionary nature of the agreement softened creditor and debtor distributive conflict and made common participation in multilateral clearing possible. The escape clause mitigated governments' concerns about how possible future shocks would affect balance-of-payments positions. As the conjectures suggest, therefore, flexibility reduced the severity of the distributional problem and uncertainty about the state of the world.

The Rational Design framework suggests that the degree of centralization in European multilateral clearing arrangements should have been shaped by the severity of the enforcement problem (conjecture C4) and by uncertainty about the state of the world (conjecture C2). These two conjectures were also supported. Once U.S. officials decided to capitalize the EPU, they addressed their enforcement problem by creating a highly centralized institutional structure that could constrain European governments' abilities to develop unsustainable trade positions. Centralization in the form of a gold-backed clearing union reduced creditor governments' uncertainty about the post-clearing value of their credits, thereby making them more willing to participate in multilateral arrangements.

Finally, the Rational Design framework suggests that the balance of decision-making power in the EPU, and the EPU's decision rules themselves, institutional components summarized in the variable CONTROL, should be influenced by asymmetry of contributions (conjecture V2), on the one hand, and by uncertainty about the state of the world (conjecture V3), on the other. The EPU provides mixed support for these conjectures. Conjecture V2 receives only weak support in this case, largely because U.S. policymakers could not participate directly in EPU decision making. U.S. policymakers did try to create a decision-making structure that limited European governments' direct control over EPU operations, but European governments' uncertainty about the state of the world had a much more transparent impact on CONTROL. Uncertain about whether a pro-creditor or a pro-debtor majority would dominate the EPU's managing board, creditor and debtor governments both insisted on maintaining the right to veto board decisions.

Overall, therefore, Europe's transition from a network of bilateral trade agreements to multilateral clearing provides strong support for the approach elaborated by the Rational Design framers. Five of the six conjectures investigated here, linking four of the project's independent variables to three of its institutional dimensions, are strongly supported by this case.

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