INTERNATIONAL CAPITAL MOVEMENTS—
PAST, PRESENT, FUTURE

Paper presented by

Sir Eric Roll, K.C.M.G., C.B.

Commentators

Henry H. Fowler

Wilfried Guth

Sunday, September 26, 1971

Washington, D. C., U.S.A.

THE PER JACOBSSON FOUNDATION

Per Jacobsson foundation, Washington, D.C.

INTERNATIONAL CAPITAL MOVEMENTS— past, present, future

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Sunday, September 26th, 1971
The Great Hall — International Monetary Fund
Washington, D. C.

THE PER JACOBSSON FOUNDATION
1971 PROCEEDINGS

CORRIGENDA

Foreword Paragraph 2, lines 2 and 3 should read –

"convertibility of the dollar and had imposed a temporary 10 per cent surcharge on certain imports, and the day before the opening of"

Line 4 – read

"Monetary"

FOREWORD

This publication constitutes the Proceedings of the eighth lecture meeting of The Per Jacobsson Foundation which took place on September 26, 1971 in Washington, D. C. It contains the text of a paper on *International Capital Movements—Past, Present, Future* prepared for the Foundation by Sir Eric Roll, K.C.M.G., C.B., as background for his oral statement on the subject delivered at the meeting. Also included are the texts of the statements by Dr. Wilfried Guth and Mr. Henry H. Fowler, as well as answers given by all of the speakers to written questions from the audience.

The meeting took place six weeks after the United States had suspended convertibility of the dollar and had imposed a ~~general~~ temporary 10 per cent surcharge on ~~all purchases of foreign exchange~~ certain imports, and the day before the opening of the meeting of the Board of Governors of the International Montary Fund at which the impact of these developments was further discussed. The audience, therefore, included many members of delegations and special guests at the Governors' Conference in addition to those who regularly receive invitations to the Foundation's meetings. Following the discussion, the Managing Director of the Fund gave a reception for all those attending and participating in the meeting. It is appropriate at this time to express again officially the appreciation of the Foundation for these courtesies and other evidences of support given to it over the years by the Fund, its Managing Director, and its staff.

These Proceedings are being printed in English, French and Spanish, and approximately 23,000 copies are being distributed by the Foundation without charge. In addition, through the courtesy of a number of banks and bankers' association, versions in Chinese, Japanese, Persian, Hebrew and Italian are also distributed in different parts of the world. Extra copies, or copies of earlier Proceedings, as listed on the inside back cover, may be requested from the Secretary of the Foundation.

The Directors and Officers of the Foundation would also like at this time to record their great sorrow at the death of their colleague Gabriel Ferras in December 1970. He had been a strong supporter of its work since the beginning and had brought to it his experience, wisdom and imagination. He will be greatly missed.

His place on the Board of Directors is being taken by René Larre, General Manager of the Bank for International Settlements.

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Opening Remarks

by W. Randolph Burgess

THIS IS THE EIGHTH of the Per Jacobsson assemblies, which have come to be, as you see by looking about you, a reunion of friends of Per Jacobsson, together with friends of the ideas and the principles for which he stood so manfully and effectively.

Now, I think we have all noticed that there are some absentees from our midst on this occasion. Normally, Mrs. Violet Jacobsson has been here; she has hardly missed one of our sessions. She unhappily is not able to come this time, but she sent a cable, which reads:

> *"Best wishes to everybody present at this critical time. Hoping for good advice to the world."*

There are also missing from our midst two good friends: — Gabriel Ferras, who was a director of the Foundation from its beginning, who ran the BIS so effectively, and was a friend of all those who worked with him and knew him. Also Karl Blessing, who gave one of the principal papers at our last meeting in Basle. He was an elder statesman who will be missed by us all for his sound and constructive ideas.

The subject of our meeting is certainly more explosive now than it was when we picked it out. It is more explosive than when Eric Roll was kind enough to send us the first draft of his paper. That was before, shall we say, The Guns of August. Fortunately, there is now an opportunity for him to add to that paper, to make any changes he wishes—though I don't see just what he would change because it seems to me an extraordinary presentation of the subject. But we are delighted that he is here, that he has done this tremendous job for us. And I will call on him now to deal with the subject from here out in any way that he pleases.

International Capital Movements—Past, Present, Future

by Sir Eric Roll, K.C.M.G., C.B.

The text given immediately below is that of a paper prepared by the author as background for the discussion on the subject on September 26, 1971. The text of his oral presentation on the subject begins on page 36.

I DEEPLY APPRECIATE the honour which the Per Jacobsson Foundation has done me in inviting me to give this lecture today. I feel bound to add, however, that to undertake to write a paper on an international financial topic in 1971, around the time of the summer solstice, for delivery around that of the autumn equinox, requires a degree of recklessness that may lead to immediate expulsion from the fraternity of bankers, whose outstanding quality is, or at least ought to be, prudence. The officers of the Foundation, recognising this hazard, were kind enough to give me a few weeks' grace. This, however, proved a mixed blessing, as every day brought new pronouncements from the authorities, new interpretations of what these meant, and new rumors of what they really intended to do, as distinct from what they said; and new disturbances in financial markets.

This audience, containing so many bankers, will, therefore, appreciate why my acceptance of this invitation was coupled with an option to supplement what I say in my paper with additional observations which may differ considerably—and perhaps in part completely contradict—the views here expressed. For who is to be sure what events the next few weeks will bring, including in 'events' the unforeseeable acts of governments!

There are other reasons for approaching this subject with some hesitation. Two formidable panellists are to initiate a discussion of the subject of this paper. They have both considerable practical experience of the problems with which it deals and they have both fairly recently pronounced on it: Henry Fowler, less than a year ago in Tokyo, and Wilfried Guth earlier this year, in Geneva, on the very morrow of the most recent monetary crisis; and they have each expressed quite decided views. This audience contains some of the most eminent among both the poachers and the gamekeepers in the monetary forest, if I may so refer to them, as well as distinguished monetary theorists. The subject itself, for some unaccountable reason, evokes strong emotions. Floaters and fixed exchange raters, monetarists and fiscalists, interveners and laisser-faire-ites, those whose greatest desire is to have more autonomy in national economic policy-making and those who are deeply devoted to the international monetary system: all seem to find in the present developments in international capital movements support for their own particular theories. Indeed it is true to say that if one wants to plunge at once into all those most complex problems in monetary economics: balance of payments equilibrium, the domestic adjustment process, the role of exchange rates, the proper policy mix for economic stabilisation and, even, the role of international institutions, it is difficult to think of a better spring board than the subject of this lecture.

It is not surprising, therefore, that it also has a very long and distinguished history, from Ricardo through the controversies after the Napoleonic wars to Keynes and the post-Keynesians. One can fill a respectable section of any economics library with discussions of international money flows. And in the last ten years—perhaps more particularly in the last twelve months—it has become virtually impossible to pick up any publication in this field that does not discuss the Euro-currency market and its real or imagined misdeeds.

There are, moreover, considerable limitations in dealing with a monetary subject as such. Not only does money, as has so often been observed, throw a veil over real phenomena, but monetary policy is often invoked to perform tasks beyond its capacity. If I may quote some words from a little known publication, the Irish Banking and Currency Report of 1938, which were almost certainly written by the man in whose honour these lectures were instituted, Per Jacobsson, I commend to you the following: "Some of the greatest difficulties of monetary policy arise from the fact that it has to be pursued in an environment largely conditioned by political and other non-monetary factors. . . . It is quite clearly unreasonable to expect all mistakes committed in the political and economic field to be neutralised by monetary action, however wisely pursued." I am sure these words will find a loud echo in the breast of many a Central Bank Governor today.

In this situation, it would be rash to suppose that one can say much that is new or say it in a way that would contribute light rather than heat. One can, of course, always pose more questions, though one should remember Charles Colton's saying of one hundred and fifty years ago that "the greatest fool may ask more questions than the wisest man can answer". What, however, I think may be particularly helpful is to try to bring some order into the debate. Here I take as my inspiration what I once heard Josiah Stamp say: "if we have to have minds like rag-bags, let us at least sort out the rags".

* * * *

Capital Movement in the Nineteenth Century

My title suggests that I have divided the subject, like ancient Gaul, into three parts. They are, however, not of equal length and weight; and on some of the aspects of the problem, I have had to intermingle past, present and future.

As far as the past is concerned, international capital movements would certainly repay renewed study both in their theory and in their actual evolution. For example, Jenks's *Migration of British Capital*, Cleona Lewis's *America's Stake in International Investment* and Jacob Viner's classic, *Canada's Balance of International Indebtedness,* are, I suspect, rarely read nowadays, but certainly should be. I want to refer only briefly, both to the theory and the history of the subject, primarily as an antidote to some of the present-day attitudes which tend often to regard every problem as unprecedented, while at the same time being only too ready to derive policy guidance from somewhat primitive theories of the past which developments of recent decades have made inadequate. There is some comfort to be got from realising that our present discontents as regards long-term capital movements or flows of 'hot money' are not unique but have been experienced many times before, and this can at least teach us to keep them in perspective. It is also salutary to be reminded that some of our reactions to current phenomena may spring from half-remembered lessons of first-year textbooks in Economics that were perhaps not wholly adequate to what was happening in the real world even at the time when we imbibed them.

The general theory of international economic relations, embracing the theory of international trade, of capital movements, and of the international monetary mechanism, has an ancient and honorable pedigree and is perhaps the most solidly established part of general economic theory. In its basic elements it is probably the least changed since the two-hundred and twenty years when David Hume first expounded the theory that became the foundation for the explanation of the relationship between the influx and outflow of the precious metals (or reserves, as we would say today) and the domestic price level; and the hundred and fifty years since Ricardo first elaborated the theory of the division of labour into one which also explained the fundamental reasons for international trade. As for the first, during the relatively limited period of a half-century or so, when the pure gold standard held sway and the specie points (the equivalent of today's 'bands') determined money flows, the total acceptance of this international system was best demonstrated by the fact that it was referred to simply as "the mechanism"; though with hindsight one can see that there was a hint of potential impermanence in the fact that it required the observance of certain rules of the game for its proper functioning. As for the origin and direction of international capital movements, the explanation was also fairly straightforward. Comparative advantage determined the international division of labour; natural endowment and institutional arrangements determined the accumulation of capital. The two combined would create export or import surplusses which would be compensated by long-term capital exports or imports, thus usually closely linking trade and capital flows, as Roosa has recently reminded us. It should be noted, however, that many of the empirical studies, for example that of Jacob Viner, show that even a long time ago, triangular, and even more complicated relationships, between trade flows, long-term capital movements, and the movement of short-term banking funds were by no means uncommon.

It is not my purpose here to trace the changes that have taken place in the corpus of economic theory on this subject, or to describe in detail the stages through which international movements of capital—long and short—have actually gone in the last hundred years. Generally speaking, the theory has been a steady adaptation of the classical doctrine to actual changes in institutions and practices which have, in turn, been due to changes in the relative position of different countries, the reasons for which must be sought in profound demographic, technological, social and political factors. What, I think, even the briefest review of the last hundred years or so, makes one realise is, first, how far the 'textbook' description of a smoothly working international monetary system is an idealised pattern that was both relatively short-lived in its pure form and, above all, underpinned by certain political or institutional factors which were the pre-requisite for the system's operation. Thus Per Jacobsson, in the report I have already quoted, after pointing out that it was roughly the period of 1850 to 1910 which marked the heyday of the pre-first world war gold standard and that this was a period when more peaceful international relations were maintained, goes on to say: "the *de facto* predominance of London in the short and long term money markets provided a centre of stability for the world credit structure which enabled the pre-war (that is pre-1914) system to work with a high degree of smoothness and reliability".

Similarly, Keynes, writing in 1930 says: "during the latter half of the nineteenth century the influence of London on credit conditions throughout the world was so predominant that the Bank of England could almost have claimed to be the conductor of the international orchestra. By modifying the terms on which she was prepared to lend, aided by her own readiness to vary the volume of her gold reserves and the unreadiness of other Central Banks to vary the volume of theirs, she could to a large exent determine the credit conditions prevailing elsewhere". It is thus important to remember—and I say this in no spirit of chauvinism or nostalgia, but purely as an objective aid to understanding—that what made the old gold standard system work was perhaps as much the existence of an *"Aequilibrium Britannicum"*—alongside a *Pax Britannica*—as its own inherent virtues.

The other point that a study of the history of this subject brings very forcibly to mind is the relative speed with which, shall we say, the surrounding data of institutional and national realities change. I shall refer to the more recent examples of this later, but even in the nineteenth century there are some to be found. It is as well to remember that in the forties, when the American Federal Government was in a less favourable credit position than some of the states, it is reported that the Paris Rothschild told an agent of the U.S. Government: "You may tell your government that you have seen the man who is at the head of the finances of Europe, and that he has told you that they cannot borrow a dollar, not a dollar"; and Barings were only prepared to raise money in London (at 3 per cent) if the Federal Government would assume the state debts.

Yet by the seventies, with the passing of the frontier and the beginning of the great industrial upsurge in the United States, the situation changed. America began to be not only a powerful trade competitor, but a great potential exporter of capital, and cries of the "American Peril" and of the "American Invasion" were almost as loud as they have been at times in the last two decades. So let us remember these quite sharp turn-arounds when we try to diagnose problems and prescribe remedies based on the experience of half a decade or less!

The Post-War World

The developments of the first fifteen years of the post-war period are sufficiently fresh in everyone's memory to require little detailed recapitulation. It may, however, be worthwhile to note briefly some of the main background changes that must be borne in mind in examining the most recent developments. These points are all obvious ones; they are listed here for the sake of emphasis only. The first is that, since the war, international financial arrangements have been conducted under the aegis—even though they have unfortunately not yet been dominated by—new institutions: the Bretton Woods machinery. Long-term capital movements, at least between developed and developing countries, have to a certain degree been influenced by the operations of the World Bank. The régime of exchange parities, the provision of world liquidity and the relation between balances of payments and domestic policy have been carried on under the aegis of the Fund, aided by the 'auxiliary engines' of the Group of Ten, Working Party

Three, and the increasingly close cooperation of Central Banks both in terms of consultation and in terms of practical mutual assistance. It is, however, to be noted that the Bretton Woods machinery was deficient. Not only did it lack—through American unreadiness to participate—an institution that would explicitly have brought together international and national economic management problems, the International Trade Organization (I.T.O.), but it almost explicitly excluded capital movements from its purview. This was an interesting example of the difficulty of reconciling the preoccupation for freedom of national policy-making with membership in an international system. Keynes himself in his original proposals for a Clearing Union, after arguing the case back and forth, concluded that "the universal establishment of a control of capital movements cannot be regarded as essential to the operation of the Clearing Union, and the method and degree of such control should therefore be left to the decision of each member state". One must remember—and this is something of a paradox—that this conclusion was reached within the framework of an expectation of a Clearing Union that would have been much more like a World Central Bank—with a single universal reserve asset—something very different from what the Fund has been, at least up to now. It would be interesting to speculate whether Keynes would have wanted control of capital movements to have remained the prerogative of national authorities had he realised at the time of the original proposal that the Clearing Union itself would not conform to his complete vision.

