THE 1978 PER JACOBSSON LECTURE

The International Capital Market and the International Monetary System

Gabriel Hauge
Erik Hoffmeyer

Lord Roll of Ipsden, K.C.M.G., C.B.,
Commentator

THE PER JACOBSSON FOUNDATION

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FOREWORD

The 1978 Per Jacobsson Lecture was presented in the Atrium of the International Monetary Fund Building, on September 25, 1978, as the fifteenth in a series of annual lectures that was initiated in the Aula of the University of Basle in 1964. The series is sponsored by the Per Jacobsson Foundation in order to promote informed discussion of current monetary and financial problems in the spirit of international cooperation exemplified by Per Jacobsson's unique career. The proceedings of this series of lectures are printed in English, French, and Spanish and are distributed by the Foundation without charge. Through the courtesy of other institutions, versions in additional languages are also distributed in different parts of the world. Further information may be obtained from the Secretary of the Foundation.

Shortly before the lecture meeting, W. Randolph Burgess died. Ambassador Burgess had served the Foundation wisely and devotedly as the Chairman of the Board of Directors since the beginning of the Foundation and he will be greatly missed by his colleagues and friends. His place as Chairman of the Board was taken by William McChesney Martin, who presided over the meeting.

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It is now appropriate for me to say a few words about Randy Burgess, whom we all knew, and with whom I had a special tie. When I went on the floor of the New York Stock Exchange at the start of my career, he was my seconder. All of us who knew him realized that he loved more than anything else to be helpful to young people. He was a student, a scholar, a banker, and a modest man who helped many, many people in the course of their careers. One of the fine things that enhanced his career, after serving as a distinguished ambassador to NATO, was the establishment of the Per Jacobsson Foundation. He was our main progenitor. I will always remember Randy because of his enthusiasm for encouraging students and others in the monetary world. It was particularly fitting to have him start the Foundation as a way of showing our high respect for Per Jacobsson. We knew Per as a man of wit and charm and drive and capacity and character, and he and Randy had one thing in common that is particularly appropriate to mention here. Both men understood, as few people understand, that the economic, military, and diplomatic power of a country resides in its currency. That is something that is overlooked today. I do not want to exaggerate the point, but nevertheless, it is a fundamental fact. No one brought this truth home more forcefully and clearly than Per Jacobsson. He did a lot of good in stimulating people to ponder about this, and the world needs to return to that sort of thinking.

We have an excellent program for you. I am not going to make the program longer by further words of introduction, but the essence of our subject is that we have seen a world capital market develop as few of us realized it would develop 15 or 20 years ago. We have, incidentally, seen the Bretton Woods concept go through some changes in that period. I, for one, happen to deplore some of the changes because I believe that the Bretton Woods concept and the Marshall Plan were probably the two greatest concepts that came out of the postwar world. I feel that to some extent we have turned our back on the Bretton Woods concept and have returned toward nationalism more than is desirable. What we all have to realize is that although we talk about an "interdependent world," we do not act as though the world is interdependent. We have tended in recent years to pay lip service to the phrase, "interdependent world," and at the same time to turn back toward nationalistic thinking. I regard this as unfortunate.

However, to return to the purpose of this meeting, we are very fortunate in having an able man, formerly the Deputy Managing Director of the International Monetary Fund, Frank Southard, serve as our President; I am going to ask Frank Southard to take over and introduce our speakers and make any comments that he would like to make. Thank you.

Frank A. Southard, Jr.
President, Per Jacobsson Foundation

Ladies and gentlemen: As Bill Martin has said, we have prepared today what we believe is going to be an outstanding program. When we thought—as we have to—almost a year ahead of time what subject might be useful, one of the worries was that we might choose a subject, which by the time the year had passed and the day had arrived, would no longer be particularly interesting or relevant. We have had pretty good luck in avoiding that difficulty in the past, and we have had good luck again this year. On the whole, the reason we chose this theme, "The International Capital Market and the International Monetary System," is because one of the outstanding developments in the international financial area since the war—particularly since the coming of the convertibility of the major currencies in the 1960s—has been the re-emergence, on a scale that I think none of us could possibly have foreseen, of the international capital market. It has now reached the point where 500 billion, 700 billion dollars of liquid funds or of investment funds—no one knows how much—are available in that market. They are of such a magnitude and they can move around with such freedom that they can have a tremendous impact on the international monetary system. It is for that reason we chose this subject.

Mr. Hauge and Governor Hoffmeyer have told me that they will be condensing their prepared texts by a substantial amount. The full texts will be available at the end of this program and you may take them with you if you wish. Subsequently, as has been usual in the past, they will be printed and distributed in English, French, and Spanish.

The first speaker is Gabriel Hauge, who has been with Manufacturers Hanover Trust Company since 1958 when he became a Director and the Chairman of the Finance Committee. He is now Chairman of the Board of that bank. Previously he taught at several universities, served in government in the United States at both state and federal levels, and, in particular, was Special Assistant for Economic Affairs to President Eisenhower. He will address you first. Mr. Hauge.

The International Capital Market and the International Monetary System

Gabriel Hauge

This occasion summons a vivid recollection from one of my last conversations with the remarkable personality whose memory we honor: the best international money system, Per Jacobsson said in effect, is a journey, not a destination. That we could always do better was for him a conviction animating all the years of an extraordinary life.

In the spirit of the journey of which he spoke, I am pleased to participate in this lecture and to join forces in that endeavor with a realistic but hardly melancholy Dane from the mystical fraternity of central bankers. Together we fall under the appraising gaze of a wise, seasoned Briton with whom I have shared the opportunity of coming to grips with this colloquium's theme in three theaters—the university, the public service, and the financial arena.

During a wide-ranging conversation with Erik Hoffmeyer in Copenhagen some months ago, the metes and bounds of today's considerable subject were sorted out. He undertook to look at the issues through a lens marked *monetary system,* while I peered through another labeled *capital market*. Needless to say, such a division of labor is not as clean-cut as it sounds, because the system and the market are entwined, integral parts of the world economy.

Profile of Change

In introducing my remarks this afternoon, I would like to cite, in sparest form, some distinctive aspects of the shifting environment in which we gather:

—Unusual nature of the sluggish and uneven recovery around the world;

—Stubborn liaison of inflation and unemployment;

—Evidence of technological recession in advanced countries, marked by slowing of outlays for research and development;

—Extensive change in international competitiveness among and between developed and developing economies;

—Persistent disequilibrium in the balance of payments of key nations and a lingering disposition to finance deficits in lieu of effective adjustment action;
—Escalating instability in foreign exchange markets in the context of vast global liquidity;
—Influence of substantially higher energy costs in shifting investment patterns;
—Sharpening dilemma of national and regional policies in an increasingly interdependent world economy;
—Monetary policy further burdened in leading countries as the consequence of fiscal weakness;
—Declining faith in Keynesian aggregate demand management as the key to economic stabilization with more reliance on monetarism and the neoclassical economics of the market;
—Speculation that secular changes are under way in the world economy that will affect the pace and nature of growth in the future;
—Regular summit meetings as a possibly meaningful dimension for coordination of national economic policies.

Against this profile of change, I invite your attention to three aspects of our inquiry: relevant elements of postwar history, response of the credit and capital market to the changing monetary system, and ways and means of improving their serviceability.

There is a view, doubtless shared by many in this audience, that we do not have a monetary system, rather an improvised network of arrangements serving the financial markets around the world. While I am intrigued by the philosophical implications of that challenge, for purposes of this discussion, I merely offer certain working definitions from the viewpoint of a market participant. By the market, I mean the apparatus for moving funds worldwide and the institutions and individuals that make that happen. By the system, I mean the official framework in which the various parts of the market operate, including international agencies, governments, central banks, as well as ground rule agreements, both formal and informal.

The System in Transition

The Bretton Woods system, as you recall, sought stability through the discipline of a par value regime as an alternative to the destabilizing competitive devaluations of the 1930s. The system in practice was based on the dollar, convertible into gold at $35 an ounce. Reserve creation came to depend on U.S. payments deficits, supplemented by British deficits, and a diminishing proportion of newly mined gold which the monetary authorities were able to secure from the market.

After a time, this concept imposed an excessive rigidity on exchange relationships. The United States, as the principal reserve center, was left with a passive exchange rate. Britain, as the second reserve center, found it difficult to alter its rate without serious consequences and without undermining confidence in the system. Surplus countries disliked formally upvaluing their exchange rates against the dollar for fear of the impact on their exports and employment and for fear that their trading competitors among the other surplus countries might not take similar action. In the absence of exchange rate adjustment, the surplus countries found themselves taking in and holding a growing volume of dollars.

Because of these rigidities, the system came under multiplying strains beginning in the mid-1960s. Contributing factors included a series of increasing U.S. budget deficits from 1965, a decline in the dollar's domestic purchasing power, larger external payments deficits, and rising concern about the dollar's exchange rate on the part of foreign holders. Confidence in the world's principal reserve currency was further eroded after the 1967 devaluation of sterling. That loss of confidence found its most dramatic expression in the flight out of currencies into gold during the winter following sterling's devaluation and the abandonment of market support for the official gold price by the major financial powers after March 1968. A holding operation characterized the next three years, but in 1971 the system of fixed exchange rates collapsed. A time of chance and circumstance began.

The immediate reaction of nearly all the major financial powers was a simultaneous stimulation of their economies to counter the expected shock to business confidence of the Bretton Woods breakdown. The inflationary impact of the monetary boom of 1972 and 1973 was compounded by exceptionally bad weather and harvests in nearly all of the world's food producing areas. At the same time, other raw material prices soared on a combination of feverish industrial demand and a hedging out of currencies into commodities. Capping this series of developments was the very large adjustment of world oil prices, which had been declining in real terms for about 20 years.

This sequence of events culminated in deep recession in the industrial countries during 1974 and 1975, followed by an uncertain recovery of output with high inflation and high unemployment.