The second important point to recall is that at the end of the 'fifties, convertibility among the major currencies had been achieved and that this greatly encouraged a much enlarged flow of capital across national boundaries. This is a development to which many have drawn attention, not least Per Jacobsson himself who, almost exactly ten years ago, in his 1961 report on the work of the Fund, spoke of the "growing freedom for the international movement of funds" and the fact that this had "created new problems which the world has not had to face since the start of World War II".

This easing up of capital movements, both long and short, led, as might have been expected, to a contradictory sort of development. For as one 'eases up', new practices are generated, new markets arise, new institutional arrangements are formed, and many of these changes are irreversible. This means that whenever the need arises—or the authorities think that the need arises—to restrain the freedom which they, themselves, have called forth, they find themselves faced with new and unforeseen pressures. In other words, they cannot simply 'return' to the situation that existed before.

Another more general point to be recalled in this connection is the changed relative position of different countries, and, indeed, the mutations which these, themselves, have undergone. The post-war period began under the overwhelming influence of the economic strength of the United States. The dollar shortage and the fear of its persistence was the overriding feature of the international economic scene; and the 'scarce currency' clause of the Fund's Articles, inspired solely by this fear, remains as eloquent testimony to the transitory nature of what appeared to be the most solid of historical data. Keynes himself had second thoughts; his 1946, postumously published, article on the U.S. Balance of Payments fore-shadowed some of the changes that have occurred, though even he would have found it difficult to forecast either the facts of the U.S. Balance of Payments as they have developed during the last decade or, even more, the attitudes to which they have given rise in many places to the dollar.

Another most important background fact of the post-war period that must be constantly borne in mind is the changed attitude of governments—and of the governed—to the level of economic activity. In the perspective of a century, the greater concern of the 'Authority' with the level of employment of resources, and therefore with the economic process has, no doubt, developed gradually and as a result of a complex of pressures and changing ideas. But as far as the last twenty-five years are concerned, the acknowledgment of responsibility of government to maintain a high and stable level of economic activity and the development of new techniques of economic management, together with a greatly advanced statistical apparatus to enable these techniques to be employed against an assessment of facts, must be accounted as little short of a revolution. The relevance of this factor to our present theme, that is to the international financial system, is not difficult to see. Throughout the inter-war years there were occasions when the dilemma between the desiderata of national policy and the requirements of an international trading and financial system appeared very acute: when Britain returned to the Gold Standard or during the Great Depression, for example. Already in 1930, Keynes had written that the international monetary system "requires that the main criterion of banking policy of each member should be the average behaviour of all the other members, its own voluntary and independent contribution to the final result being a modest one"; and, then, of the difficulty of being a member of an international system "and to preserve at the same time an adequate local autonomy for each member over its domestic rate of interest and its volume of foreign lending"—prophetic words indeed! As we have seen, the Bretton Woods system sought to remove this dilemma by allowing controls on capital movements. But what was not sufficiently realised twenty-five years ago, was the extent to which the management of aggregate domestic demand for the purpose of a high and stable level of activity was to develop into a universally practised and highly sophisticated art, nor the extent to which monetary as well as fiscal policy was to be employed in its service. The relationship, therefore, between not only the objectives but also the means of domestic economic policy and the mechanism governing the stability of the international monetary system was to be profoundly altered.

The 'sixties were ushered in by a return to convertibility of the currencies of most of the major trading countries and with it, greatly increased possibilities for the international movement of short term funds. The period was also dominated by a change in the position of the United States. The traditional and large foreign trade surplus gradually disappeared and this was compensated for by increasing capital inflows. The dollar greatly enhanced its position as a transaction currency, while its use as a reserve currency came under some pressure as a result of the turn-around in the U.S. balance of payments. The underlying trend of the decade was for world trade to increase sharply under the impetus of liberalization, currency convertibility, technological advance and population increase, and with it, both capital requirements and the movement of long-term capital across international boundaries. The growth of the multinational corporation was both a product and a cause of these developments. Its spread created a new surge in the volume of direct investment. Portfolio investment, too, despite remaining restrictions, found ways of increasing to a vast extent thus enabling many to participate in the greatly enhanced level of activity mirrored—though sometime grossly distorted—in the general upward trend of equity values.

The growing use of the dollar for financing international transactions, against the background of currency convertibility and the emerging United States balances of payments deficit, also led, as already stated, to a sharp increase in the volume of short-term money flows. The consequences of the great increase in long and in short-term capital flows were twofold. It led to the creation of new markets for the accommodation of supply and demand, the Eurobond and the Eurocurrency markets, and it made even more remote and indirect than it had been before, on the one hand the relation between trade flows and long-term capital flows, and, on the other hand, that between the normal means of the domestic adjustment process and the requirements of international balance. While this phenomenon has become particularly marked most recently, it is not a new one. Throughout the 'sixties, we find examples of countries being in imbalance on their international payments not only because of changes (positive or negative) in their international competitive position—to which the traditional domestic demand management remedies would be applicable—but also because of long-term capital movements having strong, historical or institutional origins, but no longer thought appropriate and, therefore, subjected to control; and, finally, also due to short-term flows caused by confidence factors, superimposed on more basic deficiencies, or brought about either by short-term inequities in the trade cycle position of different countries, or, indeed, provoked by monetary policy measures imposed as part of the programme of demand management itself.

A future historian of the decade will find many curiosities to wonder over. The ups and downs of the United Kingdom, of France and of Italy are among them. But so also are the changing positions of the United States, Germany and Japan. In none of them are the main factors such as the domestic economic situation, the fundamental position in regard to international competitiveness, or the measures taken either in the area of domestic credit policy—with their marked effect on short money flows—or in regard to the control of inward and outward long-term capital movements, always easy to relate to each other. Above all, I think a review of those years should have the effect, once again, of instilling in one a proper sense of caution not to regard as a lasting feature any individual country's position in the 'league table' of stability-performance in the balance of payments, and therefore to eschew solutions which are implicitly based on the assumption that such positions will continue for a long time.

The Eurobond Market

At this point, I propose to describe the salient features of the two markets that have developed in the last ten years or so to organise the flows of long and short-term capital to which I have referred, before going on to examine the most recent activities in them, particularly in the short-term market, which have given rise to a certain amount of concern. First, then, the long-term capital market. Until the last war, there were only two large capital markets for international borrowing, London and New York to which might be added Switzerland as a more modest one, though with a decided tendency to grow after the war. For obvious reasons, London, though possessing the traditional skills and institutions could not, after the war, provide funds for foreign lending out of domestic capital formation. After the balance of payments crisis of 1964, impediments to both direct and portfolio investment by British investors other than in the Sterling Area were increased, and even the last named became subject to control. Continental capital markets which, even before the war, had not played the same role that London and New York had done, remained, again for obvious reasons, mostly closed to non-resident borrowers. New York, therefore, remained after the war as the only really large market for foreign governments, international institutions or foreign corporate borrowers, as well as the main outlet for international, i.e. non-U.S. originated investment funds. These funds, including European funds, available for international investment were considerable, and, even in the first few years of the 'sixties, attempts were made to mobilise them for international issues arranged in Europe rather than in New York. But the total of such issues remained very small, amounting to only about $150 million per annum on the average, until 1963. That year saw the beginning of a series of policy changes in the United States resulting from her worsening balance of payments situation, which cumulatively had a profound influence on the development of the international capital market. In July of that year, President Kennedy, noting an increasing outflow of long-term capital (from $850 million in 1960 to an annual rate of nearly twice that in 1963), introduced the Interest Equalization Tax. This was followed later by a Voluntary Balance of Payments Programme designed to discourage these outflows and later by a mandatory programme designed to restrict them severely.

As a result of these measures, the development of an alternative market for bringing together the large and still growing volume of international funds seeking long-term investment and borrowers seeking capital proceeded swiftly. The fact that this market has to a very large extent been centered in London is easily explained, first by the fact that the traditional skills of London's merchant banking houses, supplemented by a number of American investment banks which established themselves in London, were available to take advantage quickly of the new opportunities; and secondly by the helpful action of the authorities, for example in halving stamp duty and, above all, in allowing once again the issue of bearer bonds.

In the last eight years, while the market has undergone a number of changes and fluctuations, it has, on the whole, shown considerable growth. From a total volume of $164 million in 1963 it grew to the remarkable total of over $3000 million in 1968, the peak year. After that it declined somewhat to approximately $2500 million per annum in the next two years. During the first seven months of this year, it has already reached over $2100 million, the total over the whole period being $15½ billion. These figures relate to internationally syndicated issues only, and do not include foreign bonds in the narrow sense. Within these totals, there have been interesting developments regarding the type of bonds issued, the denominations in which they are issued, and the types of borrowers. As regards the types of bonds, the two main classes have been straight and convertible bonds, and the proportion between them, not surprisingly, reflects the changing fortunes of stock markets, in particular Wall Street. Thus, the volume of convertible Euro-dollar bond issues rose from $227 million in 1967 to $1735 million in 1968, to drop back again to less than half that figure in 1969, and to $189 million only in 1970, with slightly less than that figure so far in 1971.

Another, somewhat different aspect might be mentioned to illustrate again the variety of this market, namely the experiment made with floating rate bonds, i.e. bonds in which the rate of interest varies every six months, being linked by a fixed margin to the inter-bank six-month lending rate in the Euro-currency market. These bonds, of which there have not been many, have not unnaturally been regarded primarily as banking instruments, of interest to the banking community, and their maturity has tended to be considerably less than that of long-term bonds. Unless interest rates were to drop to levels which now seem highly unlikely, it is probable that these maturities will remain limited to seven years or so and thus form a type of borrowing in between the medium-term bank credit and the long-term bond proper.

An interesting feature of the long-term market has been the fluctuation in the currency in which the bonds have been denominated, reflecting changing views concerning the strength of different currencies. At first, they tended to be almost exclusively dollar bonds, though already in 1963 some were in European Units of Account, which remained a small but fairly steady denomination right through the period, to be joined in 1970 by a small volume of issues in European Currency Units. There have also been at times issues denominated in two currencies, e.g. Sterling and Deutsche Marks, allowing the investor a certain option in regard to subscription, payment of interest and repayment of principal. I need not go into the technical intricacies of these various multi-currency formulae, which have also been employed in medium-term bank credits. The important thing to note about them is not only that they are a vivid demonstration of the liveliness of the market and a tribute to the inventiveness of the financial institutions operating in it, but also that they have been devised as means for overcoming investors' hesitation, stemming from uncertainty about potential exchange parity-changes. The formulae are complicated and provide varying degrees of assurance to the investor while carrying different degrees of risk for the borrower. It would, however, not be extravagant to see in them, limited though their use has been, proof that the market is often ahead of the regulatory authorities in creating its own safeguards in circumstances in which otherwise the whole capital-raising activity might have to be severely curtailed, to the disadvantage of lender and borrower alike.

Thus the flexibility and adaptability of the market has shown itself primarily in its change from time to time in the choice of currency in which a loan has been contracted. While the dollar has throughout remained the most important currency, for reasons which have already been touched upon, other currencies have been used from time to time. Already in 1964, Deutsche Mark issued accounted for just under 40% of the amount raised in dollars. In 1965 the proportion was 50%, but it fell off in the following two years. By 1968 it was back to one-third of the dollar amount; in 1969 it rose to about 65% (or 40% of all issues) to fall back to about one-third in 1970 and to the same proportion so far this year. To these must be added in the last year or so, some, though much smaller amounts denominated in Dutch Guilders.

In judging these developments, a number of separate, sometimes contrary, factors must be borne in mind. The surge of issuing activity in Deutsche Marks was, of course, largely the result of the rapid rise in German reserves, itself a consequence of the weakness of the dollar, before revaluation in 1969. This led the German authorities to encourage the export of capital and this coincided with the desire of many investors to find securities denominated in 'hard' currencies. On the other hand, the German authorities maintained a careful supervision of the volume of all borrowings organised on behalf of foreigners in Deutsche Marks. A committee formed of the principal issuing banks with close contact with the Bundesbank, operates a queue system which determines the issues—foreign and domestic—to be authorised each month, and this has operated and continues to operate most effectively. It is conceivable that, without this control, the volume of Deutsche Mark issues would have risen from time to time to much higher levels in response to the desire of borrowers for funds which could only be obtained in terms of a 'hard' currency obligation, though it is reasonable to suppose that the market would then have been subject to the fluctuations, to the occasional periods of indigestion, to be cured by fasting, which the dollar market has experienced. At the same time, it is noteworthy that once the Deutsche Mark was revalued in November 1969 there was considerable selling pressure on these bonds, thus demonstrating that they were in part used as a safe haven for hot money which could not be placed short-term owing to the German authorities' regulations designed to discourage short-term inflows.

The advantages of this relatively new, yet already substantial and highly developed market are not far to seek. As far as borrowers are concerned, their variety is itself a testimony to the services which the market is rendering. The most cursory glance at the list is illuminating. It includes Governments, Municipalities, Governmental agencies such as public utilities, international organisations and corporations which are household names all over the world. Many little-known, smaller corporations, particularly in new industries, engaged in advanced technology, have also been enabled to secure long-term capital resources through this market and, in the process, have become more widely known internationally, while themselves becoming acquainted with the international financial community. Many purposes have been served by the capital raised in this way and it is no exaggeration to say that much new development from international highways, pipelines and North Sea exploration to international joint ventures and mergers, might, at the least, have been more difficult to accomplish if it had not been possible to make use of the facilities of this market.

As for the investor, the service to him is less easy to demonstrate, since the identity of those who buy these bonds is not readily discoverable. Unlike domestic public issues, these internationally syndicated ones are sold (or placed) by a selling group of banks, including (but not exclusively) the underwriters of the issue. Institutional investors in many countries cannot subscribe to issues denominated in currencies other than their own. Nevertheless, many internationally operated unit trusts and investment funds have invested in these bonds in recent years, as have certain international insurance companies in respect of their 'free' funds and the pension funds of large international companies. However, the bulk of the investors are private individuals; and it is widely thought that this gives to these bonds generally a much greater stability of holding and less sensitivity to relative interest rates and currency uncertainties than is, naturally, displayed by the banks or international companies that operate in the short-term market. What seems clear is that the Eurobond market has managed to tap resources of investors in various parts of the world which might otherwise well have stayed in the short-term pool and not only remained unavailable to those in need of long-term capital but also added to the volume of potential short-term flows.

More generally, it can be said that the market has reached a certain maturity which justifies one in saying that it has added an important new dimension to the international financial mechanism. It is clearly a far cry from the earlier movements of capital of the nineteenth and early twentieth centuries, when the link between trade flows was still strong and when, not only direct export and import movements but also traditional commercial and marketing patterns no less than political and linguistic ties as well as the concentration of financial skills, largely determined the character and direction of these movements. The Euro-bond market represents a more perfect market in the economic sense, in that the motive forces behind supply and demand are now wholly generalised; it is a market in which where capital is needed and where capital can be got are the decisive factors.

This, of course, is not the whole story; and the emergence of such a market—in pure culture, one might say—serves to highlight some of the problems to which the movement of capital, internationally, gives rise. In the first place, the new issue market itself, despite its great flexibility, has shown moments of disturbance. While the issue of bonds denominated in Deutsche Marks is, as we have seen, under careful supervision which has worked extremely well, as have the much smaller, but equally supervised markets in Swiss Francs and Dutch Guilders, the Dollar denominated market is completely uncontrolled; and it is this market which has on a number of occasions in recent years shown itself to be extremely sensitive to pressure from potential borrowers who rushed in only to find the market evaporate as the result of mistaken judgment concerning interest rates, availability of funds or the investor's reaction to currency uncertainties. This sort of problem could be resolved or at least greatly alleviated, by the institution of a measure of self-regulation, as suggested by Sir Siegmund Warburg, whereby the principal issuing houses would organise a queue system similar to that operating in Germany, Switzerland and Holland, backed by the support of the Central Banks and Stock Exchanges concerned.

More difficult are the questions that have been raised by some, for example, Roosa, of the relationship between capital flows and the balance of payments problem in conditions in which these 'autonomously generated' flows take place through the intermediary of an international market. As far as nationally originating capital movements are concerned, the authorities in all the major countries have continued to regard them (with the full support of the Fund) as proper objects of supervision in relation to national policy concerning the balance of payments. Thus, the United States and Britain have maintained control on outward investment and Japan has operated a queue system for Japanese borrowers wishing to tap foreign capital markets. These measures are taken alongside various domestic policy measures in the interest of curing a surplus or a deficit of the balance of payments. But in the present state of our knowledge it is by no means clear what their actual effect is, particularly whether, in imposing impediments to long-term flows, resort to medium and short-term markets by both borrowers and lenders is not encouraged and the problem thus simply shifted to a different part of the system. While much attention has been devoted recently to the problem raised by short-money flows—to which I shall turn presently—very little has been done to study the consequences of longer-term capital movements and the attempts to influence them, often in response to relatively short-term variations in the balance of payments situation, the assessment of which itself rests on an understanding of relationships between the different items and of their statistical presentation which is, as yet, by no means perfect. It may be that the growth of world liquidity, more assured through the introduction of Special Drawing Rights, will help to resolve this problem and make it less necessary to seek to influence relatively short-run balance of payment fluctuations by action on the long-term capital account. What is clear is that this subject requires much more detailed and internationally coordinated study than it has for far received. Meanwhile, the international capital market has provided an invaluable new piece of machinery and one may well agree with the judgment of the Bank of England that "under more stable conditions it may reduce disparities between national markets in the demand for and supply of capital" and given that "the international demand for long-term capital seems likely to grow rather than diminish" the market "could ease the task of mobilising the capital required to sustain economic progress throughout the world".

The Eurocurrency Market

At this point I turn to the question which has recently been uppermost in the mind of anyone concerned with international finance, namely that of the international movement of short-term funds. This, again, is no new problem, for 'hot-money' flows have been known and much debated in the inter-war years, as well as in the earlier post-war period. What has happened is that the volume of funds now capable of rapid movement has vastly increased. This, incidentally, is exactly the phrase used by Keynes when, over forty years ago, he spoke of the difficulties created by movements in the "short-loan" fund as he called it, and which he estimated to be at the end of 1929, £1000 million, a figure which may seem less than terrifying by comparison with the Eurocurrency market (if, *pace* Professor Machlup, I may still so call it for convenience) now estimated at about $60 billion.

So much has recently been written about this market (or perhaps one should say banking system) that it will be sufficient for our purpose to recall only a few of its salient aspects—some accepted, some still highly contentious. I would like, however, at the outset, to stress again some general points to which I have had occasion to refer before. First, we must never lose sight of the fact that the phenomenon of short money flows is not new. What I have just quoted from Keynes is part of a lengthy analysis of short-term flows due to the existence of a highly mobile international short-loan fund which occupies many pages in the *Treatise on Money* and which includes, *inter alia,* an elaborate discussion of possible means for limiting these flows, in order to reduce the possibility that domestic policies might be frustrated—the very subject to which so much attention has been devoted in recent months. The second point is once again not to overlook the speed with which the situation changes. It really is not very long ago—two years at most—that the westward flow of funds was so great and sudden as to create serious fears of a renewed dollar shortage, making recent improvements in European balances of payments precarious and driving up interest rates in Europe to great heights even where domestic policy made this inappropriate. There were many then in Europe who urged the United States authorities to adopt measures—which in fact they did—to stem this flow, if only in their own interest, so as not to risk having American tight money policy frustrated. In fact, this westward flow, that is the liabilities of U.S. banks' head offices to their branches rose in 1969 from $6 billion to $15 billion, only to fall back to less than $6 billion by April of this year, at which point the eastward flow greatly accelerated still further for a variety of reasons, to which I will refer later. It is clear that any consideration of the operation of the Eurocurrency market and its relation to the speed and mutability of short-term flows cannot be separated from a whole complex of other considerations, including the domestic stabilisation policy-mix in different countries (with its effect on interest rates) as well as on the relation between domestic policy and balances of payments. It is, therefore, highly unwise to jump to conclusions as regards the causes of the observed movements.

As regards the market itself, it is clear that a good deal of further study—based on more abundant and carefully analysed statistical material—is needed before we can hope to know as much about it as we do about the operation of a domestic banking system. Professor Machlup last year sketched out the framework of concepts and theory which would need to be filled out for this purpose. Until this has been done, I would think it rash to deal with the problems of the Euro-currency market too readily by analogies drawn from domestic banking operations. This applies particularly to the vexed question of the extent to which this system is as capable, or perhaps even more capable, as a domestic banking system to create credit, since legal requirements or traditional practices that control the relation between reserves and liabilities domestically are here absent. It may well be that this capacity is considerable; Governor Carli has lent his very great authority in support of this view. But what is perhaps more immediately important, but at least as difficult to discover with certainty, is the extent to which this capacity has actually been utilised; that is, how far the existence of this mass of funds has added to the total world supply of credit. There is a presumption that it has, though there must be doubt as to how significant this has been in relation to the total. Above all, as Milton Gilbert has done well to remind us recently, the effect on total credit supply to non-bank borrowers will depend very largely on the direction of the short-term flows rather than on the total size of outstanding deposit liabilities denominated in foreign currencies as reported by the Bank for International Settlements or, for London, by the Bank of England. The westward flow in 1969 probably tightened credit more outside the U.S.A. than it eased it inside; while the recent eastward flow seems to have had the opposite effect, i.e. of easing credit more outside the U.S.A. than it contracted it inside.

Another feature which has been much discussed in connection with the size of the total market and its credit creation capacity, has been the placing in the market of balances by Central Banks and the Bank for International Settlements (B.I.S.). While this is substantial, though not overwhelming in relation to the total—Gilbert has estimated it earlier this year at $10 billion out of $60 billion, of which one-third was from the B.I.S., and the Central Banks of Switzerland, and the other countries of the Group of Ten—it is probably more significant that it has more than trebled in twelve months, as against an increase in the total volume from $44 billion to $60 billion. There are perfectly good explanations for this development: apart from the general growth of world reserves, which would create a predisposition for these placements to rise, the same relative interest rate movements which caused an eastward flow also shifted the relative attractiveness of holding these balances in the Euro-market rather than in the United States.

What, however, this increase in official placements has done is to intensify interest in the question whether the market should be controlled, while, at the same time, appearing to offer at least one means of doing so, namely restriction of these official placements. What is undoubtedly the case is that the flows of recent years and months would have taken place even if the Eurocurrency market had not been in existence. Fundamentally, these flows are not different in kind from earlier ones, particularly those in the inter-war years. One can, however, assert that, as a result of certain institutional changes, the ease with which these flows take place has been much improved and the speed of response to the underlying factors and, therefore, of the changes of direction have been much accelerated. Among these changes must be listed the greater spread of the international establishments and activities of banks, including particularly of American banks in the London market and the much more considerable funds which corporations, particularly larger, multinational ones, now have to manage. Altogether the greatly enhanced alertness now demanded of those who have large funds of money to manage, be they of pension funds, of investment trusts, or of the disposable funds of international companies, has been responsible not only for the enormous increase in the international short loan fund of which Keynes spoke, but has also caused operations in it to have become the concern of many more, and more diversified interests than in the past.

Nevertheless, the factors that influence their activities have remained fundamentally the same. The reason for short money flows are, as they have always been, relative rates of return as between long, medium and short-term employment, as well as between these relative returns in different centres, together with the relative security of these funds in the different placements. Under the heading of security must be included factors that denote not only that of outright political risk, but also the possibility of the imposition of restrictions on the movement of funds, i.e. exchange control and the risk of changes in exchange rates. In a well functioning market, all these various elements should be compounded in two rates, the rate of interest and the forward exchange rate. The Eurocurrency market has organised transactions of this kind in a more perfect manner (in the economic sense of the word) than had ever been done before. It can truly be regarded as the best organised market of any in existence today, exhibiting all the text-book characteristics demanded of one. It has had the effect of combining and integrating all the major money markets of the world and making their reactions to each other's movements virtually instantaneous.

It is at this point that the problem of the relationship between the needs of domestic policy and the response to international movements once again arises. Under the gold standard system this problem was automatically resolved, so long as the rules of the game were observed, in favour of the requirements of the international monetary system. The gold points acted as the triggers which caused inflows and outflows of precious metal, i.e. expansion or contraction of the domestic credit base; and the central banks responded immediately by an expansion or contraction of the volume of credit. This simple mechanism had become suspect already in the circumstances of the inter-war years, if only because of the improbability of different countries finding themselves at the appropriate relative position in the business cycle and, therefore, at just the right point to suffer an externally imposed credit expansion or contraction. The increased responsibility of government for the level of economic activity, now universally accepted, has made for increased awareness of this problem and, therefore, greater sensitivity to the irksomeness of being exposed to 'dictates' from outside which may seem to run completely counter to what are judged to be the proper domestic policies. Thus, in one period the credit base, insofar as it is affected by conditions in the Eurocurrency market, may be sharply contracted because American banks are drawing in funds from this source, while, at other times, European monetary authorities may find their reserves suddenly and substantially swollen, though their judgment of their own situation makes expansion of credit the opposite of what is needed.

It is not surprising, in these circumstances, that more and more thought should have been given to the measures that might be used to avoid these undesirable effects. Generally, this has taken the form of asking whether, and by what means, the Eurocurrency market should be 'controlled'; or, as the question might be more appropriately phrased, as to whether it was desirable and feasible to diminish these flows and/or to offset their effects on the domestic situation where this seemed called for. In one sense it is surprising that this question should occupy the centre of attention. It is not long since it was believed that increasing freedom of international capital flows was likely to facilitate the balancing of international payments, i.e. that such flows would generally be equilibrating. There are two reasons for the change in attitude: first, that the maintenance of exchange rate parities is no longer regarded as a fixed datum to the extent to which it used to be when post-war convertibility was first achieved; second, that a coincidence of economic cycles and of domestic rates of inflation and deflation in different countries is recognised as much more improbable than it seemed at one time. When to these are added the further facts: first, that countries differ (and that there are also sharp differences within countries) on the proper policy mix for domestic stabilisation, in particular what importance is to be attached to monetary policy; second, that the significance of the impact of capital flows on the domestic credit volume or their relation to the other items of the balance of payments varies from country to country; and third, that the short-term flows have become very large indeed, one can readily see why the earlier hopes have proved vain.

Before I examine the arguments for and against intervention of one kind or another into these capital flows, there is one somewhat different aspect of the existence of a Eurocurrency market which needs to be looked at. It is not strictly relevant to the questions with which we are concerned here, but it has been discussed in recent months in connection with various suggestions for controlling the market; that is the problem of how far the Eurocurrency market has encouraged departure from traditional banking standards in regard to the requirements both of liquidity and of proper criteria of creditworthiness of borrowers.

As to the second of these, factual information is, for obvous reasons, not easy to come by. While there have been some disagreeable experiences, the number of spectacular failures has so far been limited. Nevertheless, many people of very great experience in these matters are apprehensive because of the extremely rapid increase in the volume of transactions in this market, of the great multiplicity and variety of ultimate borrowers, and of the greatly increased number of intermediaries whose experience in this field may be inadequate, particularly as ability to establish the precise creditworthiness of the borrower, and may in any case be less than is desirable. It is sometimes thought that the rapid spread of new, and expensive to maintain, branch offices may lead to so aggressive a pursuit of new business as to impair the care that should normally be exercised in these matters. As I say, it is extremely difficult, if not impossible, to establish the facts. But, in any event, even if all the fears are justified, it is hard to see how they can be translated into arguments for control, in addition to those which, as we shall see, are often adduced in the interests of national policy. Even if measures of supervision could be devised, the purpose of which would be to underpin the skill and judgment which experience, including bad experience, should provide, these would be even more difficult to apply in an internationally harmonious manner than those designed for wider policy objectives.

As regards the question of liquidity, as the Governor of the Bank of England has pointed out in a speech earlier this year, the analogy of domestic banking and of the role of a 'lender of last resort' must not be taken too far. The dangers to liquidity (apart from that which arises from the failure of a non-bank borrower and its possible chain reactions) are related to the degree of matching of maturities of liabilities and assets. Here, the position of non-dollar (or non-Deutsche Marks) banks may be somewhat different from those whose normal, domestic transactions are in these currencies; and more careful practice in regard to mis-matching (which in the absence of standby facilities, depends for its success on the unfettered continuance of the Eurocurrency market) may, therefore, be in order. The Bank of England, as is well known, maintains a periodic survey in this regard as far as the London market is concerned. But here again, it is hard to see how 'control' could improve the position: indeed the possibility of restriction could, precisely for the reason just given, quickly have a highly inhibiting effect on transactions and lead to a rapid shrinking of what is still widely regarded as a most advantageous development on the international financial scene.

Controlling Short-Term Capital Flows

In order to analyse effectively the arguments for controlling short-term capital flows in the interest of wider policy objectives, I propose to ask, first, to what extent the fear of inappropriate influences arising from these flows on domestic policy is real, or, put in another way, what are the limits of tolerance for these inflows and outflows. In the first place, it is perhaps worth reminding oneself that there is by no means always a clear correlation between the state of the domestic economic balance and capital flows. The latter may be provoked by factors unrelated, or only distantly related, to the basic international competitive position of a country. Furthermore, the existing machinery in a country for stabilising inflows or compensating for outflows may be more or less effective. Thus the argument that inflation is exported or imported by means of short-term capital movements, requires a good deal of qualification. Not many, I imagine, would argue that the inflation from which Britain is still suffering has been induced by the inflow of reserves during the last twelve months or so, or that the outflow of funds from the United States during the same period has significantly diminished inflationary pressures. The correlation depends clearly on exactly what the domestic situation is, in particular, if it is inflationary, whether the inflation is one of demand-pull or of cost-push; and in the second place, on what measures the authorities can and have taken to reduce the effect of capital inflows and outflows on domestic credit policy.