It is a fact that world output and living standards rose for about 25 years following World War II at a rate unprecedented in history and in a climate of relative stability. It is impossible to demonstrate, much less measure, the contribution made to that achievement by orderly currency relationships. But it is reasonable to hold that the system constructively reinforced the rapid and yet relatively stable economic expansion which a combination of favorable factors allowed governments of major financial powers to encourage during that time. Steady economic growth created a framework and was also advanced by the liberalization of trade through the General Agreement on Tariffs and Trade (GATT), a process which at present has lost momentum.

Just as an agreed set of international monetary rules, however imperfect, contributed to world stability for about a quarter century after 1945, its abandonment appears to have contributed to instability during the past half-dozen years. Fluctuations in fashionable economic attitudes are sometimes more volatile than economic fluctuations themselves, but the conversion of large parts of the academic, official, and banking communities to the concept of floating exchange rates after 1971 was astoundingly sudden and widespread. Since that first burst of enthusiasm, it is frequently said that floating has not worked as badly as feared or as well as hoped, according to the point of view or the tactic of intellectual hedging adopted. In reality, the cycle of uncompetitive devaluations since 1971 has simply led to a hardening of the categories. Strong currencies have continued to strengthen and weak ones to weaken. Monetary discipline and price stabilization in some countries have been reflected and reinforced by the appreciation of their exchange rates. Other countries have experienced the opposite of such a virtuous circle. When unaccompanied by restraints on domestic demand, the promise of increased international competitiveness held out by currency depreciation has proved a mirage.

Market in Transition

Within this environment, the private financial community's innovative responses have focused in the Eurocurrency, Eurocredit, and Eurobond markets. A striking feature of this process has been the gap along the way between private and official action, due to the difficulties of negotiating an orderly reform of the monetary system in a climate of growing strain and in the sometimes unwieldy forum of more or less than a hundred finance ministers and central bank governors.

In recalling relevant aspects of this evolution, I will refer, as a matter of convenience and convention, to the international money market as the market in Eurocurrencies, and to the international capital market as the mechanism for medium-term to long-term finance provided by internationally syndicated bank loans and by two classes of international bonds: (1) the traditional foreign bonds for nonresident borrowers in a domestic capital market, and (2) Eurobonds placed throughout the world by international syndicates of investment banks and securities firms. Again, as a matter of convenience and convention, these markets together are viewed, in the context of this paper, as the international financial market.

Needless to say, the market, as thus characterized, by no means offers the only channels for the global flow of funds, which also embraces such elements as short-term financing of international trade, foreign direct investment, foreign portfolio investment, and official loans and grants. But it is the Eurocurrency, Eurocredit, and Eurobond markets which have become increasingly significant.

Economic role of the market

In helping to bridge greatly enlarged payments gaps, the market, among its services, allowed many industrial countries to meet higher oil prices without more serious consequences. It did still more for the developing countries. As a whole, these economies avoided recession, approximately maintaining their average 5 per cent real annual growth of the preceding 20 years. Indeed, in some of them expansion actually quickened. Among the poorest countries this was due largely to good weather and harvests. But in the more economically advanced developing countries, ". . . most were able to borrow heavily from private sources to maintain their investment," in the words of last year's Annual Report of the World Bank.

International payments, of course, balance by definition, no matter how capital is transferred from countries in current surplus to those in current deficit. But temporary balance of payments support, as distinct from international capital flows for productive investment, cannot "solve" the problems created by instability in national economies or the excessive imbalances in current payments and wide exchange rate fluctuations which are symptoms of such instability. Nor can capital flows, except those for productive investment, "solve" the problem of adjustment to higher energy prices nor what appears to be a change in the structure of the world economy as some developing countries reach the point of competing on a growing scale with older industrial economies for capital, raw materials, and outlets for manufactured goods.

However, the channeling of a greater proportion of capital through the international market has important implications. This kind of funding tends to go to the advanced developing countries, unlike official aid which is made available more broadly throughout the developing world and which is often provided not only for economic reasons. Through its more efficient allocation of resources, moreover, the market tends to speed the process by which the older economies are faced with new competition from the advanced developing countries.

At the same time, the market allows deficit countries a certain period in which to make a less abrupt and less painful adjustment than might otherwise be forced on them. Time, of course, is not unlimited, as shown by the curtailment of lending on various occasions in recent years to a range of countries which appeared to be using borrowed money to avoid adjustment or to postpone it indefinitely. In language which the International Monetary Fund first applied to its own lending many years ago, the market provides, "time, but not time to waste."

Market evolution

The growing part played by the international market in transmitting capital across the world represents an important change of recent years. For a considerable time after 1945, a far larger proportion of international capital consisted of official flows, initially for the reconstruction of Europe and Japan and, thereafter, for development of the world's poorer countries. During that period, private capital tended to bypass the international market.

Private capital exports from the United States were mainly in the form of foreign direct investment, whose cost advantages to corporations over exports from the United States persisted until relatively recently. But until controls were imposed on the export of capital from the United States in the early 1960s, such foreign direct investment was financed mainly in the domestic capital market.

Western Europe was in no position to export capital for some years after 1945 and, when able to do so again, the preference in many places was to import labor. When Japan once again began to export capital, it concentrated on foreign direct investment, initially for assured access to raw materials and, like industry in the United States, financed this expansion mainly in its domestic capital market.

For about 20 years to 1965, the only sector of the international capital market functioning, even on a small scale, was that involving the sale of traditional foreign bonds, but this provided only a residual channel for international flows, because most leading financial centers were either closed to foreign borrowers or were severely restricted in their access.

The beginnings of the contemporary international financial market, of course, did not hastily emerge out of the oil crisis nor will dismantlement follow as that particular strain eases. Indeed, this year's estimated aggregate current surplus of Japan, the Federal Republic of Germany, Switzerland, and the Netherlands is running at about one and one half times that of the member countries of the Organization of Petroleum Exporting Countries (OPEC), of whose members only the least populous remain in chronic surplus.

First to emerge out of premonitory strains in the world's economic environment was the Eurocurrency market in which foreign currencies are lent and borrowed, mainly among banks and multinational corporations, and mainly for the short term. It has been grafted onto the foreign exchange market, in which currencies are sold and bought. This first became an active market in the latter 1950s, but was given new impetus in the 1960s by restrictions on U.S. banks bidding for interest-bearing deposits in their domestic market. Instead, they bid for such dollar balances through a growing number of branches abroad, although largely from the same U.S. corporations which shifted their deposits from domestic to foreign branches of their banks. The net result of this sequence was to export a significant part of U.S. money market activity to foreign centers.

The next sector of the modern international financial complex to take shape was the Eurobond market. The catalyst in this case was the Interest Equalization Tax of 1963 in the United States, a step which effectively closed its capital market to most foreign borrowers. This control on the outflow of capital from the United States was one of the many emergency measures of the 1960s by which leading countries sought to win time, vainly as it proved, for an orderly reform of the monetary system. Its main result, however, was the regular issue of dollar bonds outside the United States. Then, in 1964, the German authorities, trying to stem the flow of foreign capital into Frankfurt, began to tax the income of nonresident investment in German domestic bonds, but exempted such income from the bond issues in deutsche mark of non-German borrowers, thus stimulating a regular market in external bonds denominated in deutsche mark.

The evolution of the market in Eurocredits can similarly be traced in good part to innovation prompted by the emergency capital controls of the 1960s, in this case the Voluntary Credit Restraint Program in the United States and the rules of the Office of Foreign Direct Investment. One of the effects of this tightening of capital export controls in the United States was to lead its corporations to finance their direct investment abroad by borrowing there. They did so partly by joining the ranks of foreign borrowers in the fledgling Eurobond market and partly by medium-term syndicated bank credits, arranged in dollars, but in Europe. In this way, the export of part of U.S. money market activity to foreign centers was followed by a similar export of part of its capital market activity. The syndication of Eurocredits had its precedents in both U.S. and British banking practice. The multibank provision of loans and credits was born in the United States out of the nature of its unit banking system and the limitations on the loans of individual banks to individual borrowers. Its antecedent in London was the merchant banking practice of syndicating acceptance credits rolled over for the medium term to finance purchases of capital equipment, as distinct from the majority of acceptance credits, which provided only for the short-term self-liquidating trade financing.

Market initiative thus coped effectively with the lagging efforts of official negotiation to create a successor to Bretton Woods. The protracted debate of the 1960s regarding deliberate reserve creation resulted in an experimental issue of less than $10 billion of special drawing rights

(SDRs) by the IMF in the three years to 1972. The bulk of the liquidity needed to finance the growth of world trade was provided instead, and without fanfare, by the Eurocurrency market, whose net size has grown about eightfold to some $400 billion in the past dozen years, in the context of an estimated $700 billion gross size in mid-1978. Market lending to official borrowers made a major contribution to the quarter of a trillion dollar increase in world reserves which has taken place during that time, helping to keep the level of world reserves close to four months of world imports, as it was in 1970. Looking back, last year's Annual Report of the IMF was straightforward, in saying of SDR creation that, "things did not turn out as expected in the short or longer run," and adding that the international markets, "have, in effect, become major suppliers of reserves."

A similar contrast of scale is seen in the official participation in the recycling of oil exporters' surplus earnings since the end of 1973. To date, these have provided the IMF's oil financing facilities funds totaling $7 billion. During the same period, however, the international capital market mobilized more than $250 billion, as likewise acknowledged in this comment from last year's Annual Report of the IMF: "There was a time when official agencies would have been expected to be the principal intermediaries between surplus and deficit countries. When the need arose, however, private international markets had already developed to the point at which they were able to perform this function effectively for a number of countries and have continued to do so."

In its evolution, the market has become authentically international. Time zones lose significance as funds are managed around the globe on a 24-hour a day basis. Money flows to a hundred places in response to small rate differentials. Financial intermediaries—commercial and investment banks, universal banks, clearing and merchant banks, city and long-term banks—have developed a global reach on which the sun never sets. Among the less profound implications are some bizarre banking hours; it is not unusual, for example, for a New Yorker to start work at 4 a.m. at home with reports on markets opening in Europe and closing in Tokyo. Moreover, new money centers are emerging, some initially because of time differences or national considerations. Hong Kong, Singapore, Tokyo, Bahrain, and Kuwait are rapidly giving added substance to an offshore money market.

Concerns about the market

The rapid growth of the Eurocurrency market has raised some concern about the soundness of its banking practices and its potential for monetary disruption. One aspect of this anxiety relates to the lack of conventional regulation of the market, a second that it does or may generate excess liquidity. Both fears are rooted in the fact that banks are not required to maintain reserves against foreign currency deposits as they must against domestic currency liabilities, and uncertainty as to whether there is a lender of last resort.

The absence of a reserve base could, indeed, invite a certain degree of imprudence if it were the only safeguard of sound banking. That, of course, is not the case. Bankers monitor themselves in this arena, as in every part of their business. In addition, cognizant authorities in the major countries increasingly treat the foreign currency operations of banks in their jurisdiction as part of the total business of those banks for the purposes of supervision. Some use guidelines in respect to matching of assets and liabilities by currencies and maturities, as well as capital and liquid assets against their deposit liabilities as a whole, including foreign currency liabilities. Indeed, exemption from reserve requirements tends to stand out as the visible aspect of permissiveness. Although the market is not regulated as such, the banks in it are supervised in the leading financial centers.

Significantly, the worst shock so far experienced by the Euromarket—the Herstatt case—resulted from speculation in the foreign exchange market, where currencies are bought and sold, and not from overtrading in the Eurocurrency market, where currencies are lent and borrowed. For a time thereafter, smaller banks found it difficult and costly to obtain Eurocurrency deposits in the interbank market for no reason other than being small, while large banks in some countries were inundated with funds for the opposite reason. But equally instructive, though less dramatic, was the reassertion of market forces. Bigger banks were finally obliged to push their excess funds back into the market, where deposit rates for all banks then settled back into a normal pattern.

Another source of concern to some observers is the mobilization of short-term funds to help provide credits of longer term and its presumed vulnerability to some large nonbank depositors. Maturity transformation is certainly a task which the Euromarket performs; it is, after all, a quintessential function of banking. But some observers remain troubled by what they regard as inadequate matching of funds acquired with funds used.

Concern about the supply of funds to the market is linked to the fundamental question of what influences the market's growth. A simple connection with U.S. payments deficits is challenged by the fact that the Eurodollar market has expanded at times of such surpluses as well as deficits, and that its present size far exceeds U.S. cumulative payments deficits of the past 20 years. The point is reinforced by the existence of Euromarkets in the currencies of surplus countries like the Federal Republic of Germany and Switzerland.

The indirect supply of funds is as relevant as the direct and traceable supply which attracts more attention. To cite only one example, the OPEC supply to the market has not been confined to the funds placed in it directly by the monetary authorities of oil-exporting countries. OPEC investment, such as in U.S. treasury bills, can free up an equivalent amount of funds for placement elsewhere, including the Euromarket.

The pattern of supply and demand in the market has been consistent from the earliest days of its existence. Users typically have made their first entry as depositors to build up the balances and banking relationships which later allow them to become takers as well as providers of funds. And, as is likewise normal in banking everywhere, borrowers in the Euromarket are depositors at the same time. The temporarily unused proceeds of international bonds and Eurocredits are normally deposited in the Euromarket. Concern that the Eurocurrency market does or may contribute to world financial instability rests in part on the assumption that the absence of a reserve base allows banks in the market to create credit faster than banks in a domestic system. The evidence of a larger multiplier remains inconclusive. In any event, C. W. McMahon of the Bank of England, put it realistically when he stated that, even if a larger multiplier were conceded, that in itself would not imply any net addition to world credit because the Eurocurrency market is mainly an alternative channel for credit flows which would take place in some other form.

The belief that the Eurocurrency market is a chief cause of exchange destabilization can be questioned on similar grounds. All asset holders that are not subject to foreign exchange control in their own countries are free to switch among currencies at will and, if necessary, to borrow in whatever market they choose for that purpose. International capital flows, especially on today's scale, do indeed have the capacity for great impact on the exchanges. But they are not an autonomous creation of the Eurocurrency market, nor is this market the only conduit. The proof is that exchange rates were upset by market forces before the Eurocurrencies had been dreamed of, and even today large foreign exchange movements still bypass this market.

Needless to say, this realistic appraisal is not to be taken as a complacent one. The market is only as good as the banks that serve it. The Herstatt scare, although it did not result from imprudent Eurocurrency lending, had the useful effect of alerting market participants and their regulators to the risks inherent in the business. As a result, commercial banks in the major countries are addressing the matter of responsibility for their foreign branches in this regard, while central banks have recognized a responsibility for lender of last resort, even though their response in time of market stress is still untested. These are constructive initiatives.

A considerable service is being provided, not only to bankers but to the entire international community, by the increasing amount and sophistication of data provided by the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), the World Bank, the Bank of England, and especially the maturity analyses which the BIS is refining. Of course, the value of these statistics depends on how they are used. They are of benefit to banks in their assessment of risk, but when viewed with an undiscriminating eye, the sheer volume of statistics itself can impede conceptual understanding. It has certainly done so in leading many observers to confuse bank lending to a handful of highly advanced and rapidly growing countries in Latin America and Asia with the generalized debt problems of the Third World as a whole.

The much debated question of sovereign risk can be brought into perspective only by analyzing its components, as the banking community does in practice. Lending to industrial countries has been very large and highly concentrated. Lending to Eastern Europe has grown more deliberate after an initial burst. In the most controversial aspect of the exposure discussion—lending to non-OPEC developing countries—Eurocredits have been extended selectively. About half has gone to two nations in this group, which are diversified and advanced, and almost three-quarters to no more than six. Considerable difference exists between such economies at one extreme, about another 60 which have qualified for some bank credit and, at the other extreme, the poorest countries which remain largely dependent on sources other than the market.

The credit markets, it is fair to say, have so far shown their ability to restrain credit availability to various borrowers until they have taken action to stabilize their economies and external balances, at which time lending has been resumed. It is significant that real difficulties have, at least so far, been confined mostly to borrowers heavily dependent on a particular raw material or other single source of income. It is in this context that the U.S. Comptroller of the Currency, among others, has encouraged banks and bank examiners to look at diversification of risk rather than country exposure alone.

Linked only partly to apprehension about the degree of banking exposure to some borrowers is concern about pressure on Eurocredit lending margins from stiff competition among banks. This point applies particularly to those banks which do not have an assured dollar base, since well over 90 per cent of all publicly reported medium-term Eurocredits have been denominated in this currency. The pruning of margins to a point where costs may not be adequately covered raises a serious issue and the remedy lies with banks themselves. In many cases, they have declined to join syndicates when they considered the terms imprudent. Moreover, the classic differentials in lending margins persist in this as in all markets, reflecting the lender's assessment of the borrower's credit standing. The function of this differential is to allow banks to make adequate provision against loans to weaker borrowers.

International bonds

The growth of the international bond market, the other major sector of the international capital market, has been no less impressive than that of the Eurocredit sector. During the eight years ending 1977, finance raised on international bond markets, foreign bonds and Eurobonds, totaled some $120 billion compared with $150 billion of Eurocredits. The Eurobond market has become the world's sixth largest fixed-interest market in terms of the value of securities outstanding and third after London and New York in terms of secondary market trading in these obligations.

Growth in Eurobond activity has been particularly rapid since the beginning of 1975, initially in response to more attractive yields. But the persistence of large issuing volume even on a flattening of the yield curve this year suggests a secular and not merely cyclical growth.

Although there are no pertinent data, a growing number of institutional investors has begun to give new strength to this market in the past few years, including the monetary agencies of some of the oil exporting countries. It is true that such investments of these agencies are very small in relation to their total assets, but they constitute a noteworthy factor in a market traditionally dominated by individual investors. Another development has come in recent years from the entry or expansion of participation by strongly capitalized investment banks and securities firms making a secondary market.

Observers of Eurobond activity have expressed concern about such matters as relatively high issuing costs, a legacy of early days when the search for investors willing to take what was then a new instrument was, indeed, a time-consuming and labor-intensive business. A related issue is that nominally large selling concessions and loose underwriting commitments make for certain problems in the distribution of new issues, reflected in high turnover immediately after issue, price fluctuations which are often relatively wide during that initial period, and the fact that investors receive new bonds at different prices according to their market power.

The reopening of the New York capital market to foreign borrowers since the beginning of 1974, the inauguration of the Japanese foreign bond market on a significant scale during the past two years, and the Swiss foreign bond market have all heightened competition for the Eurobond market. Moreover, many methods of distribution are less acceptable to institutional investors than to the individual investors who have historically provided the predominant interest. At the same time, the presence of institutional investors and a greater number of strong investment banks and securities firms have combined to produce higher turnover and a narrowing of trading margins in the secondary Eurobond market.

Another aspect of this market which has generated discussion is the relative shortness of maturities which have tended to average between 7 and 9 years, as against the 20-year to 30-year capital obtainable by foreign and domestic borrowers in a market like New York. These shorter maturities reflect the preference of borrowers and investors in an uncertain climate. Borrowers have shown an increasing tendency to take advantage of various forms of early redemption in order to switch flexibly between the fixed-interest Eurobond market and the floating rate Eurocredit market. Investors have likewise shown a preference for shorter maturities at a time when alterations in exchange relationships have tended to outweigh by far interest differentials between Eurobonds in weak and strong currencies.

Improving the Market

My discussion of the market has analyzed certain concerns that have been expressed regarding structure and operation. In this concluding comment, I wish to focus on enhancing its serviceability.