Quite another question is the extent to which the Central Bank is prepared to see its reserves diminished or swollen as a result of short-term flows, regardless of whether and in what way this may, or need, affect its domestic policy. In the past this question has usually appeared most acute in the case of a country losing reserves. As Keynes put it, the problem "is likely to prove more severe and intractable in the case of a debtor nation than in the case of a creditor nation because it is easier to lend less in an emergency than to borrow more". Though, more generally, it has long been recognized that the correction of short money flows, even where it is closely related to an underlying payments imbalance requiring correction, is not easy—the high mobility of international lending contrasting sharply with the low mobility of international trade in the short term—while it may be inappropriate where this close relation does not exist. More recently, the problem has appeared more acute from the point of view of the country gaining reserves through a heavy inflow of funds. The problem then becomes one of the willingness to accumulate a certain reserve asset. At the present time this question is inevitably linked with the role of the dollar and cannot be further pursued without at least some reference to this problem. To clear the ground, let us for a moment leave out of account the position of the U.S. balance of payments, the question of how far its persistent deficit has been responsible for the greatly increased volume of international capital movements and for the doubts that have arisen regarding the dollar's continued fitness to serve as the key currency and, therefore, as an asset which creditor countries would be willing to hold in unlimited quantity as once they were willing to hold gold. We will revert to these questions after we have looked further at the alleged responsibility of the Eurocurrency market for frustrating domestic policy, in particular, for 'exporting inflation', as well as the various means which have been proposed for controlling the market.

First of all, it should be clear that it is wrong to look at the Eurocurrency market rather than at the forces that determine the volume and direction of flows through it. It is as if one looked at a conduit pipe rather than at the alternating pumps that determine the flows through it. We have already looked at the forces that are responsible for these flows: interest rate differentials (and the policy decisions that influence these) together with expectations regarding exchange rates. We have seen that we cannot assume that the relation of foreign borrowing and lending to the management of the total volume of credit is the same in all the major countries concerned, nor can we assume that each country will always be in an appropriate relationship to the others as regards the economic cycle so that inflows and outflows will be responses to the needs of expanding or contracting the credit base.

Nor can we assume, *pace* the monetarists, that the role of credit policy is the decisive one in this process, nor, even if it were, that it would be so regarded in each country. The reality is, of course, very different. It would be a bold man indeed who undertook to quantify precisely the degrees by which the rates of inflation in say, the United States, Germany, Britain, and France had differed at any one moment of time during the last twelve months, or the shares of difference of the origins of these respective inflations, or the weight of the different elements in the economic policy mix in each of them; and who would derive precise guidance from such an analysis for what should be the proper levels of interest rates in each of these markets, (as well as their relations to rates in the Eurocurrency market) and, finally, for the extent to which short-term money flows should have been acceptable.

Simply to enumerate these various factors is enough to demonstrate the formidable task that awaits anyone who wishes to impose controls on short-term flows that would in some way harmonise the diverse policies that various monetary authorities follow which, even if their objectives are fundamentally the same, namely economic stabilisation, may be based on quite different appreciations of the various factors that I have listed, even if one ignored the intrusion of different political pressures. Thus, as I have said before, it is not possible to achieve clarity regarding the problem of short money flows, let alone agreement on policy, without some clarification of the domestic policy mix, that is, on the emphasis to be placed on fiscal as against monetary policy or indeed other measures of economic stabilisation such as incomes policy, a subject on which opinion both academic and governmental is still in a considerable state of flux.

There are various ways that may be used for dealing with disturbing capital flows. First, there are measures to offset in the domestic economy the capital flows that give rise to major reserve changes; second, there are those that would prevent reserve movements by the use of official borrowing or lending operations; and third, there are ways of influencing the private short flows themselves by varying the incentives that give rise to them. It is the third group of measures that has most actively been discussed recently, and various devices have in fact been tried in one country or another from time to time. These include banking regulations relating to net position vis-à-vis non-residents regardless of currency, or in foreign currency vis-à-vis residents and non-residents alike and combinations of these. Maxima and minima may be set; or reserve requirements may be imposed which may be different for domestic liabilities than for those to non-residents. Interest rates may be set at differential levels for foreign depositors; non-banks may also be subjected to regulations which would generally have to be on the transactions themselves, and would, therefore make it practically inevitable that it should be based on a comprehensive exchange control embracing current as well as capital transactions. Finally, there are various fiscal measures that can be adopted to change the relative incentives for capital flows. All this, apart from analytical questions, raises formidable difficulties, particularly where control of intermediaries, i.e. banks, are concerned which can usually find a non-controlled 'haven' from which to operate.

There is also the possibility that the use of monetary policy, in particular interest rate policy, might be directed more to international, rather than national policy objectives, leaving fiscal policy to take the burden of the latter, a point of view that has been urged by some economists, in particular by Professor Mundell; but the fiscal instrument is seldom sufficiently flexible. No clear conclusion for or against control of the Eurocurrency market is possible now, in my opinion, but no one can help but be impressed both with the difficulty of applying the various measures and with their limited effectiveness when applied. I, for one, remain highly sceptical and I agree with the view of Sir Leslie O'Brien that "the danger of concentrating attention on the Eurocurrency market is precisely that it distracts attention from the real causes of international maladjustment". Without by any means eschewing short-term measures to offset some of the disturbing effects of these flows, it is on these real causes that I believe attention must continue to be kept.

There is, however, one other area that must be examined since, as we have seen, capital flows are also influenced by expectations regarding exchange rates, while, at the same time, the attitudes to them of central banks are determined not only by their real or supposed disturbing effects on domestic economic management, but also by the central banks' willingness to hold certain reserve assets. At the present time, as I have said, this means dollars. Indeed, while interest rate differentials can usually be regarded as the main initiating cause of capital flows, they have often quickly had superimposed on them exchange rate uncertainties; and these have then become the main force maintaining or even accelerating the money flows.

The problem of the U.S. balance of payment deficit, of the dollar as a key currency, and of central banks' willingness to accumulate dollar balances, has been a feature of the international financial situation for nearly a decade. Its specific linking with the problem of short-term money flows (and, not altogether relevantly, with the Eurocurrency market) is, however, rather more recent. As a result, discussion of the role of the dollar and of the U.S. balance of payments has once again clouded by emotion, as it has been on one or two other occasions in recent years. But that is the one thing it should not be. It is not easy, but essential to consider the matter dispassionately and in perspective. While I think the phrase 'benign neglect' which has been suggested as the watchword for a U.S. balance of payments policy is unfortunate (and even the less emotive 'passive policy' is ill-chosen) I would myself regret even more a policy of 'hysterical anxiety'. The facts, though clouded by changing statistical presentations, are not particularly obscure. The United States has had a varying deficit on her balance of payments for several years. While in recent months, some concern has arisen over the trade balance, in general the U.S. deficit on the 'official settlements' basis has been relatively moderate in recent years and has indeed shown surpluses in 1968 and 1969. The basic deficit which is, no doubt, a better measure of long-term overall performance has been fairly persistent and considerable for most years since the mid-'fifties, but the reasons for this state of affairs and, in particular, how far it amounts to a 'fundamental disequilibrium' in the sense of the Articles of the International Monetary Fund, require careful analysis. Leaving aside aid programmes and military expenditures, the main causes of the basic deficit are to be found in a shrinking of the technology gap to America's disadvantage and in massive outward long-term capital flows, until the mid-'sixties at any rate. On the other hand, differential rates of inflation are by no means a proven source of the deficit: indeed, when measured by price movements, the United States enjoyed more prolonged phases of stability during this period than many of her competitors. It is, therefore, very doubtful whether the longer-term imbalance in America's international payments was by itself sufficient to cause questions about any 'overvaluation' of the dollar even though the dollar may not have fully met the four conditions for a smoothly functioning key currency which Wilfried Guth has recently referred to. Indeed, it is widely acknowledged that the U.S. deficit has had some beneficial results in enabling many other countries to rebuild their reserves and, thus, in general to have acted as a source for supplementing world liquidity before the introduction of the Special Drawing Rights.

In this connection one must also remember that, if on a number of occasions in recent years the United States had attempted to correct its balance of payments deficit either by the restrictionist means to which some other countries have had recourse or by a more drastic domestic deflationary policy designed radically to improve her international competitive position, it is far from certain that this would have been welcomed by those who have been most emphatic in their strictures on America's balance of payments performance.

More recently, as Dr. Burns and Mr. Volcker have pointed out, there has been superimposed on the more lasting deficit, a sharp fluctuation as regards short-term capital transactions. These, rather than the underlying balance of payments deficit itself, have been responsible for triggering off the recent disturbances and doubts.

It remains important, nevertheless, that the United States should tackle, and be seen to tackle, the underlying deficit, though, if I have understood the advocates of a so-called passive policy right, I would not disagree with the view that, provided means are found for avoiding excessive short-term flows or at least their self-perpetuating enlargement, improvement of the underlying deficit should be a by-product of the right domestic policy. It is clearly essential for the economic health of her trading partners no less than for her own, that the United States should, as soon as possible, achieve much higher levels of economic activity with a substantial reduction of inflationary pressures, by whatever changed mixture of old policies or the adoption of new ones, such as in the field of prices and incomes, this can be brought about. How soon such a development would be reflected in an improvement in the underlying balance of payments cannot easily be predicted, but to the extent that it was it would deprive the short-term flows of one possible source of encouragement; and it is reasonable to predict that success on the domestic front would soon, even by itself, dispel the doubts that have nourished the massive money flows of recent months. It is also desirable that world liquidity should no longer have to rely to the same extent as hitherto on the American deficit but be consciously and increasingly based on the use of SDR's with a view to encouraging continued progress towards the emergence of a single, universally acceptable and internationally controlled reserve asset.

But it must yet again be emphasized that restoration of a better balance in America's international payments would not completely remove the risk of short-term capital flows going too fast and too far for the stability of the system, as Dr. Burns has said. If we rule out, as I have done, as neither desirable nor feasible, some general, overall 'control' of the Eurocurrency market, then we must look for other means of removing that risk. Some have already been tried. Certain unilateral moves in the field of banking regulations such as those employed in the United States have helped, so long as the flows did not reach flood proportions due to the operation of the confidence factor. Similarly, the imposition of certain restrictions on foreign borrowing by the Bank of England may have moderated the flows somewhat. Certain debt management operations by the United States Treasury, and special issues by the Treasury and the Export-Import Bank designed to 'mop up' funds have probably also reduced the total volume in the market, as has the decision by the B.I.S. not to place any further funds with it.

But, in essence, these measures are, at best, palliatives. Even in the relatively well-understood area of interest rate differentials which are the basic cause of international movements, they cannot hope to overcome the sharp fluctuations that are due to divergent national policies. There are two equally difficult sets of problems on which further progress will be necessary before one can hope to see much prospect of improvement. In the first place, there will need to be much greater agreement than there is today on the role which interest rate policy should play in domestic economic management as compared with its part in the stabilisation of the international monetary system. I have already touched upon this issue at a number of points, and there is nothing else that I would add except that I welcome the signs which I detect of greater readiness in a number of countries to make more use of prices and incomes policy, in the present conditions of cost-push inflation. I hope that those who have been sceptical in the past will not hesitate to change their minds for fear of inconsistency. As Alvin Hansen said, "a man may wear an overcoat in winter and a straw hat in summer without being charged with inconsistency".

The second question is that of the international harmonisation of interest rates to which a solution of the first problem could make an important contribution. Attempts made hitherto in this direction, apart from routine and unpublicised central bank consultation, have not been notably successful. I confess to some doubt whether much more can be done in the absence of progress, first, on the question of exchange rates (of which more in a moment) and, second, on the subsequent and much wider question of the evolution of the international system towards a World Central Bank.

As I have said, while interest rate differentials are usually the predisposing cause of short-term money flows, they would normally tend to be self-correcting, unless they are strongly combined with, or followed by, uncertainty regarding exchange rates. For this then leads to movements which are totally unmanageable by normal means, because they are the result of a crisis of confidence. When such movements occur, and in particular when they affect the relations between the key currency, the dollar, and the rest, as they have done since May of this year, the whole of the international monetary system is thrown into disorder and short-term money flows are seen as the outward signs, rather than as the causes of maladjustment. Attention then turns, as it has again in recent weeks, to exchange rate policy, both as a means to overcome a temporary crisis, as well as to make the system more lastingly sound. Naturally, all the old debates concerning the dollar and the official price of gold are revived in a specially acute form and I do not propose to enter into these now, having made my own position clear on many earlier occasions. Similarly, the advocates of a completely flexible system of exchange rates have professed to derive considerable support from recent events. This is not the time or place to go into this question. I cannot, however, refrain from saying that I find it hard to follow those who say that the exchange rate is 'a price like any other' and should therefore be left to 'find its own level'. Even if the dollar were to be excluded from this principle (though I do not quite see the logic of this), I doubt whether the prices of Sterling, the Yen or the Luxembourg Franc are really no different in kind from the prices of a packet of cigarettes, a bushel of wheat or an oil refinery.

There are various devices, however, that might be used, ranging from forward exchange rate intervention, through dual exchange rates for current and capital transactions (the latter too often wrongly identified with 'speculative' ones), to greater exchange rate flexibility within wider margins.

Of these, the second and third have been most frequently considered in recent months. They differ from each other substantially, in that one involves control, while the other does not. Controls will tend to be uneven in their incidence and unnecessarily hampering to individual transactions. There is, basically, the conceptual difficulty of distinguishing capital and current transactions except on a basis which is arbitrary and which such experience as there is has shown would in practice mean that control would quickly involve some current transactions as well. Even if one ignored the intellectual and practical difficulties of segregating these payments, experience has also shown that a system based on such segregation will work only so long as the discrepancy between the two rates of exchange remains small. As soon as it becomes substantial for any length of time, the problem of evasion becomes troublesome and efforts to deal with it would quickly lead to more and more extensive exchange control.

The use of wider bands of exchange rate fluctuations around parity is not based on any attempt to classify transactions. I leave out of account here the argument that is advanced in favour of this device, namely that the possibility of wider fluctuations would assist to produce a more smoothly functioning balance of payments/domestic adjustment process mechanism; and furthermore that, because it would accustom everyone to the possibility of greater swings that hitherto, it would make changes of parities less 'political' and, therefore, traumatic. For our purpose, the advantage claimed for wider bands is that they tend to make expectations of further exchange rate changes in one direction weaker, the more the rate actually moves in that direction. This will have an equilibrating effect on short-term capital movements. It is not entirely clear why this should be so, and the experience in this regard from floating exchange rates is not, perhaps, entirely relevant; but it may be that, provided the whole system of exchange rate parities is generally regarded as reasonably stable for a considerable time ahead, the greater freedom of manoeuvre of the authorities in adjusting their intervention policy will encourage the equilibrating tendencies in capital flows rather than their escalation. The proviso is, however, extremely important; and there is the further point that it is not *a priori* clear how wide the margins should be to produce this beneficial effect. Announced margins should not be wider than those the authorities intend, in fact, to enforce, nor should they be too narrow for the equilibrating tendencies to assert themselves.

But it should not be forgotten that greater flexibility also has disadvantages since some of the flows themselves contain self-correcting equilibrating forces and one would not wish to discourage these by the possibility of wide exchange fluctuations. This may theoretically be less of a danger in the case of long-term capital movements than in medium and short-term ones; but in practice, especially as the result of the great strides made in recent years in refining the operations of different markets and their interrelation, one must be prepared to see considerable disturbance created by exchange fluctuations, the net effect of which may be a general discouragement to international capital movements, desirable and undesirable ones alike. Similarly, some price in terms of discouragement to international trade itself may also be involved.

The paradox about wider bands, thus, is that they are unlikely to produce the good effects which are claimed for them unless they operate against a background of general stability of the whole system, while the greater that stability is, the less will wider bands be needed. Nevertheless, of all the specific measures suggested, moderately wider bands may be the most useful, at least in a period of transition to a better general system.