—Let me begin with a caveat. The Eurocurrency market has come to play a valuable role in the world economy precisely because it is free. It could not, in my view, go on making its contribution if attempts were made to fit it with a new harness of controls. The arguments against such a course of action are strong and the need for it is by no means clear. The proposal of GATT-type regulation of capital flows in this market holds little or no promise. U.S. experience in the last decade indicates that such controls are not much good for very long, and that impeding outflows can deter needed inflows. As previously noted, the banks in the market are supervised. The refinement of supervision and the clearer demarcation of responsibility for banks in the market which emerged from the Herstatt scare of 1974 were welcome in themselves and for underpinning confidence. Nevertheless, the price of freedom is eternal vigilance, and a heavy responsibility rests on banks and their national supervisors in all sectors of the market.

—The initiative taken by the World Bank and its affiliate, the International Finance Corporation (IFC), as well as regional institutions, such as the Inter-American Development Bank, in parallel financings and investments with participants in the private market are likewise welcome. The presence of these agencies does not afford a guarantee, but it does offer assurance not only to the providers and intermediaries of international capital but also, and just as importantly, to the recipients, who know that the projects being financed will have had the benefit of additional and expert scrutiny. Needless to say, this category of lending would be reinforced if the loan agreements were cross-referenced. The parallel financings by the World Bank itself have so far been few, while those of the IFC, although more numerous, have necessarily been small in individual amount. The record of the IFC shows that a small investment by one of these official agencies can attract many times its amount in the form of private capital. More such parallel financings should therefore be encouraged and ways might be found for shortening the delays which have sometimes occurred.

—Some countries might well consider it in their own interest to seek conditional financing from the IMF before an acute need arises. There is the view, of course, that it is a sign of health never to have visited the doctor, but it can be argued that a medical certificate—in this case, the Fund's certificate of worthiness—is more reassuring still.

—The relationship between the IMF and private banking holds promise of further development. To seek ways and means of linking more imaginatively the unique functions, but relatively limited resources, of the Fund to the greater credit potential of the private market is a worthwhile effort. The purposes of IMF financing are, of course, different from those of official development or export finance institutions, a fact requiring a more innovative approach. In my remarks to the International Monetary Conference in Tokyo last year, the possibilities of cofinancing, sometimes called complementary or parallel financing, were raised. These and other suggestions so far have apparently been faulty. It would, however, be a pity if misguided suspicion of the banks in such an effort were to abort further exploration. Nor need collaboration jeopardize the wisdom of maintaining an appropriate arm's length relationship between the Fund and the banks.

—Banks have a high obligation to resist erosion in credit and pricing standards in their Eurocredit lending. In the long run they will not be doing borrowers in this market a favor by conceding uneconomic lending margins. In banking, as in all fields of business, from time to time the salesman's natural tendency asserts itself, a truth made clear by a leading Latin American finance minister who remarked, "Bankers need debtors." Management has the responsibility of making sure that banks seek good business, not just business of any kind at any price.

—The Eurobond market can improve efficiency from the play of its internal forces. In this regard, a vital contribution can continue to come from the Association of International Bond Dealers, whose membership, devoted to the establishment of improved and uniform market practices, has grown to some 480 financial intermediaries in 30 countries.

Toward a Better System

Before undertaking, as a market participant, to prescribe for a better monetary system, I am constrained to get one thing off my chest: in many nations a belief, or a yearning, persists that there is an escape into an international solution from problems plaguing us at home. Unhappily, the reverse is true, for the plain reason that we live in what has been called an "intermestic" world. Collaboration of nation-states is clearly indispensable to the kind of world we seek, but gaining a healthy global economy, a well-functioning credit and capital market within a stable and serviceable monetary system is beyond reach without the kind of economic and financial policies that make for health in our individual countries. Only then do essential efforts of coordination of national policies have a chance. Band-Aids and rhetoric do not constitute much of a durable remedy.

I realize that to speak thus is to expose oneself to the charge of being tiresome and bereft of the "new ideas" that are supposed to provide salvation in an international context from the consequences of national indulgence. I am not, however, deterred from doing so by the prospect of such a remonstrance.

Needless to say, I do not presume today to prescribe for all the nations represented in this room what these policies are, but I would like to speak briefly, in an illustrative sense, about my own country which, by virtue of its weight in world economic and financial affairs, must get things right at home if it is to discharge its obligations as a leader of the world community. I do so in the spirit of Admiral Alfred Mahan's dictum, "If your strategy is right, you can survive some errors in tactics."

(1) Winding down inflation must be the first objective of public policy, as indeed it now is acknowledged for the first time since the end of World War II. This new order of priority is due in good part to a growing realization that the chief friend of unemployment and the chief foe of high and steady employment is inflation. To achieve this objective, we, as citizens, must pay our way in the public sector, except in times of war or serious economic reversal, and press on with our withdrawal from debt addiction. Deficit and debt have enjoyed more rationalization than they merit. Fiscal integrity must be cast in stronger stuff than the subjunctive mood. There has been abuse of public debt in my country—and I daresay elsewhere—a fact that has burdened the monetary policy of the central bank in its role as defender of the dollar. As a merchant of debt myself, I say this with deep conviction.

(2) Slowing the cost-price spiral is essential through emphasis on increasing competition and removing deterrents to cheaper supply. In my view, pay and price controls are not the means to discourage over-

paying ourselves for the work we do and to encourage business pricing for volume at viable margins.

(3) Spurring research and development is urgent, in both the public and private sectors, to foster modernization and broadening of our capital base.

(4) Reducing the gap in our balance of payments is vital through conservation of energy and development of alternative domestic sources, more vigorous export efforts, and providing a hospitable environment for foreign investment.

(5) Resisting encroachments on an open world trading and financial system is a necessary national commitment.

Attitudes and actions of this kind are what my country needs to render its part in building a sturdy and resilient international system. I am prepared to believe that such strategies may fit other countries as well.

Improving the system

At the risk of trespassing on Erik Hoffmeyer's terrain, let me venture a few closing comments on useful guides for the monetary system as seen by a market participant. Needless to say, I doubt we have the knack of so arranging the world, in the words of a recent observation, that we do not need to experience it.

—First and foremost, *stability* must be recognized as the condition in the foreign exchange markets that best serves our needs. Although many would like to see a return to the par value concept, this is unlikely in the foreseeable future. Equally unlikely is the emergence of a free floating system. Consequently, our collective challenge is to make the present arrangements more effective and less crisis-prone, for which, as I have already stated, the condition precedent is sound economic and financial policies at home and their coordination abroad. To be national is all right, if we are also neighborly.

—In aid of stable exchange markets, the *surveillance function* of the IMF may be expected to play a steadily growing role. With the entering into force of the amended Articles of Agreement last April, members have been given wide latitude regarding the form which their exchange rate arrangements may take, but less freedom of behavior in implementing exchange rate policy. Thus, manipulating exchange rates in order to obstruct balance of payments adjustment or to seek unfair competitive advantage is enjoined. But since rates respond to a wide variety of influences other than actual exchange rate policy—such as domestic monetary and fiscal policies and political developments—it is a challenging task to determine instances of such manipulative behavior. For this, we look to the Fund under the new responsibility given it in the amendments.

It comes as no surprise to this audience, therefore, that debate continues as to whether it would be more appropriate to adopt what has been called a tracking strategy, in which a set of reference exchange rates would be established and adhered to, or, setting our sights somewhat lower, a smoothing and braking strategy in which we attempt to limit allowable fluctuations around existing exchange rates. Whatever we determine as to the appropriateness of exchange rates themselves, we must go beyond them to their underlying economic and financial policies. If the Fund is to exert effective influence on the domestic economic policies of its members, it must be privy to full information from members as to the intent of domestic policies, so organized that transgressions of Article IV can be quickly spotted and acted upon, and capable of taking effective action to ensure compliance with its recommendations. A viable monetary system, in my view, requires the Fund to exercise influence, in different ways, upon sovereign behavior in the interest of the world community. To be sure, this is challenging turf for the IMF, but until that remote day when we may have a world central bank, as envisioned by William McChesney Martin in his 1970 Per Jacobsson Lecture, the Fund will increasingly have to act like one.

—Well-designed *intervention* in the foreign exchange markets by central banks with organized capability has a facilitating role to play in the workings of the current monetary arrangements. Free floating has proved to be neither a viable nor likely regime. Appropriate intervention to smooth erratic fluctuations and brake precipitous gains or slides can perform a bridging function in the interest of gaining time for basic solutions to work. Issuance by the United States of foreign currency-denominated securities to official holders as well as modest periodic gold sales may well have merit in supplementing intervention of this kind.

—Against the backdrop of recent volatile exchange markets, a weakening dollar and an increasing desire of international asset holders to diversify the currency composition of their assets, a variety of proposals has been put forth aimed at *limiting the role of the dollar as a reserve currency*. For example, the proposal for a substitution account in the Fund is entitled to further examination, although any initiative which relies on exchange rate guarantees raises serious questions. The role of special drawing rights, especially their financial attractiveness and commercial usefulness, will doubtless continue under review, but clearly creation of substantial additional international liquidity from this source would certainly be inappropriate at this time and unnecessary to maintain the credibility of the SDR. The feasibility of encouraging the use of other currencies in a reserve asset role will, doubtless, have limited applicability as long as the United States remains the world's largest economy and its credit and capital markets perform well. It must be noted as well that disinterest continues among the issuing countries of the possibility of having additional reserve currencies.

—In this regard, much attention has recently been focused on the attempts of the European Economic Community to fatten the currency snake. The goal of *European monetary union* has been discussed for many years and has long been frustrated by problems similar to those which have plagued the monetary system as a whole —divergence in inflation and growth rates and large payments imbalances among the nations concerned. The Schmidt-Giscard d'Estaing proposal for a zone of monetary stability in Europe can be a step in the right direction, if it encourages economic growth there and in the world as a whole, if it is not discriminatory either within or outside the EEC and, and if it is administered in conformity with the amended IMF Articles of Agreement and in full cooperation with the IMF.

Conclusion

During the course of preparing these remarks, I have keenly sensed the reality of Per Jacobsson's conclusion that the creation of a well-performing market within a well-functioning monetary system is, indeed, a journey, not a destination. In our time, progress on this journey has been marked by an extraordinary capacity to surmount the obstacles with which we have hobbled ourselves along the way. That we have among us the intelligence and judgment and energy to continue this forward movement, I have no doubt. What must be assured above all things is the commitment to look past the near horizon as well as to see our best future in the broad community. Such a mission requires of us, as citizens of the world, the discharge of a vital leadership role in our own countries.

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MR. SOUTHARD: Thank you, Gabriel Hauge, for your talk. We will now be hearing from Erik Hoffmeyer, who became an economist in the National Bank of Denmark in 1951 and has been the Chairman of the Board of Governors of that Bank since 1965. During part of that period, he was also a professor of economics at the University of Copenhagen. He is the author of several books and the editor of others, and during his career he has held a number of distinguished posts, both within and outside Denmark, including a Directorship of the European Investment Bank and Chairmanship of the Committee of Central Bank Governors of the European Community. I introduce Governor Erik Hoffmeyer.

The International Capital Market and the International Monetary System*

Erik Hoffmeyer

It is a great honor for me to be asked to contribute to the debate on this important subject and, at the same time, a challenge because it is an extremely complicated set of relations that characterize the interaction between the international capital market and the international monetary system.

It is clearly impossible to present a satisfactory analysis within a brief paper like this. I shall try therefore to concentrate on fundamentals, or rather what I think are the fundamental questions, because even that is controversial—not to speak of the answers. I fully accept that there must be different attitudes, since for more than 25 years I have discussed and tried to analyze this set of problems, both as a professional economist and later in a policy formation capacity.

I have chosen three main problems.

The first one concerns the breakdown of the Bretton Woods system—the fixed rate system or adjustable peg system. In order to understand the forces now at work, I think it is necessary to have a clear notion of why the old system was abandoned. It is in line with one of Per Jacobsson's favorite remarks that history cannot teach you what to do except to avoid repeating past mistakes.

In the second part, the structure of the present system is reviewed, including the basic features of monetary integration and the exchange rate system. It goes without saying that the offshore monetary system (I use offshore in the broad sense including all monetary transactions outside the country of the currency) will be discussed in some detail as its role is often misinterpreted.

The third part deals with stability problems which, of course, are essential for the functioning of the system and thereby its chance of survival, which then again leads to the question of a possible strengthening of the system or the establishment of a substitute.

* I am heavily indebted to Miss B. Vibe Christensen for her untiring efforts to provide background material for this paper, and for a thorough discussion of all the major points in the analysis. My colleague, Svend Andersen, and Professor N. Thygesen have read the manuscript and made valuable suggestions.

I. Why Was the Bretton Woods System Abandoned?

It is a well-known fact that the Bretton Woods system was based on the philosophy that the mistakes of the 1930s should be avoided. During the Great Depression economic warfare was characterized by restrictions on trade and payments and so-called competitive devaluations. It was therefore decided that restrictions on goods and services should be abolished, thereby liberalizing the transactions on current account of the balance of payments.

On the other hand, the references to capital movements were meager. In the two main plans leading to the Bretton Woods system, the Keynes Plan and the White Plan, some discussion actually took place on the role of capital movements. The general idea was that some sort of restrictions on capital movements was necessary. On this point Keynes especially was very clear: "It is widely held that control of capital movements, both inward and outward, should be a permanent feature of the postwar system." However, it was left to the individual countries to decide about capital movements.

In the final version of the Fund's Articles of Agreement, capital movements were only mentioned briefly in Article VI: "A member may not use the Fund's resources to meet a large or sustained outflow of capital . . . and the Fund may request a member to exercise controls to prevent such use of the resources of the Fund." Finally, regarding controls of capital transfers: "Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments. . . ."

In order to avoid competitive devaluations, a country was—apart from certain transitory rules—allowed to change its exchange rate only if the International Monetary Fund agreed that its balance of payments was in fundamental disequilibrium. This concept was, however, never defined; but it was clearly unnecessary to do so.

The pressure for adjustment had been an old issue in international economic discussions, i.e., how strong should the pressure be on surplus or creditor countries compared with deficit or debtor countries. The Keynes Plan took a very clear position on that by proposing that the pressure should not be applied only to deficit countries but equally to surplus countries. Eventually, only the famous scarce currency clause was left, according to which the Fund was allowed to impose limitations on the use of a currency which had become scarce because of a country having a constant balance of payments surplus.

After the war, the United States took a strong leadership role in building an international trade and payments system based on market forces. This was, however, not done primarily via the IMF but via a special aid program to Western Europe and the establishment of the Organization for European Economic Cooperation (OEEC)—later the Organization for Economic Cooperation and Development (OECD).

In a way there were two phases in this liberalizing process.

The first phase was the most difficult. It concerned the liberalization of goods and services, which included a lot of bargaining among the participating countries, but eventually it gathered momentum and, to all intents and purposes, it was brought to a successful conclusion by the introduction of convertibility at the end of 1958. Production had been integrated among the member states in such a way that market forces in principle determined the location, magnitude, and trade of production. By historical standards this was indeed an impressive achievement obtained in less than ten years.

The second phase concerned the liberalization of capital movements, first and foremost, credit connected with trade and direct investments, whereas portfolio capital movements were not included among the obligatory commitments. The liberalization of capital movements was far less dramatic than for goods and services. To a large extent it was a natural consequence that free trade gradually included trade credit. The two phases overlapped, but the impact of freer capital movements was felt particularly in the 1960s. It implied a far-reaching monetary integration among the member states, which meant that the degree of national monetary independence was drastically curtailed.

It became quickly perceptible in a country like my own. If we wanted to restrict monetary policy by reducing the money supply and increasing interest rates, a large part of the effect was offset by private sector borrowing abroad. Similarly, it was obvious that the market mechanism put stronger and stronger pressure on exchange rates that were not credible.

The exchange crises became bigger and bigger in the late 1960s, and much to the chagrin of many central bankers, politicians got more and more involved in the negotiations to solve the crises. I only have to mention March 1968 (the dissolution of the gold pool and the partial abolishment of the convertibility of the dollar into gold), August 1971 (the final termination of the dollar-gold convertibility), and December 1971 (the Smithsonian Agreement).

Particularly the last event may be considered as a rearguard battle to save the Bretton Woods system of fixed rates. It was hailed as a historical event, because it was the first time in monetary history that a comprehensive exchange rate adjustment had been negotiated. But, in little more than one year, the system was abandoned.

Whereas the trade integration process ended with convertibility of currencies, the monetary integration process ended with the abandonment of the fixed rate system.

Having participated in some of the negotiations and read and listened to reports of other meetings, it does not seem reasonable to me to argue that it was a deliberate decision taken by the authorities to abandon the old system. I would rather say that market forces were too strong to be handled by the authorities. It was a struggle between politicians and the market forces—let loose by the politicians—and the market forces won.

It was quite clear that the authorities were not willing to adjust exchange rates sufficiently—with the advantage of hindsight, the size of adjustments in the Smithsonian Agreement could have been doubled—and they did not have the imagination to foresee the amount of exchange market intervention that was necessary to defend the decisions taken.

This is one example of authorities underestimating the severity of realities.

Consequently, my contention is that the unwillingness of authorities to adjust to realities was the main factor causing the breakdown of the Bretton Woods system and that monetary integration based on market forces was instrumental in this respect.

Many seem to feel some nostalgia toward the old system. I do not. I think it is far too dangerous to have a system that is so unstable as the old one. The instability came mainly from the confrontation between the market-oriented trade and monetary integration on the one hand and the unwillingness of authorities to undertake the necessary adjustments on the other hand. You cannot play a game with different rules for the various participants.

II. The Structure of the Present System

I have put so much weight on the confrontation between monetary integration and the exchange rate system that it seems natural to follow the same pattern when describing the present structure.

Whereas there is a fairly high common degree of freedom for capital movements in the dominant countries—in particular regarding credit connected with current account transactions and direct investments—there are substantial differences regarding portfolio capital movements. Some countries have restrictions on inward movements in order to avoid becoming reserve countries (the Federal Republic of Germany, Switzerland, and Japan) and to try to maintain monetary independence. Other countries have restrictions on outgoing movements in order to prevent reserve losses and possible capital flight (e.g., the United Kingdom, France, Italy, and the Scandinavian countries). The United States has, since January 1974, reintroduced freedom for capital movements in both directions. Finally, there are the so-called offshore markets which essentially are money and capital markets where transactions are conducted in currencies other than the currency of the country concerned. The largest market is the much debated Eurodollar market with dollar borrowing and lending outside the United States.

The offshore markets are characterized by very few, if any, restrictions, much to the dismay of many authorities. The function and role of these markets has created much confusion during the last 15 years, although quite a number of important studies have been published.

There is an increasing tendency to stress the line of presentation which has recently been given by Professor R. Aliber in a very clear way.

I shall give a brief outline of this kind of reasoning.

As regards long-term capital transactions, throughout history it has been quite usual for loans to be expressed in a currency unit that is external to the national system. Such transactions do not present special problems for the analysis of monetary integration.

However, things are different regarding banking operations. If a bank receives a deposit in a foreign currency, e.g., a bank in London receives a dollar deposit, this deposit is ordinarily treated as an external affair by the local monetary authorities and similarly by the U.S. monetary authorities. It is a monetary transaction in no-man's land and therefore suspect from the point of view of national monetary authorities. But, if a bank has a demand-deposit or a time-deposit obligation, it is necessary at the same time to be certain that cash can be provided if necessary. This means that deposits with offshore banks must, in the end, have a relation to the money base in the country of issue.

There has been a long and animated discussion about the money multiplier of the offshore banking systems. That is probably not a relevant question any more than you can ask for a separate money multiplier for banks on 5th Avenue in New York, or in the southern part of California.