In the end, however, despite the understandable search for relatively simple, limited and quasi-automatic solutions, it is difficult to escape the conclusion that, at this stage in our economic evolution, a much more general attack on the problem of international financial stability is the crying need. As we have seen, even in the calmer days of a hundred years ago, the system was sustained by what I called an *Aequilibrium Britannicum*. The attempt, in recent decades, to underpin the Bretton Woods system by an *Aequilibrium Americanum*, while it has considerable successes to its credit, has proved inadequate essentially because, in the conditions of the world today, a broader base is required. A pre-requisite for at last creating this is an atmosphere in which different views, based on national interests—whether real or illusory—are not to be equated with virtue or vice. Of course, if divergent policies are immediately made objects of moral obloquy, progress will be non-existent. As far as being moved only by enlightened concern for the well-being of the whole system, we should assume that all countries have an unblemished record. And as far as the pursuit of sensible policies to this end is concerned, it is as well to assume that all countries live in glasshouses. Unheroic though this may sound, it is unfortunately the case that nothing other than continued and more intimate international co-operation can produce the right result. Even most of those who believe in *nostra,* like universally freely floating exchange rates, will admit that for such a system to function, more rather than less international co-operation is required not only in the international field itself, but ineluctably as we have seen, in regard to domestic policy also. The lesson to be learnt from the history of the last twenty-five years is not that the Bretton Woods system has broken down, nor to indulge regrets that those primarily concerned were not ready after the war to knit the world economy more closely together. It is rather whether they are ready now.

International Capital Movements—Past, Present, Future

by Sir Eric Roll, K.C.M.G., C.B.

The text which follows is that presented orally on September 26, 1971 by the author. A background paper on the subject had been distributed earlier to all those participating in the lecture meeting; its text begins on page 2.

IT GIVES ME GREAT PLEASURE indeed to be appearing here under the chairmanship of Randy Burgess. He may not recollect it, but I remember vividly the first time I met him. It was when I first came to the United States as a Rockefeller Fellow, very many years ago. I was armed with a list of introductions from Josiah Stamp, whose son I am glad to see here today. And the first of these introductions which I used was to a young but already very eminent commercial banker in the city of New York, Randolph Burgess. And since then, I have been fortunate enough for our paths to have crossed quite frequently, particularly when he and I were both in the public service.

As for the man in whose honor these lectures have been founded, I cannot claim to have known Per Jacobsson as intimately as many of those who are present here today. But it was my good fortune to see a great deal of him from time to time, and more particularly during the Marshall Plan. And I have very clear recollections of early breakfast meetings with him in his hotel in Paris, or of late night nightcaps in Montmartre bistros. He combined in a unique fashion three great qualities—fine theoretical understanding of the international monetary mechanism fortified by keen appreciation of the practicalities of finance; warm sympathy for the problems of individual countries, but subordinated to concern for the well-being of the international commercial and financial system as a whole; and, above all, fearlessness in expressing his views.

Happily, these qualities, as vital today as at any time since the war, are once again combined in the present distinguished holder of the post of Managing Director of the International Monetary Fund, who for reasons that are well-known to all of us cannot be present this afternoon, and is engaged, I hope, on much more fruitful occupations.

I spoke in my paper of my hesitation in broaching this subject. And as the distance, both in space and time, between the Oxfordshire Chilterns and the Great Hall of the International Monetary Fund has diminished, hesitation has turned into trepidation. For we are on the eve of an annual meeting of the Fund which is taking place after what must surely be accepted as the most climactic development since the Fund was created.

I have prepared an inordinately long paper for this occasion. I am fully aware of it. But knowing that it would not have to be delivered, I felt it right to provide a fairly detailed background to our discussion.

It will be evident to you, even if Randy Burgess had not told you so, that my paper was finished before the announcement by President Nixon of the August measures. Rereading my paper, I do not feel—and I hope this is no sign of complacency—that as a result of these measures I would need to change anything that I have written. But clearly, something must now be added.

No one, I am sure, would wish for progress in human affairs, whatever they are, to be the result of sudden convulsions or of crises. Nevertheless, when these do occur, as they have, they can be useful if they enable us to distinguish, as is perhaps difficult in more tranquil times, between the essential and the inessential. They can help to clear the air.

For my part, I would hope, for example, that one result of the events of the last six weeks or so will be to remove the exclusive concern that was evident before, and against which I have argued in my paper, I hope convincingly, with the Eurocurrency market as such. I hope that at least one lesson we shall learn from the present monetary disorder is that fundamental factors are at work and have therefore to be dealt with, rather than to concentrate on the surface phenomena to which these give rise.

Again, to take the same example, I have given various arguments in my paper for taking the view that so-called controls of the Euro-currency market are undesirable. Since then, the number of measures that affect the free flows of short-term funds has grown. But I remain unrepentant in thinking that, so far from making more fundamental remedies less necessary, they have had the opposite effect.

A universal system, for example, of dual markets seems to me, even if it were feasible, to be highly undesirable.

This is not to say that there may not be occasions when the monetary authorities, finding themselves in an extremely difficult situation, may not need to resort to measures which restrict the freedom of short-term capital movements, measures of the kind to which I allude in my paper and which I don't propose to go over again here. But if they do, I do hope we won't fool ourselves into thinking that these are good in themselves or that they are anything but the most superficial symptomatic therapy.

It is as well, I think, for the authorities to remember the old Horatian tag—though you drive nature out with a pitchfork, she will still find her way back. And that way, some of us know, will lie through various control-free Ruritanias.

The emphasis which I have tried to place on interest rate differentials, and the forces which determine them in each country, including the differing significance attached in the various countries to monetary management, and on expectations concerning the stability of existing exchange rates, together with the forces that determine these, seems to me to have been fully justified by recent events.

I myself, more than ever, am convinced that in the long term flourishing international capital and money markets, the advantages of which I am sure are fully accepted by everyone, depend for their continuance as a beneficient force, rather than as one of disturbance, on, first, greater progress in the harmonization of domestic economic policies, and second, the underpinning of the stability of the international monetary system.

In the longer term, moreover, these two objectives are really one and the same.

I have given sufficient indication, I think, in my paper, of my own views on these objectives, which I profoundly believe should ultimately lead to a world central bank as the guardian of a single international reserve asset, sustained neither by the nineteenth century *Aequilibrium Britannicum,* of which I spoke in my paper, nor by the *Aequilibrium Americanum* of the last twenty-five years, but by true *Aequilibrium Universali.*

However, it is not on these longer objectives that I want to dwell in my brief remarks today.

As is clear from my paper, it is all very well to start off by talking about international capital movements, long or short, but one is inevitably, and very soon, at that, obliged to deal with the whole range of current international monetary problems. This means, particularly after the August measures and the various international discussions that have taken place and are still taking place since, that one must talk about the present currency disorder.

This is not easy.

Having spent a very large part of my life in the service of government, I am particularly keenly aware of the hazard of saying anything publicly at a time when difficult and delicate negotiations are going on. Nevertheless as I speak only for myself today, and this is an occasion when the speaker, I think, can regard himself in Shakespeare's words as a "chartered libertine", I will give a few personal views on the events of the last six weeks and their consequences.

In the first place, I am bound to say that I have enormous sympathy for the position of the United States, the pressures that the Administration was under, both nationally and internationally, and for the need it felt for bold decisions. Particularly as far as the international side is concerned, it seems to me to be hardly for those who have been lecturing the United States for so many years on the need to put its house in order to complain about its decision finally to do just that. One might express regret at the tardiness of these decisions. One might feel that had they been taken earlier, they might have been less radical and troublsome. One might disagree with some of the individual items in those decisions. But the determination as such, both to set the U.S. economy back on the path of growth without inflation and at the same time to bring the deficit in the balance of payments under control should surely evoke nothing less than the warmest welcome.

As I said in my paper, it is essential for the economic health of the world that the United States, in common with so many other countries, including my own, should quickly achieve much higher levels of economic activity with a substantial reduction of inflation.

It would be presumptous for me today to comment on the domestic parts of the measures taken here to this end. But I for one am delighted that the Administration was not deterred by possible charges of inconsistency to make some moves on the prices and income front.

When it comes to the decisions in the international field, their consequences must naturally be subject to debate. But so also must be the reactions of other countries, both in word and in deed.

For my part, I find that the decision to "close the gold window", which necessarily entailed a decision by a large number of countries no longer to endeavor to maintain the fixed parity of their exchanges with the dollar, to have been entirely correct.

I would emphasize, as should be clear from my paper, that I am strongly opposed to floating exchange rates as a normal regime. But in certain circumstances it becomes inevitable as an interim measure. And this is clearly very much the case at present.

I am less convinced that in strictly economic terms the imposition of a ten percent surcharge on imports was essential. And lest it be thought unseemly on the part of one who in 1964 had to explain to the American Administration—I may say with some success—the virtue of the British decision to impose such a surcharge, I must point out that the circumstances were different, in that Britain was at the time trying to maintain its parity, while the United States was effectively producing a devaluation of the dollar.

More important, there must surely be considerable doubt whether in a situation in which the international competitiveness of the United States has declined, due to a relative deterioration of productivity over a number of years, the provision of further protection to the domestic market in this form, as well as by other devices, is likely to be a corrective in the medium and longer term. Experience elsewhere does not support such an expectation. However, I can quite see the political factors, both domestic and international, behind this particular decision.

I also have very great sympathy with the view which, if reports are to be believed, is being held by the U.S. authorities, namely, that the present situation requires a fundamental reform of the international monetary system rather than a hurried patching up of some sort of agreement. Many of us have long argued that fundamental reforms were becoming increasingly necessary, and therefore we must necessarily agree that every opportunity should be taken, such as the present situation, to press on with these.

However, these are, as we all know only too well, matters that are not easily resolved quickly. The experience of the discussions on improving the methods for providing world liquidity and in the process creating the beginnings of what would eventually become the basic reserve asset, which led to the creation of the Special Drawing Rights, does not make one sanguine that progress can be achieved in a short time.

Furthermore, the inclusion of other problems in the field of aid and defense burden-sharing, if these are really meant to be tackled concurrently, can hardly be looked upon as improving the prospects for an early overall long-term solution. I myself would be much happier to think that these matters will be dealt with seriatim rather than all at once.

What, then, must we hope and work for?

My own feeling is that the present state of affairs in the international financial system must not be allowed to continue much longer. True, life has a habit of going on, and markets and individuals and institutions operating in them tend to adjust themselves even to the most disorderly situation.

But there is already evidence of the inhibiting effect which this is having on international economic relations. And it would be totally wrong to think that if this present situation is not remedied soon, it will simply stay as it is. It will certainly deteriorate further through the spread of further restrictions of exchanges, both commercial and financial.

At a time when so many countries are trying to reactivate their economies, not yet having fully conquered inflation; at a time when great developments, both public and private, are needed, in the field of, say, oil exploration, extraction and transport, or in the provision of a better social and economic infrastructure in a large number of countries, even in the rich, developed world; and when these are crying out for huge capital resources, the prospect of a gradual shrinking of capital markets must be truly terrifying.

At the same time, it is naturally highly desirable that whatever early agreement is reached in the monetary and trade field, it should be in the direction in which the longer term reform in the international monetary system is being sought.

Suggestions, for example, which I have seen attributed in the newspapers to the distinguished Italian Finance Minister, Sr. Ferrari-Aggradi as well as, of course, to the Managing Director of the Fund himself, certainly recognize this essential link. Nevertheless, I am particularly anxious to see an early agreement for the reestablishment of exchange parities vis-à-vis the dollar at levels which command credibility. I expect that this will now have to be combined with a greater margin of fluctuation within support points, though I have shown in my paper that I for one do not regard wider bands as the great remedy that some people do. I do not myself consider that there is any cogent economic case for including in such a realignment the modest increase in the official dollar price of gold which is advocated in some quarters. I can see that this might have some significance in terms of bookkeeping for central banks.

The more sophisticated arguments which I see are now being used in favor of this proposal, although seductive, seem to me to be drawn from quite a different universe of discourse; namely, from a régime appropriate to a situation in which there is a single reserve asset already in existence and accepted, and from a consideration of how this asset, as a yardstick, is to be related to all the currencies that will be linked to it.

I am not yet convinced, thought I am open to persuasion, of the relevance of this proposal to a solution of the interim period problem of parity realignments designed to secure a better U.S. balance of payments performance, including a discouragement of sharp fluctuations in short-term money flows.

Thus, essentially this particular proposal seems to me still to be political rather than economic. And while that may in no way diminish its importance, we must remember that in politics usually there is some political element on both sides of the argument. Still, if this one measure really made all the difference between an early agreement on parities and continued deterioration, I for one would naturally not oppose it.

However, I would strongly hope that an early realignment of currency parities would be accompanied by the withdrawal of the ten percent surcharge and of the other new protectionist measures of the United States. These seem to me to be the minimum elements for immediate action.

It is also, I think, essential, that they should be accompanied by agreements which will make the new pattern of exchange parities, as I have said, one commanding a high degree of credibility as to its viability for a reasonably long period ahead. To this end, some action must, I think, be taken in regard to dollar balances as has been advocated by a number of people, including, I think most recently by Bob Roosa.

Whatever may be the arguments which the United States may see in favor of adopting a purely waiting attitude while other currencies float, mainly upwards, and whatever may be the arguments for more rapid progress towards the elimination of the dollar as a reserve asset and its replacement by a single, universal, internationally acceptable asset à la Special Drawing Rights, it cannot be in anybody's interest in the meantime to allow confidence in the dollar to continue to be eroded without limit. It certainly cannot be in the interests of the United States for this to happen, however much she may desire an immediate upward movement of certain other currencies.

Lack of confidence in a currency can be extremely dangerous and beyond a certain point, impossible to control, particularly when it begins to effect one's own nationals.

Moreover, however much we may all want to see a new reserve asset, the dollar is bound to continue to be the principal transaction and intervention currency.

I believe, therefore, that some action in regard to dollar balances in parallel with a realignment of parities is essential.

It is vain to hope that one can at one stroke find parities that will reflect all the varying factors that, in theory, go into the determination of relative exchange rates—factors such as relative competitiveness, probable relative rates of inflation over time, and so on—to such a degree of accuracy that they will lay to rest all anxieties or hopes which lead to what are called "speculative" movements—particularly if large short-term balances of the major currency overhang the market. These must, therefore, be consolidated in one way or another.

Indeed, in the light of the remarkable turnarounds which we have witnessed in the last twenty-five years in the relative fortunes of so many countries, there is some danger that parities chosen under the impact of an immediate crisis may be very much out of line with the likely development in relative international productivities and international competitiveness that we are likely to witness over the next few years. And I must say that some of the figures that I have heard mentioned, without authority, of course, give me a certain amount of anxiety in that regard.

I do not think that I need say anything much about what should constitute the longer-term improvement of the Bretton Woods system which one would hope could also be proceeded with, though necessarily at a somewhat slower pace. Happily, there seems, in theory at least, to be a fair measure of agreement on much of this, though no doubt there will be sharp disagreement when it comes to deciding the rate at which a new reserve asset should be installed. And much as I would like to believe it, I cannot see that degree of international pooling of decisions on matters such as domestic monetary policy without which, I fear, we shall never be free from the risk of recurrence of crises, to be just around the corner.

These matters, we must remember, are not decided by economists or financial journalists writing from their secure fastnesses. They are not even decided by bankers, who are, of course, subject to the vagaries of the market. Though we must remember that in many an economist and in many a financial journalist there is a politician hidden, wanting to get out. They are and must be decided by politicians, who are subject to the at least as hazardous vagaries of the electorate. Long acquaintance with politicians over many years has taught me that while they are only rarely much better than other people, they are hardly ever worse. But their priorities and their time horizon are necessarily different. It is no good, therefore, trying to turn them into economists or bankers. The most important thing I believe one can say to them in the present situation is what I mentioned in the concluding remarks in my paper. When it comes to doing the right thing in international economic matters, none of us has an unblemished record. We all live in glass houses. And we know what people who live in glass houses should not do.

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MR. BURGESS: Well, Eric, we are very grateful for a pungent and forthright and penetrating statement.

Now I call on our second speaker, Dr. Wilfried Guth, also a man of large practical experience, as well as great theoretical understanding.

Commentaries

by Wilfried Guth and Henry H. Fowler

The texts below are those of the two papers on the subject presented orally by their authors on September 26, 1971.

DR. WILFRIED GUTH: When Per Jacobsson was in the chair in this building only ten years ago, the world monetary scene looked quite different from today. Capital movements, both short- and long-term, were of much smaller size, and the Eurodollar was an unknown entity. Yet I think Per's basic ideas, or should I say ideals, are very relevant to our situation today.

Discussing the various problems which international capital movements undoubtedly create, we should remember his untiring effort and final success to achieve free interchangeability of the major currencies under Article VIII of the Fund Agreement, as well as his deep belief that economic nationalism is in our time an anachronism which must be replaced by a truly international spirit, a recognition that we live all in one interconnected world.

Sir Eric has conceived his lecture in this very spirit. And I am not only much impressed with what he had to say, but I also find myself in very broad agreement with his line of thinking. And I know in advance that what my good friend Henry Fowler will have to say will be on the same line. And I think, with all due deference, there might perhaps be some reason to criticize the organizers to have invited three good friends of old international spirit to comment on the same subject. My only chance, under these circumstances, is to take some shades of difference with Sir Eric and put them under the magnifying glass. In other words, to try to be as precise and as provocative as possible.

I shall concentrate mainly on the question of controls and freedom, having in mind what I just said about Per's basic philosophy. I also think the greatest danger at this moment is the possible withdrawal of major countries into restrictions and protectionism.

Let me first say a few words about the importance of international capital movements in the context of present events.

On the one hand, as Sir Eric has just pointed out, international capital movements have not been and are not the key problem of our world monetary system. They are not the center of the hurricane. In my view, the fight against inflation on our various home fronts and a realistic realignment of currencies, plus a return to fixed parities are the main problems which have to be solved.

On the other hand, however, as Sir Eric has also so aptly demonstrated in his paper, international capital movements may have a strong impact on these key problems. Moreover, they are a crucial and indispensable element of our world economy. I would daresay that today, for the wealth of nations, they are equal in importance with trade.

I find it therefore surprising that while many people worry about the harmful effects of floating rates or restrictive practices for world trade, relatively few get excited about the consequences of such measures on capital movements and world investment.

I think that we have to try to strike a better balance in our thinking. When I remember last May's banking conference in Munich, one could sense the feeling that the one problem we had all to solve—as I said at the time, the only villain of the play—was short-term international capital movements. Now we seem to think only of currency alignments and forget about capital movements.

If we agree on the general importance of international capital movements, it seems nevertheless necessary to make a clear distinction between short-term and long-term movements. Although there is no clear-cut dividing line between them, and although they are both used—and sometimes misused—for the same purpose, I think they are very different so far as their effect on monetary policy and on the balance of payments is concerned. And the case for freedom or controls in my view at least is not the same for both categories. Recent discussion has in my opinion suffered from a lack of such distinction.

I follow Sir Eric in commenting first on the long-term movements.

He has described the great merits of the Eurobond market, and I fully share his views. I would like to add direct investments, both among the developed countries and especially in the less-developed countries, as other highly desirable components of international capital movements. And of course, the sizeable flows of official aid to these countries through national or multi-national agencies must also be mentioned here.

All these movements of longer-term funds contribute to economic integration and to a better allocation of world savings and world resources. In my view, they are useful almost without exception and we should all wish to see them grow further.

They have one other element in common which is often overlooked. They are autonomous, not induced capital movements or residual items. This means that they are based on investment decisions and cannot be turned on or off as we want just to compensate for surpluses or deficits in the current account of balance of payments. They may compensate—think of the German case on the surplus side. But they may also, as we have recently seen, aggravate a given current account situation. Although I would point out here that the long-term movements are not likely to have such big effects as the huge waves of short-term capital movements that we have experienced in recent years.

Because of their adverse effect on weak balance of payments situations, long-term capital movements have been restricted by voluntary or mandatory controls in many countries. Trying to keep my promise to be provocative, I want to challenge these policies as a matter of principle. I wonder whether the harm being done by such controls to capital markets, world investment patterns, or, to put it broadly, general welfare, is not in most cases greater than the gains in the balance of payments.

It should not be forgotten that what has been proved by events so convincingly in trade is also true for capital movements. Liberalization brings strength, not weakness. And as a side remark to Sir Eric's presentation of the emergence of the various Eurobond currencies, I would like to say in this context that it was their widely liberalized capital market which has made the Swiss franc and the Deutsche mark desired international issue currencies beside the dollar. Or to quote another example, it is the freedom, the lack of restrictions for Eurodollar transactions which has given the City its powerful financial position of which Sir Eric has rightly spoken. And it is evident that I align myself here completely with what Sir Eric has said about the dangers of imposing a ten percent surtax on trade.

To come back to capital movements, some of you may say, "This is a wonderful sermon, but what then to do with balance of payments deficits which become difficult to finance?" As a minimum approach, I would say that controls on outward long-term capital movements should only be applied as a temporary measure if all non-protectionist means to improve the balance of current accounts have been truly exhausted. But I would like to go even one step further and question the whole concept of treating long-term capital movements as scapegoats in all cases of balance of payments disequilibrium. In this context, I refer to Roosa, who has said, "The classical concept of the causes of imbalance in a nation's external accounts . . . presumes an unrealistically simple structure of the determinants of international payments."

If one accepts the thesis that long-term capital movements are structural elements of a country's economic situation, its relationship of savings and investment, its industrial and export pattern, and its role in world finance, then they should be treated according to the same principles as are universally accepted, though not always followed, for trade. In other words, they should not be subject to restrictive controls. It would then only be logical to say that, if a country's current plus long-term capital account remains in sizeable deficit for a number of years, its balance of payments must be considered in fundamental disequilibrium. It would therefore have to reappraise its exchange rate relationship with its main partners.

I hope it is no sacrilege to ask in this context whether the United States balance of payments program on private capital movements, though undoubtedly induced by restrictions on such movements in other countries, was really useful: whether it has not diverted attention from the real battlefield (I include here also the thorny question of fair burden-sharing in aid and in unavoidable defense expenditures); whether it has not merely postponed the "moment of truth" for the United States and all other countries concerned.

In particular I wonder whether the closing of the New York capital market for most international borrowers has brought net advantage to the United States. At any rate, it has tended to overburden other free capital markets which had to introduce the queue system and some other devices. I repeat, Mr. Chairman, this is a question, not an answer.

In some other industrial countries, access to their capital market for foreigners has been prohibited, or at least partly prohibited, even in the absence of balance of payments problems. Such policies have been motivated by the overriding needs for domestic investment funds.

While recognizing this problem, and admitting a certain natural preference for domestic needs, I do not think that the protective solution, or should I say the mercantilist solution, is compatible with the state of integration in our world. I might add that the burden of international issues on national capital markets is likely to be smaller if it is more evenly spread over a greater number of truly free markets.

Sir Eric has recalled in his historical remarks why long-term capital movements were left out of the Bretton Woods Agreement. I share his regret, and I wonder, at the same time, whether it is too late to establish appropriate machinery for this purpose.

Again it seems only fair to quote that pioneering spirit, Bob Roosa, who has said, "The conspicuous fact that almost every country turns almost immediately to reliance upon capital controls of one form or another at the earliest sign of strain, calls for a systematic attempt to formulate some rules of the game. . . . Some new approach will have to be found for a multilateral consideration of criteria and concepts to guide the behavior of nations over the years ahead."

I would only add the question whether this new concept should not be elaborated in this building. And it is not for sentimental reasons, Mr. Chairman—although I have such feelings for the Fund—that I would like to say that the role of the Fund should in my view be reinforced for several purposes.

Turning now to short-term capital movements and the Eurocurrency market, I think I can pass over a description of their usefulness as a lubricant of world trade, as someone has put it, or as shunting station for private international liquidity, in particular for the multinational corporation. In this sense, they are not only useful, but necessary, if we do not want to march backward.

Yet we have to admit that they are potentially much more dangerous for the working of our monetary system than the long-term movements. I say potentially, because they may also work in an equilibrating sense, not in a disequilibrating one.

What are these potentially greater dangers? I shall enumerate them only very briefly.

First, their dimension is much more apt to upset the applecart. Compare only the estimated $60 billion of the Eurodollar market with the annual issue volume of $3 billion to $4 billion on the Eurobond market. Although it is well to remember in this context Per Jacobsson's words, "It is important that we should not allow our thinking to be dominated by the movements of short-term capital, overwhelming as they may seem to be over a short period."

Secondly, they may shift direction much more rapidly, thereby bringing much more unrest to our monetary system. As we have seen, they may create strong expectations of parity changes, even in cases where such changes are clearly not justified by the situation of the basic balance of payments.

Third, they may endanger not only balance of payments equilibrium and the distribution of international liquidity—fortunately central banks have learned to cope with this problem by swap arrangements, recycling and other methods—but they may be dangerous also for internal equilibrium, i.e. price stability. In other words, there is a built-in inflationary potential which makes short-term capital movements so conspicuous a problem for central banks. And I may cite in this context the German Bundesbank, otherwise a very powerful institution, which for a long time has felt quite frustrated in view of this influence.

At first sight, then, there seems to be a clear-cut convincing case for controls of some kind. And it is by no means surprising that this was the almost universal opinion in the days of the May crisis. There was one remarkable and notable exception, Sir Leslie O'Brien, who has made us think twice about it, and I think we owe him sincere gratitude for that. First of all, his statement that trying to curtail extensive capital inflows by way of controls is only to cure the symptoms, is very true. But more importantly, we should never forget the experience of many countries, including my own, that controls have a natural tendency to spread more and more in a sort of Parkinson's Law, and become all-embracing, penetrating in the end also the mentality of people, which I think is the worst damage.

For countries which have completely liberalized their payments, and which therefore have, of course, the greatest exposure to such movements, the reintroduction of exchange control would be a dramatic step backward.

Thus, in my view, we are faced with a real dilemma. It is difficult to argue in favor of letting short-term movements of capital go unchecked. And it is as difficult to disregard the severe disadvantages of exchange control. Are there any possible ways in between? This can be regarded as a true $64,000 question.

Let me try to enumerate briefly the main avenues of possible action to reduce the potential threat of massive short-term money flows. I make my apologies in advance for again being necessarily sketchy.

First, through a realignment of parities and the establishment of realistic exchange rates. I shall not dwell on this subject, but I repeat this is a key issue today.

Secondly, through central bank cooperation in the field of interest rate policies to avoid unnecessary differentials, and in the better use of policy mix, including efforts to try to arrive at some sensible incomes policy. (Whether this is possible or not, I do not know.) Here again, I refer to what Sir Eric has so elaborately said in his paper.

Third, through general surveillance of the Eurodollar market by the central banks and joint action to check its growth, if necessary by way of open market operations and agreement not to "re-feed" official balances into the market.

I think it is fair to say that, if international cooperation could be improved in these three fields, we would be far better off than we were in the last years. Still, I would consider it dishonest or illusionary to pretend that these requirements could be fully achieved and that there would be no more intractable situations for central banks stemming from short-term capital inflows. Even if we arrive at the best possible solution of the present crisis, the problem of short-term capital movements will again at some point pose itself again.

I therefore think that central banks must be allowed to equip themselves with some suitable weapon to cope with such inflows. It would be almost illogical if the field of credit creation from abroad would be excluded from their universal task to control the money supply.

As far as inflows to domestic banks are concerned, central banks have already applied preventive minimum reserves in a number of cases. There is also the possibility of not allowing interest payments on foreign deposits.

But the real problem is Eurodollar borrowing by non-banks. In dealing with this problem we are still in the experimental stage.

One possible method discussed last year in Germany was to require non-banks to apply to the central bank for such borrowings. True, this is a sort of exchange control. But it could and should be limited as far as the number of firms supervised and the amounts are concerned.

Nowadays another concept, that of minimum reserves for non-banks, has been considered more elegant and more liberal by our authorities. Whether it could be managed by a reasonably small apparatus remains to be seen. No doubt there are still other and perhaps better devices.

Whatever method is chosen, it seems to me of paramount importance that it is used flexibly and more as a "fleet in being" than as an actual weapon, except in emergencies. It is only then that the chain reaction of controls which I have described can be avoided. For this very reason, I would give such instruments to central banks and not to ministries.

I am of course aware of the problem of segregating short-term capital movements from the long-term ones. But I think it can be solved in a reasonably satisfactory way with the selective method I have mentioned. I am also aware that you can invoke against me the old joke that there is no such thing as a slight pregnancy. But I think in this field it could be invented.

Some of you might be surprised that I have not mentioned so far one method to cope with unwanted short-term capital inflows, the favorite weapon of our theoretical economists, the permanent float, either for all transactions or only for capital transactions. I therefore want to say clearly—and I find myself here in the good company of Sir Eric—that I do not consider this a good solution, except as a truly temporary device—and I think we should all be careful not to corrupt the word "temporary"—a device to gain some time, a thinking pause before fixing a new parity, as in the German case, for instance, of 1969. Even then, one should not nourish the illusion that market forces will lead to the right new parity. One will get some useful market indication, but one will also get speculation on the one hand, central bank intervention on the other hand. In the end, it will remain a political decision to fix a new parity.

I can explain my arguments against universal longer-run floating again only in extreme brevity.

First, it brings a strong disintegrating element into the world economy.

Secondly, I think the uncertainty created by this method is unbearable for trade as well as for foreign investment and international bond markets. In my view, this latter fact is mostly overlooked by those who recommend the split system now practiced in France. What I call unbearable uncertainty should not be confused with the question of how to manage a system of flexibility. Technically the floating is possible for industry and banks. This is not the problem.

My third criticism of the floating formula is directed against the very smoothness of this device which is considered such a decisive advantage by its proponents. For countries with balance of payments deficits, it becomes almost painless to continue inflationary policies at home. In surplus countries—and I know one quite well—this supposedly elegant way to avoid short-term capital inflows and their liquidity effect might well lead to a smooth killing of export industries if central banks do not intervene at some point to arrest the upward movement of the exchange rate which rumors and speculation will induce.

If, to avoid this danger, the floating is limited to capital transaction, exchange control comes on top of the disadvantages of uncertainty.

As against the general floating, I am, as is Sir Eric, in favor of wider bands as a sort of buffer to avoid disturbing minor parity changes.