Insofar as reserves held voluntarily by offshore banks are proportionally less than required reserves in the United States, the composite money multiplier becomes fractionally larger than the national U.S. money multiplier. What is more important is that these markets work as catalysts for international monetary integration. This role of the market was underlined two years ago by Helmut Mayer of the Bank for International Settlements (BIS) in an article which clearly demonstrated how significant a part of the gross figures of the Eurocurrency market was accounted for by interbank positions. Only a tiny fraction of the net size estimated by the BIS would have to be added to the narrowly defined world money stock (M_1) and about 25 per cent to the other world monetary aggregates, making up a very small part of the total world money supply. This, however, is not equivalent to reducing the role of the Eurocurrency market to this small percentage, but to stressing the nature of the market as an important channel for money and capital flows.

This integration of national and international capital markets has important implications for the effects of policy actions in the sense that whenever there are restrictions of some sort or another, these will tend to be offset if possible by the unregulated offshore markets.

This point is very clearly illustrated by the development of the Eurodollar market, which took place in the light of restrictions on international capital movements and ceiling on the rate of interest (Regulation Q) in the United States. The introduction of the Interest Equalization Tax in 1963 and the Foreign Direct Investment Program in 1965, as well as the curtailing of the U.S. commercial banks' short-term lending in 1965, gave a strong impetus to the development of the Eurodollar market. The market developed in countries like the United Kingdom which had the fewest restrictions on international banking transactions.

There is no mystery. It is simply a consequence of a law that is just as important as Gresham's, namely, that financial transactions tend to take place where restrictions are least.

I think it is a general experience in the international financial system that transactions may originate from national or offshore institutions. The effects are identical and substitution is easy.

My main point is that the monetary integration which developed in the 1960s and was instrumental in changing the fixed exchange rate system is still dominating the exchange markets and that the offshore markets make this dominance stronger. The road from the Smithsonian Agreement to general floating will undoubtedly become a central issue in future analysis of international monetary problems.

From an official point of view it has proved to be impossible to negotiate a so-called symmetrical system.

Leading non-U.S. countries wanted the United States to undertake a commitment to make the dollar convertible into another asset, e.g., SDRs, implying that the United States had in effect the same obligations as other countries. This would obviously have diminished the role of the dollar as a reserve currency. The U.S. answer was that symmetry must include not only a convertibility commitment but also a commitment to adjust either the exchange rate or internal economic policy if certain economic indicators, e.g., reserve positions, showed signs of disequilibrium.

It was the old unsettled issue of the degree of pressure on surplus countries (now the Federal Republic of Germany and Japan) versus pressure on deficit countries, which now, more often than not, include the United States.

As might be expected, it was impossible to negotiate such a treaty and future historians may well express doubts as to the sincerity of the wish to reach a successful conclusion to the negotiations.

Be that as it may, the outcome was a system of more or less managed floating among the most important currencies, whereas small countries, for well-known reasons, as a rule chose to link their currencies to one of the major currencies, the SDR, or some other composite unit. It is not necessary in this connection to go into detail about the degree of management of the floating system, the willingness to intervene, the need for reserves, and the degree of monetary independence. This is dealt with in the Fund's Annual Report.

I think the major point is that the impact of market forces is such that we now have a more symmetrical system in the sense that pressures through exchange rate adjustment concern deficit and surplus countries equally. On the other hand, the symmetry does not apply to economic policy. Recent developments have shown that deflationary policies in many deficit countries have not been accompanied by correspondingly expansionary policies in surplus countries.

I know very well that it is widely felt that the dollar, as the leading reserve currency, is in a special position and that pressure for economic adjustment is not so strong as on other currencies.

I wonder, however, whether this is true to the same extent as before. In the old days under the fixed rate system with little pressure on surplus countries, the United States could finance a deficit without difficulties; but today things are different. Neither the United States, nor Japan, nor the Federal Republic of Germany have an obligation to intervene in the exchange markets, and U.S. monetary policy cannot any longer be independent of the exchange rate of the dollar. As has been demonstrated recently, market reactions are quite strong, and the decline of the dollar is so big, that it is safe to say that benign neglect belongs to the past. At any rate, the word "benign" should be omitted, because neglect is costly as has been proved by recent U.S. monetary policy measures.

Even though we have a mixed system regarding both the degree of monetary integration and the degree of management of floating, I think that the present system is more coherent than the old one. But this does not necessarily mean that it fulfills the necessary stability conditions.

III. Problems of Stability

It is extremely difficult to present a satisfactory analysis of the stability of the present system. One often has a feeling that it should be lawyers who present the arguments rather than economists. The criteria used are subjective, the concepts are unclear, and the statistical material is unreliable. Nevertheless, it is necessary to evaluate the performance of the present system in this respect.

What are the tasks assigned to the system? The system must be flexible in order to absorb shocks but, at the same time, it must support forces that work for stable development. There are particularly three aspects. The first concerns financing. Deficits should be financed but not so easily that the adjustment process is not set in motion. The second concerns the role played by exchange rates. The adjustment process should be influenced by changes in exchange rates but not so much that too strong demands for protection (surplus countries) or too strong inflationary pressures (deficit countries) are generated. The third concerns economic policy actions. Pressure should be exerted via movements of exchange rates or foreign exchange reserves on political authorities to change economic policies; but neither deflation nor inflation should be created.

Let us take these three aspects one after another.

(a) Financing the deficits

The role of capital movements has been discussed extensively in the economic literature. Some have analyzed so-called autonomous capital movements from one country to another and the economic mechanisms that determine the real absorption or transfer of resources between two areas. Others have been more interested in the fact that differences in economic performance—growth and inflation—create deficits and surpluses between countries and consequently a need for counterbalancing finance. The basic problem here is more political in the sense that financing is necessary in order to keep the system flexible; but there should be pressure on authorities to introduce corrective policy measures. This raises the big issue of the degree of conditionality of international lending.

The system should be shockproof but not so flexible that it is instrumental in creating instability. It can also be formulated very simply that it should neither be too difficult nor too easy to borrow. Irrespective of how it is formulated, it does not lend itself to precise interpretation.

During the last five years the international payments system has certainly been exposed to shocks: First and foremost the oil price increase in 1973 and later, large discrepancies in growth and inflation rates.

Figures for the current account of the balance of payments for certain groups of countries are given in Table 1.

It appears that the accumulated surpluses of these country groups over the five-year period have been approximately \$260 billion and the deficits approximately \$410 billion. The discrepancy between surpluses of \$260 billion and deficits of \$410 billion represents quite a substantial margin of error, even though it is small compared with total trade flows. On the other hand, the amounts are enormous compared with the resources that are available under the facilities of the IMF or the abandoned OECD Financial Support Fund.

Table 1. Current Account Balance of Payments of Selected Countries, 1974–78

(In billions of U.S. dollars)

	1974	1975	1976	1977	1978	Total
OPEC	61	29	39	34	19	182
OECD, hard-core surplus countries [1]	8	8	14	18	29	77
OECD deficit countries	−41	−14	−39	−50	−46	−190
Non-oil developing countries	−24	−40	−27	−27	−38	−156
Other	−10	−18	−13	−11	−10	− 62

[1] The Belgian-Luxembourg Economic Union, the Federal Republic of Germany, Japan, the Netherlands, and Switzerland.

In the years 1974–77 the total identified net external lending in domestic as well as foreign currencies of banks in the Group of Ten countries, Switzerland, and foreign branches of U.S. banks amounted to $230 billion. In the same period registered Eurobonds and foreign issues of bonds totaled $95 billion, i.e., international bank lending and bond issues added to $325 billion. In comparison, the net lending from the International Monetary Fund came to only $16 billion (gross lending $23 billion).

For the present discussion, this is the relevant issue because here again we have a confrontation between the market mechanism and the authorities.

It is a plain truth that deficits of this order of magnitude could not have been financed via official channels, either national or international. Had it not been for private market financing, we would probably have been in a much more serious recession than the present one. I would, frankly speaking, not dare to assess the consequences of the alternative.

It has been a remarkable feature of recent lending that not only the industrial countries but also several larger non-oil developing countries have obtained access to the private capital markets and, indeed, to such an extent that these countries as a group have been able to build up their international reserves quite significantly, almost by $30 billion during the last two and a half years. The credit available under the existing development aid organizations did not correspond to the increased financing requirements of these countries.

For the developing countries, however, it can be argued that it would be desirable to have an increased share of official credits carrying a longer maturity and a higher grant element than is obtainable in private credits. Most observers have a positive attitude toward the private international capital market, but many contend that it has "crowded out" official channels, including the IMF, to such an extent that the degree of conditionality is too low. In other words, it is too easy to borrow, which tends to maintain balance of payments disequilibrium and inflationary conditions.

It is very hard to establish criteria to form an opinion on this but we have seen quite a number of policy adjustments to reduce deficits on current account of countries that had no difficulties in borrowing internationally. Over the last years, the United Kingdom, France, and some smaller European countries could be mentioned. The reason has been that there are widespread political anxieties about becoming too dependent on foreign loans, and, at the same time, domestic considerations regarding inflation have played a significant role.

Besides the self-imposed adjustment by the borrowing countries, the market itself also exerts discipline. During recent years we have witnessed several situations where the private banks have denied countries access to the market and subjected the countries to the conditional borrowing of the International Monetary Fund as a prerequisite for obtaining further private credits. The question is whether the private banks are able to perform this role satisfactorily. With the knowledge I have of the conditions imposed by the market I have no serious doubts about discipline.

There are, however, serious differences of opinion in this field and many participants in the discussion have favored some kind of regulation of the private capital market. In particular, there has been much interest in proposals about regulating the offshore markets, especially the Eurodollar market. The debate has been kept alive for many years, but must definitely be considered a blind alley.

There are, in principle, two ways in which authorities could gain control of offshore transactions. One way is to reach agreement among countries where offshore transactions take place. This would mean not only the Group of Ten countries but also the newcomers—Bahamas, Barbados, Grand Cayman, Singapore, etc. It seems, however, highly unlikely that agreement could be reached. And what would happen if some commercial banks hired a satellite and conducted bookkeeping there? Another method is to bring transactions under the control of authorities in the country of issue, e.g., dollar transactions under the control of the U.S. Federal Reserve.

However, in order that such control is not circumvented, far-reaching restrictions on payments are required with the consequence of curtailing not only the Eurodollar market but also the use of the dollar as an international currency.

(b) Exchange rate movements

Exchange rate movements have an impact on relative prices of goods and services and consequently on the balance of current account. In addition, they influence the relative attractiveness of national and foreign assets and consequently the portfolio composition. These are two markets, and an equilibrium rate of exchange in one market may not necessarily be the equilibrium rate in the other market. Furthermore, short-run equilibrium rates may not be identical with long-run equilibrium rates. To complicate matters further, a vicious circle may develop in the sense that, for example, a deficit country with a higher than average inflation rate may experience a decline in the value of its currency, which, in turn, causes more inflation. Again, it is not possible by objective criteria to determine the degree of stability in the system.

Do market forces "overshoot" when exchange rates are determined, or do they hit equilibrium levels more or less accurately?

I do not consider it useful on this occasion to deal with the theoretically highly complicated interrelationships between the current account aspect (flows) versus portfolio (stock) approach, the role and determinants of expectations influencing the relation between spot and forward rates, and the interaction between exchange rate movements and internal demand. I should like to express an opinion on the stability of the system in a more general way.

Many measures have been proposed in the current debate in order to evaluate exchange rate movements. A common approach is to select a base period with the implicit assumption that this period represents a state of equilibrium and then correct exchange rate movements for differences in price or cost behavior. There are admittedly many non-price factors that affect competitiveness, e.g., product adaptability and delivery conditions. Furthermore, the balance of payments is influenced to a large extent by differences in growth rates. This means that exchange rates corrected for purchasing power differences or real effective exchange rates only give part of the answer and in several cases obviously unreasonable ones, e.g., when the United States and Japan are compared.

In order to illustrate my point, the calculations in Table 2 may be useful. Real effective exchange rates have been calculated with second quarter 1973 as basis, using unit manufacturing costs, export prices of manufactures, and consumer prices.

It is a bewildering picture with particularly large discrepancies beween export price and consumer price corrected exchange rates.

It can be said that exchange rates in general have moved in the right direction; but it is difficult on the basis of these calculations to judge about "overshooting" or interaction between exchange rate and price behavior.

A more simplistic attitude is to illustrate on the one hand the degree of floating measured by the amount of official intervention and, on the other hand, the magnitude of exchange rate movements over short periods. The idea is that adjustment takes time and big changes over a

Table 2. Changes in Real Effective Exchange Rates, Second Quarter 1973–Fourth Quarter 1974

(In per cent)

	Adjusted for		
	Unit manufacturing costs	Export prices of manufactures	Consumer prices
United States	−9	½	−7½
Japan	17	−3	25½
Germany, Fed. Rep.	−1½	−4	−½
Switzerland	9½	5	17
United Kingdom	0	2	−3

short period can most often be considered a sign of instability, especially if the exchange rate moves in an opposite direction within a few weeks or months.

During the five years of floating, we have experienced a dramatic increase in official intervention in the exchange markets. In the first three years interventions were modest compared with the imbalance in the international economy. But the last year and a half have witnessed official dollar intervention in the order of magnitude of $50 billion. The major part has been undertaken by the United Kingdom and Japan, whereas Italy, France, and the Federal Republic of Germany have bought lesser amounts of dollars. In spite of that, exchange rate stability does not seem to have improved. But, in the absence of intervention, exchange rate instability probably would have been more pronounced.

Exchange rate movements have been very large since the beginning of widespread floating. For instance, three currencies—the yen, the deutsche mark, and the Swiss franc—appreciated vis-à-vis the U.S. dollar by 45, 47, and 105 per cent, respectively, from March 1973 to mid-August 1978. The movements have not been smooth. In several shorter periods exchange rates have fluctuated widely in both directions. The recent exchange rate movements have been especially abrupt, e.g., the yen appreciated 25 per cent and the Swiss franc 27 per cent in terms of the U.S. dollar in the three months from the end of May to mid-August 1978.

It is hard to avoid the conclusion that, in spite of periods of massive intervention, there are examples of serious instability created by market forces.

Perhaps the most useful criterion for evaluating the stability performance of the system is to examine whether it has been satisfactory from a political point of view. Recent developments have demonstrated the fragility of the system. The numerous periods of instability have created demands for restrictions, trade disruptions, and investment uncertainty, just to mention some of the severe consequences.

It seems worth considering whether the exchange rate changes during the last year and a half have not carried too large a part of the adjustment burden. Once more the experience has been that exchange rate movements cannot do the work alone, but must be accompanied by appropriate economic policy.

(c) Economic policy reactions

When authorities want to influence markets there is often a three-step process: declarations, market intervention, and economic policy measures.

There is sufficient experience to show that declarations, which are the easiest way out, are not impressive. Declarations are not taken at face value, to say the least. Market interventions have greater effect but, as has been shown above, instability cannot be prevented by intervention alone.

The obvious conclusion is that economic policy measures are necessary in order to convince market forces. This is an old experience and therefore not surprising, but nevertheless, one of the important truths that has to be learned by every new generation of authorities.

The IMF, which has a special educational role, has recently introduced a new concept "the underlying balance of payments position" to illustrate this. An endeavor is made to show what will happen to the balance of payments of the industrial countries, if price competitiveness were maintained and a stipulated growth pattern was achieved.

If such scenarios—to use a modern word—are analyzed, the dire consequences of not taking policy actions become clear and, very often, seemingly unrealistic exchange rates become justified in the sense that market forces anticipate the lack of economic policy response, e.g., the movements of the yen and the deutsche mark vis-à-vis the U.S. dollar.

This again brings us back to the confrontation between market forces and the authorities. The authorities are always reluctant to react, which means that the stimulus from the markets may grow very strong, as has indeed been the case lately.

To some extent this awkward relation may turn into a highly dangerous race, where authorities react to last year's market stimulus not being aware that new stimuli have superseded the previous one. An example of this is the deflationary effects of profit squeezes in countries with revaluing currencies like the Federal Republic of Germany, Japan, and Switzerland.

The inevitable conclusion is that a floating rate system does not relieve authorities of harmonizing economic policy. This statement should probably be strengthened in the direction that the present floating rate system cannot be maintained unless the important countries take more seriously the obligation to harmonize economic policy.

IV. Concluding Remarks

I have chosen the confrontation between market forces and authorities as the strategic relation in the development of the international monetary system over the last 30 years.

It was a political decision of fundamental importance to let market forces play a dominating role in the OECD area. Free market forces do not necessarily lead to optimal conditions, and there are, furthermore, many departures from the system in all countries. Nevertheless, it cannot be denied that this system has been one of the major forces behind the strong economic growth during this period.

Market forces in the form of what I have called monetary integration were let loose by the political authorities in the 1960s and some may feel that I have described the ensuing process as a repetition of the sorcerer's apprentice.

That was not my intention; but I think it is necessary to understand that market forces are not necessarily creating long-run equilibrium, that there are extremely complicated and delicate relationships between market forces and economic policy performance, and that it is highly dangerous to ignore them. This is particularly important when we look into the future.

We have been through a period of unprecedented growth and easy expansion until the beginning of the 1970s.

We have not experienced economic equilibrium in the past and we cannot expect it in the future. Economic equilibrium exists only in textbooks. But tensions in the economic system are now becoming more serious.

Let me just mention three points.

—The monetary hegemony of the United States is declining, which points in the direction of a multiple key currency system as was the case in the late nineteenth century. This will probably increase instability.

—The difficulties in combining full employment with reasonable price stability are increasingly creating serious political problems in all countries.

—The structural changes in the location of production between the old and the new industrial countries require changes of a very large order of magnitude.

Faced with these problems it is vitally important to understand the different significance of declarations, intervention, and economic policy measures. The Bretton Woods system collapsed because leading countries relied too much on declarations and intervention, but were too reluctant to apply economic policy measures. The old system was superseded by managed floating, but there is still too strong an inclination to try the easy way out by relying on declarations and intervention, which are weak instruments against market forces. The core of the problem is that exchange rate movements should produce economic policy reactions. There is no short-cut road to stability. This is just as true of the present system of managed floating as it was of the pegged rate system. In my opinion, this also implies that it is misleading to put a great stake on IMF surveillance over exchange rate policy because such surveillance will probably not provoke economic policy reactions. The reason why I stress this so strongly is that the alternative to the present system is not a fixed rate system but a return to a world of restrictions.

* * * *

MR. SOUTHARD: Thank you, Governor Hoffmeyer. We have asked Eric Roll (Lord Roll of Ipsden), who gave an outstanding Per Jacobsson Lecture in 1971, to serve as commentator. He is the Chairman of S.G. Warburg & Co., and during a long career of public service he served the United Kingdom in such diverse capacities as Undersecretary of the Treasury, Deputy Leader of the U.K. Delegation for Negotiations with the EEC, Economic Minister and Executive Director in the Bank and Fund here in Washington, Permanent Undersecretary of State for the Department of Economic Affairs, and Director of the Bank of England. He is the author of many books and is Chancellor of the University of Southampton. Lord Roll.

Commentary

Lord Roll of Ipsden, K.C.M.G., C.B.

Mr. Chairman, ladies, and gentlemen: May I begin by adding a word of sorrow at the passing of Randy Burgess. He very kindly took the chair for me seven years ago when I had the honor of delivering the Per Jacobsson Lecture. I had known him for about forty years and met him when I was a young academic on my first visit to the United States on a fellowship and he was a young but already very prominent commercial banker.