Mr. Chairman, I am old-fashioned enough to believe that, with new parities fixed between the main currencies, with somewhat wider bands, with SDR's becoming the principal reserve asset, greater liberalization of long-term capital movements, a combination of international and national measures to check unwanted short-term capital flows—our monetary system, as it has developed by way of gradual reforms over the years, remains workable and must not be replaced by a brand new one.

But let me say in concluding, this belief rests entirely on the admittedly optimistic assumption that the spirit of international cooperation, of a common purpose, will prevail over egoistic nationalism of every kind. Clearly, Mr. Chairman, this is a political option, as Sir Eric has said, not a question for currency experts. And it might be well to remember in this context that actions conceived under such an egoistic national spirit will undoubtedly, in the end, harm also the national interest.

With this hope, that we return to a true spirit of international cooperation, I should say to the spirit of Bretton Woods which in this sense remains fully alive, I want to pay tribute to the work of Per Jacobsson.

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MR. BURGESS: Thank you very much, Dr. Guth, for a very close analysis and a very challenging statement. And if I heard correctly, I think I can see where some of those challenges might properly be directed to a former Secretary of the Treasury who had to administer some of those controls. So I am doubly grateful that our next speaker has served exactly in that capacity. Also he was, shall I say the father or shall I say the midwife, something like that, of the SDR's. Ex-Secretary Fowler.

MR. HENRY H. FOWLER: You will note on the program that my good friend Wilfried Guth and I are listed as commentators. Now, that term in its given context means that we are to stick to the subject—"International Capital Movements—Present, Past and Future". It also directs us to refer in passing to this very splendid and comprehensive analysis provided by Sir Eric in the advance paper on the subject.

movements is accurate and perceptive and provides an admirable background for future planning. His analysis, as Wilfried Guth has indicated, quite properly sharpens the sometimes obscure distinction between long-term international capital markets and flows and the international money market, and the movement of short-term funds over national borders. It very properly identifies the different types of problems for the international monetary system presented by these two distinct phases of international finance. And, in particular, the paper has provided a timely and penetrating critique of efforts, real or hypothetical, by monetary authorities to impose overall massive control or regulation of short-term flows in the Euro-currency market to harmonize them with the domestic economic policy of the given country.

He concludes, and, I believe, quite wisely, that "No clear conclusion for or against control of the Eurocurrency market is possible now in my opinion, but no one can help but be impressed both with the difficulty of applying the various measures and with their limited effectiveness when applied."

Now, in fact, there are only three specific points, perhaps in the nature of *caveats,* that I would venture on Sir Eric's advance paper. These naturally have to do more with his treatment of options for the future than with his analysis of the past and the present.

The first has to do with his treatment of short-term money flows that are destabilizing to the international monetary system and are a consequence in part of substantial interest rate differentials due to divergent national policies, combined with uncertainty regarding exchange rates.

He does, and I use his word, "welcome" more use of prices and incomes policy to meet cost-push inflation. All of us, I think, can say Amen to that. And restrictive domestic fiscal policy as an alternative to restrictive monetary policy where the interest rate result of the latter tends to destabilize the international monetary system.

He also recognizes the important contribution that international harmonization of interest rates could make to a solution.

But I would characterize his approach at best as passive on these two measures of international cooperation.

Moreover, his reservations on the utility of the use of wider bands of exchange rate fluctuations around parity apparently reduces his search for future solutions to the problem to what he terms "a much more general attack on the problem of international financial stability".

While heartily endorsing that hope, I prefer the intent and bite of Paragraph 8 of the communique of Ministers and Governors of the Group of Ten meeting in Bonn on November 20, 1968, when short-term money flows in the Eurocurrency market had created problems for the French franc and the mark and the pound.

That particular paragraph read: "The decision on the above-mentioned credit facility underlines the determination of monetary authorities to counter speculation and to offset the effect on reserves of destabilizing short-term flows. For the same purposes, the Governors, together with the BIS, will examine new central bank arrangements to alleviate the impact on reserves of speculative movements."

My second point requires a more extensive treatment and is really the heart of the matter that I wish to bring before this distinguished group. It is the absence in the paper of any prescription for the future liberalization of long-term capital movements and a determined effort to make them serve both as an important part of the balance of payments adjustment process and a more effective international development and utilization of resources. Contemporary events, as well as the history of these movements, make an attempt at prescription timely.

One of the striking features, of course, of President Nixon's new economic program of August 15 is that it does make change and modification of the international monetary system a necessity and not just an option. And this, as I have indicated, converts the present crisis into an unusual opportunity to arrive at multilaterally negotiated decisions by governments, finance ministers, and central bankers. Decisions can be taken that would strengthen the system, refashion it, and update it in many important features, and make it a more suitable instrumentality for institutionalizing international cooperation as well as conducting international monetary affairs.

It is not just enough, I would hope we would all agree, to adjust exchange rates to achieve temporary new relationships for the dollar with other currencies, fundamental as that may be. As international integration and interdependence has surpassed the slower evolution of the international monetary system, at least four kinds of international money flows have come to play an important role in the system. And they are not as responsive as trade to exchange rate changes. They are military expenditures outside national borders, tourism and remittances, intracorporate transfers, and long-term capital exports and imports.

The evident preoccupation of the founders of the Bretton Woods agreements with trade left international capital movements without a GATT-type organization to foster their liberalization or a rationale for maximizing their contribution to international financial cooperation and development.

Even the World Bank and the similar regional development organizations—the Inter-American Development Bank and the Asian Development Bank—are dependent on purely national decisions to authorize their borrowings in national markets of the developed countries. Yet the Free World faces the greatest demand in history for the generation of vast quantities of long-term capital and their movement over national boundaries for both direct and portfolio investment.

Indeed, long-term international capital flows are becoming as important as trade to world economic development and are now a major factor in the international monetary system and the adjustment process. Hardly a week goes by in which some interested party—I notice we have another one this afternoon in Mr. Guth—does not ask when the United States is going to eliminate or substantially reduce the Interest Equalization Tax and dismantle the mandatory control of outflows from the U.S. to other developed countries for direct investment.

Every day, certainly every week, would-be foreign and credit-worthy public or corporate borrowers in the national capital markets learn in those markets that they are closed to them either by law, regulations, or bureaucratic decision. Or, if they are open, they learn that the queue, informal or formal, is too long to permit an early offering. And I would suspect that, despite a few recent spectacular successes, the financial managers of the World Bank, the Inter-American Development Bank and the Asian Development Bank constantly wonder whether they will be permitted to borrow adequate amounts of new capital in the national capital markets of the developed countries to fulfill their mission as the primary lender for projects or enterprise in the less-developed countries.

But there is more than this concern about existing barriers to international financing from national capital markets. There are signs that the one functioning and free international capital market, the Euro-issue market, could lose its freedom and flexibility to regulation, or its capacity and effectiveness to uncoordinated national monetary policy.

What better time, then, to convert the danger of a return to autarchic patterns into an opportunity for the rational liberalization of international capital movements and markets.

The current concern with the role of government, central banks and public international institutions with this market and with flows of long-term capital over national boundaries suggests some specific questions that deserve examination:

1. Under what circumstances should the United States abandon or relax substantially the restraints on long-term capital exports to other developed countries that are incorporated in the Interest Equalization Tax and the Foreign Direct Investment regulations of the Department of Commerce, and what "rules of the game" should the United States follow thereafter?
2. Under what circumstances should the other developed countries, through the action of governments or central banks, encourage the export of capital raised in their national markets, thereby contributing to a thoroughgoing and rational multilateralization of the international capital market?
3. What should be the responsibilities, if any, of the governments and central banks of the developed countries or of the public international financial organizations for fostering, protecting or regulating the Euro-issue market?

Developments affecting the role of long-term international capital movements in the system have been somewhat mixed in recent years. But it has been a period marked by intensive intellectual examination of the questions posed. I shall omit reference to the many splendid reports, official and from the private sector, which have laid a very adequate background for this subject. The difficulty is that there has been little or no action on these blueprints by the governments, central banks, or public international organizations.

Yet the situation has been overtaken by other events and pressures and the period despite that has been a dynamic one in terms of a developing international capital market.

Indeed, it may be fairly stated that the Free World has backed inadvertently into a developing international capital market rather than effected a rational and conscious entry. This has been, ironically, a consequence of the restraint programs on private capital export to developed countries launched by the United States in 1965 as a part of its balance of payments program.

That is my answer to Dr. Guth's question as to whether these U.S. programs have been useful. They have been useful in finally once and for all I believe creating a viable and important international capital market in Western Europe.

In any event, as the history of this development given in Sir Eric's paper makes clear, the European side of the international capital market has become a well-established source of capital for international issuers. In the last few years, we have seen a tendency towards the gradual equalization of long-term interest rates between the United States and capital markets in Europe. The monetary and balance of payments conditions in the the major industrial nations of the world have become increasingly more interrelated, and one can hope and probably expect that the very substantial interest rate differentials between the U.S. capital market and other sources, and the relative unavailability of capital in the latter on comparable terms and in comparable amounts that existed in the late 1950's and early 1960's will not return in the 1970's.

Moreover, the volume and scale of capital flows, both short- and long-term, representing both portfolio and direct investments, have reached dimensions that make capital transfers and investment a major factor in the balance of payments adjustment process.

In this historical perspective, so ably outlined by Sir Eric Roll, it would be ironic and regrettable if the relaxation of U.S. restraints on capital outflows and the increased availability of its capital market for international issues should be accompanied by putting the market that resulted from the U.S. restraint, the Euro-issue market, under regulatory restrictions, public or private, damaging the continuing availability and growth of that market. Indeed, the prospect of the eventual elimination or reduction of U.S. restraints on capital movements that might follow from a return of the U.S. balance of payments to a solid equilibrium presents an unusual opportunity. It should be accompanied by a simultaneous and reciprocal freeing up of other national capital markets to foreign issuers and the assumption of official multilateral responsibility for the strengthening and nurturing of the Euro-issue market, as well as the removal of the pattern of long fixed restraints on outflows of direct or portfolio investment which mark most of the major financial nations except Germany.

And certainly much remains to be done to secure a further freeing up of national capital markets for the feeding of international long-term capital flows or the linkage of national flows in an international framework on a rational pattern.

It is for these reasons that I want to take this occasion to align myself once again very strongly with the very constructive and challenging proposal Bob Roosa advanced last year, and in supporting it I would like to supplement it in several particulars.

In May 1970, at an international conference in Geneva, Bob proposed, and I quote, "a long and painstaking review and appraisal of the place of capital transfers and investment in the adjustment process—comparable to that which preceded eventual agreement upon the SDR's."

He further suggested the establishment of an organization parallel to the one created by the General Agreement on Tariffs and Trade, or possibly within it, "that would have the responsibility for evolving 'acceptable' rules of the game for the movement of long-term capital among the developed countries, between the developed and the underdeveloped, and among the underdeveloped countries themselves".

The year 1971 and the current crisis in the international monetary system would be a most appropriate time for the national leaders of the principal financial nations to take this initiative. And should President Nixon's proposals looking to an improving U.S. trade surplus and a prospective offset to or decline of the U.S. military out-payments in Western Europe and Japan, as well as Southeast Asia, put the United States in a position to modify its restraints on capital outflows, this initiative would become feasible. An agreement on the norms of good conduct permitting or encouraging capital outflows from all countries would enable the United States to make its move in the context of multilateral arrangements that promised a liberal, constructive movement outward, not only of dollars but of yen, francs, marks, guilder, lira, pounds sterling and the other major currencies that would have significant international uses.

There should be no illusion that the liberalization of capital markets and foreign access to a national capital market can be fashioned to fit a single country, the United States. The rules of the game should apply to all alike. And the fact of history is that, without these rules and an institution to maintain them, countries turn readily to capital controls whenever their payments are threatened, and retain them long after they are no longer necessary or justifiable.

Only by rational determination of the ways, circumstances and methods by which long-term capital flows will benefit and improve the adjustment and development processes can the nations truly multilateralize the capital movements that the founders at Bretton Woods only faintly envisaged and failed to take into account in establishing our modern international monetary system.

Moreover, only by this type of ambitious initiative can the developed nations mount an adequate scale of capital movements to the less-developed ones that will be responsive to the need and yet serve to promote equilibrium and adjustment in the balance of payments between the developed countries.

Now, my third and last observation on Sir Eric's paper brings us closer to some of the topics for discussion in the week ahead. It concerns his treatment of the U.S. balance of payments deficit as he linked that deficit to the recent problem of short-term flows in the Euro-currency market.

Now, much of his analysis is acceptable and indeed commendable. But I must take exception to his apparent conclusion that "improvement of the underlying deficit should be a by-product of the right domestic policy," *if* that conclusion is intended to exclude a major contribution by the principal trading partners and allies of the United States towards the adjustment process whereby the United States is to achieve a solid equilibrium in its balance of payments.

Sir Eric's comments here today make it clear that such an inference was not intended and that he does contemplate a major contribution from other countries to this adjustment process.

I would only underscore, therefore, that surely the United States must put its house in order internally and demonstrate the will and discipline to achieve prosperity at home without inflation or excessive unemployment, if the speculative flows away from the dollar are to be avoided and a balance of payments equilibrium achieved and sustained. And that is the objective of the domestic phase of the President's August 15 program and of Phase II which presumably is to follow.

But an acceptable equilibrium in its balance of payments is not likely to be achieved by the United States alone unless it should follow the undesirable unilateral course of withdrawing from a constructive role in maintaining free world security and political stability, sealing itself off from international competition by long-term artificial restrictions on imports and halting exports of capital.

U.S. equilibrium should be achieved through multilateral cooperation and multilateral decision-making. This nation and the countries closely associated with it in trade, security, capital movements and tourism, must undertake those multilateral efforts which will produce an equilibrium that will enable the dollar and the United States to perform a constructive role in international affairs and institutions.

In the closing paragraph of his paper, Sir Eric referred in a nostalgic way to the calmer days of a hundred years ago, when the international monetary system was sustained by what he calls *Aequilibrium Britannicum,* and the more recent decades when the Bretton Woods system was underpinned by *Aequilibrium Americanum.* I join him in the hope, in the wish, and in the confidence that the events of August 15 and the coming week of meetings will complete a transition to an era which so many of those present have dreamed and labored for, an age of *Aequilibrium International Cooperationum,* or whatever the Latin would require.

In my closing, may I just have the privilege of expressing a few personal observations that are not on the program but may contribute in a small way towards an appropriate ambience for dealing with the issues that lie ahead. I believe these remarks are in keeping with the spirit and ideals of Per Jacobsson whose memory we once again honor on this occasion.

I would devoutly hope that the resolution of these issues by negotiated multilateral decisions will mark another great step forward in a developing pattern of international economic and financial cooperation. That policy has been practiced over the last twenty-five years by the United States and the nations associated with it, and it is one of the great success stories of this or any other century. And that is the course most likely to result in peace, freedom and prosperity for the future.

National decision making, for the countries concerned with the adjustments generally outlined by President Nixon, could culminate in negotiated, multilaterally agreed solutions. This achievement would constitute yet another in the unbroken string of successes since World War II for the foreign economic policies of the nations represented in this room in a common effort to foster international economic and financial cooperation.

As a result, interdependence as a way of international life would be confirmed and the most difficult test yet presented would be surmounted.

However, we must not blind ourselves to the possibility that national decision making, here and abroad, may fail to achieve multilaterally-agreed decisions that strengthen the ties that bind us. The consequences of this failure might be to dismantle or greatly diminish the effectiveness of the existing international monetary system, set off trade wars, refasten more tightly controls on capital in the manner of the old pre-war exchange control system of Europe, and weaken or drastically alter the alliances that have served the cause of peace and security for much of the Free World.

With some hesitancy, I would tender a bit of advice to those officials who hold responsible positions in foreign governments and central banks. I served as a colleague with many of them, and together we took many curves along the highway of international cooperation in the 'sixties. I am encouraged to make these comments by the experience we shared in multilaterally negotiating decisions to amend the

Articles of Agreement of the IMF for the creation and utilization of Special Drawing Rights.

In my opinion, the future promise for increasing international financial and economic cooperation depends upon the willingness of the principal trading partners and allies of the United States to take early a giant collective step towards President Nixon's proposals for a cooperative adjustment of the U.S. balance of payments. Only by so doing will they enable the United States, by multilaterally-agreed arrangements, to bring its balance of payments into solid equilibrium without risking a worldwide depression, lasting restraints on trade and capital movements, or the hazardous adjustment of security arrangements for financial reasons. By so doing, they will open the door to a meaningful and needed strengthening of the international monetary system.

Sir Eric, in his closing remarks here, referred to the danger, in terms of the international monetary system, of people who live in glass houses. I once related to a fellow finance minister with whom I had a certain number of difficult problems that my philosophy of the role of finance ministers was something like this: I thought we were all together involved in a mountain-climbing expedition. I am not an expert mountain climber or an experienced one. But I have understood that success is more likely to be achieved if the climbers tie themselves together so that when one's foot slips, the others can hold him up while he regains his footing, and they can all continue the climb together. This is my own concept of the working of the international monetary system. But, without these ties, if one's foot slips and he goes down, he may carry down many on the slope below him.

And I want to say as a private citizen something that the current Secretary of the Treasury would not be likely to say, but that I as a private citizen can say without too much ill grace: every country involved in a major way in the process in which we are now involved to provide an opportunity for equilibrium for the dollar—every country, at one time or another in the last twenty-five years, has been helped to regain its footing and to establish or re-establish its international economic and financial viability. And I believe that on every such occasion the United States has extended a helping hand as a part of that process.

Now we are all faced with the acid test of the international monetary system of 1971. The question is—will the major trading countries and allies associated with the United States play a reciprocal role in making new multilaterally-negotiated decisions to deal with the very serious U.S. imbalance of payments that has emerged and then join with the United States in updating and refashioning and modernizing the international monetary system that is our heritage, which we received in no small way from Per Jacobsson, whom this occasion honors.

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MR. BURGESS: With those practical words ringing in our ears, I suggest we take a very brief pause. But before we start the questions, I want to introduce to you Mr. Larre, who succeeded Gabriel Ferras as head of the BIS and who automatically becomes one of the five directors of this organization.

Question and Answers

Following the statements reproduced in the earlier sections of this publication, the speakers responded to written questions received from the audience. The text of these questions, as read by the speakers, and their answers are given below.

SIR ERIC ROLL: *With respect to President Nixon's August measures, are there some with which you disagree?"*

I think I have indicated in my remarks today that I am a little regretful about the ten percent surcharge, although I can quite see some of the pressures toward it—I made that clear. But I should hope that, if we can reach a fairly early agreement on new parities with the principal countries, the surcharge will not be considered necessary by the Administration.

"If new parities cannot be set so as to eliminate speculation, why not let exchange rates float so as to eliminate some of the bases for destabilizing speculation in crisis situations?"

If this question refers to something I said today, there is a little misunderstanding in the minds of the questioner. I didn't say that parities cannot be set so as to eliminate speculation. What I said was, if I remember rightly, that it is vain to hope that we can at one stroke, in the next few weeks, however long these negotiations may have to last, hope to set parities which will so accurately reflect the evolution of international relationships over the next three or four years that all cause for anxiety or hope about their persistence, their continued viability, will disappear. And it is for that reason that I am partly in favor of wider bands, although I don't regard them as a panacea. It is also for that reason that I said, despite the fact that I am not at all enamored of controls of the Euro-currency market, that the authorities may from time to time have to impose certain restrictions. And it is also for that reason that I place some emphasis on finding some solution for existing dollar balances, because this would be a stabilizing influence and would make the new parities, however impermanent they might be in the longer term because of changes in relative competitiveness and productivity, less likely to lead to a revival of speculative movements.

DR. GUTH: I have three questions here. The first is, *"What role, if any, have multi-national industrial corporations played in speculation in currencies in the last year?"* Well, the answer is—a very big one. But of course one has to define what "speculation" means, and I think it has been said often enough that speculators are not "some somber enemies of our system" as it is sometimes theoretically argued. I think speculation is a legitimate way of trying to take advantage of the existing differences in the exchange markets on the one hand and a necessary effort to avoid losses in these markets due to such differences, on the other hand. And therefore I think each financial manager of a corporation is in the market every day and will deal in these markets according to changes. This is the very reason why we should make all possible effort, as I tried to outline in my remarks, to cooperate in the field of interest rates, not to create unnecessary differentials. By unnecessary I mean to say that sometimes they will be unavoidable, because we cannot absolutely synchronize our business cycles. And this is also the reason why it is so important to have realistic exchange rates which do not induce such movements by themselves.

But I repeat that, in spite of such efforts, there will be disturbing short-term capital movements in the future and, as Per Jacobsson has said, we shouldn't be too much afraid of these movements and we shouldn't lose our courage and our calmness in such situations.

The second question is *"Would you prohibit controls on incoming long-term capital movements?"* Certainly I would. As I have tried to make clear, I think long-term capital movements should be free of controls. I expressed myself more cautiously in my remarks earlier, saying they should be submitted to the same rules as trade, which means that they should basically be free. Knowing that we live in a world where the ideal will never be fully achieved, there might, from time to time, be some cases, and I think here particularly of the outward flow cases, where it becomes very difficult to maintain complete freedom. But the essence of what I think all speakers here have said is that these cases should have to be justified internationally and that a country cannot just impose controls like that as a national measure. This is a big difference and this is where the Fund should play a role.

The one possible case of control of incoming long-term capital movements is of course the case against direct investment, be it—let's put it in a very extreme sense—a Canadian case or be it the case of the less-developed countries. But again I would say generally it is a bad case, and both the world economy and the economic welfare of the given countries will certainly suffer if these movements are prohibited or severely restricted.

Realistically, we know the development of nationalistic attitudes in developing countries, so there will be some restrictions on direct investment. But it is important that these, too, should be submitted to international justification. That I think is a very important point.

Now, the third question. *"Is not the effect of the aid programs and military expenditures so essential that they cannot be left out of the analysis. The cures must be sought in these causes, too."*

Well, certainly. This is what I had in mind when I said the real battlefield is the exchange rate and the burden-sharing in aid and unavoidable defense expenditure. And it is certainly true that the United States could not apply the strict rule I have set here, i.e. change the exchange rate if you cannot bring your balance of payments into equilibrium in the current account and long-term capital account, if there is not real burden-sharing. I think this must be one key element in the negotiations which have to come.

MR. FOWLER: The question presented to me is, *"Are there any indications that the interests of the developing countries will be properly taken into account in the reshaping of the international monetary system?"*

I am not in a position to answer that, because I am not sufficiently familiar with what is going on behind the scenes and what is the agenda of the various countries in their approach to a new international monetary system. However, I think that the very fact that this seminar is devoted today to international capital movements, and the need for a nurturing and strengthening of the system to promote and encourage capital exports, particularly to the less-developed countries—this is an indication that, at least, those of us here on the platform feel that the interests of the developing countries ought to be served in reshaping the international monetary system, and that one of the ways of doing so is to deal with the long-term capital movements in the fashion that we have all referred to as desirable in the years ahead.

Another question that has been sent up to me—*"Could you explain the proposal for an international security fund in NATO?"*

The most recent proposal to receive any current examination is a fairly detailed one by Dr. Timothy Stanley, which was submitted to a meeting in London last week of the private sector representatives of the Atlantic Assembly meeting.

Of course, this is a matter that was alluded to in President Nixon's August 15 statement, and I think we would all agree that there is great importance in maintaining a NATO Alliance on a solid basis, as well as, for the United States, its arrangements with Japan. And that any substantial destabilization of these alliances is fraught with serious consequences. And furthermore, that the absence of any multilateral financing arrangements to offset in an orderly multilateral sense, the balance of payments costs to the United States of the forces that are stationed beyond our borders and within the borders of major industrial nations now strong financially, for their and our mutual security, is a source of political, military and financial weakness to these alliances, and also to the monetary system.

The net balance of payments deficits on U.S. military expenditures outside the United States in the decade of the 'sixties was $32 billion. And obviously that cannot be tolerated in the decade ahead. Indeed, the cumulative deficit on the military account in Western Europe in the last fifteen years was nearly $19 billion, after taking into account the reverse purchases of military equipment from the United States. It was against this background that, in November, 1968, at the NATO Ministerial meeting in which I participated, a proposal was made and solemnly agreed as a matter of principle that no country stationing forces on the borders of an ally for the common defense should suffer for that reason in its balance of payments. What is needed is a formula or a procedure or an arrangement to implement that principle on a multilateral basis. It would strengthen NATO and it would strengthen the international monetary system. But it would clearly not be feasible or appropriate to put the administration arrangements for this in the International Monetary Fund. And this is the thrust of Dr. Stanley's paper. He would set aside much of the burden-sharing argument as it has to do with budgets and limit it simply to this balance of payments question. And he has presented a very intriguing proposal, asking this question:

"Why should NATO not now create what might be called an international security fund to act as a military foreign exchange clearing house which would implement the agreed principle noted earlier that foreign exchange costs for common defense should be neutralized?"

And Dr. Stanley has advanced a precise technical formula for doing this, which would naturally call for the major share of the balance of payments costs of this nature to be undertaken by the country in which the forces were located. But it would also call for some participation by all the countries to the Alliance, who presumably are benefitting from this, and for some contribution, of course, and some taking up of some of these costs by the country whose troops are stationed within the borders, because it benefits, too.

So this is a kind of spreading of the balance of payments burden, as it were, according to a very precise formula which I don't think time permits to detail here, and therefore, with all deference, I commend to you Dr. Stanley's paper and the various discussions of it which will ensue. It is available at the offices of the Atlantic Council here in Washington.

* * * *

MR. BURGESS: Before concluding I would like to ask Sir Eric if he has any comments, either on questions or on anything that some of the other speakers have said.

SIR ERIC ROLL: The only thing, Mr. Chairman, that I think I might say, bears upon some of the things particularly Secretary Fowler has said about long-term capital movements, and also one or two things that Wilfried Guth said in that connection. I really want to say only two things.

First of all, I agree one hundred percent with Joe Fowler that it would be an enormous pity if, when U.S. outward investment is freed, as some day it will be, the international capital market, the Euro-bond market or whatever you like to call it, were not to continue. Happily, I think that fear is unlikely to be realized. I think it has become a well-established market. Contrary to some people in the investment banking fraternity, I personally have no great fear that London will suddenly lose all its business if and when the interest equalization tax is abolished and the balance of payments program is eliminated, and that all the business will suddenly flow to Wall Street.

I am quite confident that it will continue. This is a remarkable new development, and I am sure that both Joe Fowler and Wilfried Guth will agree with me when I say that the ideal situation in a well-ordered, flourishing world is one in which, in all rich countries, developed countries, there is both an inward and an outward movement of capital of substantial magnitude most of the time.

The second thing I want to say is that I also agree very much with him in his reference to the proposals made by Bob Roosa. In my paper I have made one or two references to Bob's work which I need hardly say I very much admire and agree with, in particular his fairly recent comments on the absence of adequate international machinery for study of, and machinery for negotiation in, the combined field of trade and investment. It seems to be extremely important.

In March of this year Joe Fowler and I had the privilege of participating, together with Aurelio Peccei whom I see in the audience, in a meeting in Tokyo organized by the Atlantic Institute, which was precisely concerned with that question. And I am sure it is right to think in terms of trade and investments as a single problem in the decade to come. One doesn't want to multiply international organizations; that's the last thing in the world we want. But one has to find some solution to the fact that today these problems are split between a number of international organizations, and that some means must be found—we all may have our preferences as to where the center should be, and I don't propose to reveal mine—but some means must be found for dealing with these questions in one place.

Biographies

Sir Eric Roll, K.C.M.G., C.B., is Deputy Chairman of S. G. Warburg & Company, Ltd., and has been a Director of the Bank of England since 1968 and of The Times Newspapers, Ltd. since 1967.

For many years he was closely connected with United Kingdom economic and financial policy development, most recently as Permanent Under-Secretary of State, Department of Economic Affairs. He was Economic Minister and Head of the U.K. Treasury Delegation to Washington and Executive Director for the United Kingdom to the IMF and IBRD during 1963/64. He has also served as Under-Secretary in the Treasury and in the Ministry of Agriculture and has represented the United Kingdom at numerous negotiations in the field of agriculture and economic affairs—to O.E.E.C. N.A.T.O. and E.E.C.

Sir Eric was educated in Europe and obtained his B.Com and Ph.D. from the University of Birmingham. He was Professor of Economics and Commerce at the University College of Hull. His writings include "A History of Economic Thought" in 1954, "The World After Keynes" in 1968 and a number of other books and articles on economic and financial subjects published in both Great Britain and the United States.

Henry H. Fowler is a General Partner in the investment banking firm of Goldman, Sachs & Co. and was formerly Secretary of the U.S. Treasury (1965-1968) and Under Secretary (1961-1964).

Mr. Fowler received his A.B. degree from Roanoke College and his LL.B. and J.S.D. from Yale University Law School.

Prior to his recent government service Mr. Fowler was senior member of the Washington law firm Fowler, Leva, Hawes and Symington. Earlier government service included the post of Director of the Office of Defense Mobilization during the Korean War and membership in President Truman's Cabinet and on the National Security Council.

Mr. Fowler is currently a Councillor of the National Industrial Conference Board, and a Trustee of the Alfred P. Sloan Foundation, the Carnegie Endowment For Peace, the Institute of International Education and of Roanoke College. He is also a Vice-Chairman of the Atlantic Council of the United States and a member of the Board of Directors of the United Nations Association of the United States as well as a number of industrial companies.

Dr. Wilfried Guth has been a member of the Board of Managers, Deutsche Bank AG, in Frankfurt (Main), since 1968 and is Chairman and member of the supervisory boards of several other companies. He is Deputy Chairman of the Investment Committee of the International Chamber of Commerce and serves in various other non-profit organizations. He was educated at the Universities of Bonn, Heidelberg, and Geneva, and at the London School of Economics.

Dr. Guth began his career in the Central Bank of Germany (Research Department) in 1953 and served there in various capacities until 1959 when he was appointed Executive Director for the Federal Republic of Germany in the International Monetary Fund. He returned to Germany in 1962 as Member of the Board of Managers of the Reconstruction Loan Corporation, the principal German lending institution for development aid, where he remained until 1968.

Dr. Guth's publications includes "Capital Exports to Less Developed Countries" (1957). He was the German member of the Commission on International Development (Pearson Commission) which presented its Report "Partners in Development" in 1969.

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