As for the man in whose honor we have these meetings and these lectures, I must say, with the utmost respect for those who are currently managing our monetary affairs, that I have often been tempted in recent months and years (as I am sure many of you must have been tempted) to echo Pope on Milton—Per, thou shouldst be living this day; the world has need of thee.

We have no more important subject, I think, to discuss than the one that is before us today. It is very wide ranging; it covers, really, everything that those of us here in the financial community, in central banks, and in ministries of finance are concerned with, and we could not have had two more magisterial surveys than the ones we had—from a commercial banker with a much more varied background than that word by itself implies and from a very distinguished central banker.

Perhaps the only factor that has not been sufficiently mentioned today is the political one. I wondered whether perhaps the officers of the Foundation would have been better advised, instead of asking me to comment, to have invited a finance minister to do so. Now some of my best friends are finance ministers, but we all know the constraints that they are under, especially just now. And, in any event, Gabe Hauge, Erik Hoffmeyer, and I myself in our minor ways have been close enough to politics to know that behind all the factors that have been discussed today there is always one other—and that is the need to be re-elected.

Both speakers have necessarily dealt with the monetary history of recent years. They have both shown concerns over the present situation, each including aspects both of the capital markets of the world and of the monetary system.

Gabe Hauge, by no means complacent (that would be totally out of order in the case of what I might call with all respect, the common or garden banker), nevertheless ended up with a moderately optimistic view of the world, which again is a proper thing for a banker to do, because otherwise he would go out of business.

As for Erik Hoffmeyer, his concerns go perhaps deeper, and as a central banker he obviously occupies that very uncomfortable position in the middle—on the one hand between the financial community and on the other between our political masters. And he might well be tempted to say, as another Dane said in Shakespeare's words, "The time is out of joint; O cursed spite, / That ever I was born to set it right!" A very good motto for central bankers, I suggest, as past, present, and future ones are present here today. So I think, Erik Hoffmeyer ended up perhaps in a somewhat more skeptical, not to say pessimistic, mood.

Let me try in a few moments to pick out for comment a few of the many salient points which they touched upon and perhaps to conclude with a few more general remarks.

First, then, to Gabe Hauge's far-ranging and profound survey. He began with a formidable catalogue of changes which to my mind cover a great many socioeconomic and political circumstances of the climate in which we operate today. Incidentally, may I congratulate him on having got away from that very ugly word "stagflation" and to have used that much more elegant and indeed attractive word of "liaison" between inflation and unemployment.

The changes he talked about seemed to me to fall into three categories. First of all, changes in what I might call perception. That is to say, mental attitudes: Changes in the intellectual view of what it is all about. And we are all familiar with that. The relative certainty of the immediate postwar period in macroeconomic management, sometimes (I think rather unfairly) associated with the name of that very great man Keynes, has given way to great uncertainty about the limits of economic policy, both macroeconomic and microeconomic. And we are very much in an uncharted sea as regards economic policy today as compared with those years 1945 to roughly 1960.

Secondly, there are changes in the real world stemming from demographic or technological causes but showing themselves primarily (and I believe Gabe Hauge rightly stressed these) in the changes in international competitiveness, in the relationship between raw material producing and industrial countries, for example; or in the relationship between the rapidly industrializing less-developed countries and the non-oil producing but still quite underdeveloped countries. And if one may add such things that are still on the horizon as the emergence of the People's Republic of China as a rapidly industrializing country with the enormous impact this will have on world trade, I think we have here a background of great change and great uncertainty.

And thirdly, there are the changes of an institutional character to which he referred, which are a little more difficult to assess and to absorb into the system but which are nonetheless very real. Above all I have in mind the extent to which we nowadays have recourse to summitry. This is a very important factor. The incidence and frequency of summit meetings with the attendant publicity and the attendant politicalization of all the economic factors and monetary factors over which we are concerned must not be underrated as a very potent cause or aggravation of problems. No longer can we operate in the decent or, as some critics would say, indecent obscurity in which these matters were dealt with by our ancestors not so very long ago.

Gabe Hauge went on to take us very rapidly through the history of the breakdown of the Bretton Woods system and the subsequent attempts to reintroduce some degree of order into the monetary affairs of the world, and here I have absolutely no quarrel with his account. I find it totally excellent, and I agree with every word that he said.

Perhaps one slight comment I might make—a reference to the sudden and widespread conversion of academic, official, and banking opinion to a system of floating rates. Now in that regard I must confess that I am still unconverted. I am still a heathen. Although as a realist I recognize the necessity of floating rates at certain times, I do not believe in making a virtue of that necessity. I do not believe Gabe Hauge does either, but I just wanted to make that point.

He then devoted a good deal of his paper to sketching out the development of international financial markets both in regard to bank lending and in regard to the capital market, properly so called, the so-called Eurobond market. And here, although there are certain minor points on which if there were time I might take issue with him, these are points mainly of detail and emphasis and no doubt arise from the fact that he is a commercial banker and I am not. I am what we call a merchant banker (an investment banker as it would be called here) and where he compares the international banking market with the Eurobond market to the advantage of the former and the disadvantage of the latter, you will naturally not expect me to agree with him 100 per cent.

But I agree wholeheartedly with his analysis of the market development as a whole. I think he rightly emphasizes that these markets predate the oil crisis, and he also rightly stresses the extraordinarily effective way in which they were able to absorb the consequences of the oil crisis. Indeed I think, if one casts one's mind back to these days, and if one has any regrets at the absence of any great demonstration of statesmanship which might have been possible in bringing oil producing and oil consuming countries of the industrial world together—some grand attempt at a more systematic cooperation—that opportunity was lost. And if one remembers also the difficulty in activating quickly and effectively official financial mechanisms to take account of these great revolutions in world payments balances, then I think the answer is very obvious. I think it is that the private financial markets (private, in quotes) have performed admirably. And it really makes one shudder to think of what would have happened not only to the weaker industrial countries of the world but also in the developing world, both those who are rapidly industrializing today as well as those who neither produce oil nor have any other great resources at their disposal, if the financial markets of the world had not operated in the way they have in recent years. I think the consequences are just unthinkable in social and economic as well as in political terms.

This international money and capital market is, therefore, a major innovation of the last 15 years, and despite the problems to which Gabe Hauge has pointed and which I will refer to in just a moment, I think it will and should remain a permanent feature, an integral part of the world's financial structure. But there are problems, and Gabe Hauge has pointed to the most important of these, which are risk (both sovereign and otherwise), the constant concern as to whether excessive liquidity is being generated through excessive credit creation, and thirdly, whether this market creates certain autonomous impulses toward exchange rate destabilization.

He recognizes all these, but I think it would be fair to say that in the end he is not excessively concerned about them. And perhaps one may agree very largely with his counterarguments. First of all, he points rightly to the standards of banking prudence which have been exercised by the lenders and which have withstood many temptations to depart from them. Up to this date, at any rate (touching wood very hard) they have withstood, and banking prudence is still very high.

Secondly, he said (and Erik Hoffmeyer agrees with him and I do too) that the so-called multiplier effect of the Eurocurrency market in regard to liquidity creation has been highly exaggerated, and I agree with them that it can be, to all intents and purposes, overlooked.

And finally he talks about the destabilization of the exchange rate system and admits that this may take place and has indeed taken place, although he (and there I agree with him) rightly points to the fact that exchange rate instability has existed before and quite independently of the development of the international financial markets in recent years.

Nevertheless, I hope he will allow me to say that there does remain a slight feeling (in my mind, at least) whether he has not dismissed too lightly these concerns and these dangers, at the point where he links up to some extent with Erik Hoffmeyer. He is a commercial banker, and it would be indelicate of me to, not being a commercial banker, to push this point too far, because it is really for commercial bankers first and foremost to assess these matters. But I just wonder whether the inherent problems of the Eurocurrency market, such as, for instance, sketched out some years ago in a notable lecture at Naples by Guido Carli when he spoke of a house of cards (where he may have gone somewhat too far the other way), do not deserve to be still further borne in mind and still further studied.

Nevertheless, I agree with both the speakers wholeheartedly (and this I think will command pretty general agreement in this audience) that it would be pouring the baby out with the bath water if, because of concern of the risks of this tremendous market that has been created in a relatively short time, one were to resort to official controls even assuming that these are practical. And here I would commend to us all the new Hoffmeyer law, namely, that "financial transactions tend to take place where restrictions are least." And I think this is a powerful caution that treasuries, finance ministries, and central banks should bear in mind if they are tempted to try and devise controls for this market.

As for Gabe Hauge's suggestions for improving statistics, and the practices in the market that would give those who operate in them a better assessment of the risks, including sovereign risks, obviously these must be highly welcomed, and I hope very much that he will press on with these and that all his colleagues will do likewise. So are the areas for further exploration, which he has mentioned. Although here I would be a little more cautious. Obviously the cooperation between the IFC and private lenders or the World Bank itself more generally and private lenders is wholly to be welcomed. Whether cooperation in any more direct sense between the IMF and private lenders is either feasible or desirable, is something about which I am a little more doubtful. We must all be very conscious of the importance of potential borrowers' position inside the IMF. Those of us who are concerned with some of the less developed or developing countries in one capacity or another (either in an advisory or in an actually lending capacity) must be well aware of the importance of discovering at an early stage exactly where that country stands in relation to the IMF and to drawings from the IMF, and obviously private lending from the financial markets of the world will be very closely influenced by the IMF's position. But whether one can push this further into some kind of more systematic and formal cooperation between the IMF and the banking systems of the world, is something on which I keep an open mind. Still, it is an interesting thought.

As a practical banker I, of course, agree with him on the resistance to the erosion of credit and, above all, pricing standards, though perhaps these remarks are best addressed to his fellow commercial bankers rather than to an investment banker.

As for the prescription for the United States, which both he and Erik Hoffmeyer touched upon, I am not going to indulge in any great oratory myself here because I really feel that this is an area where there is so much difference of view inside this country that it is, perhaps, a little indelicate for an outsider to take a part in this. In any event, economists are tremendously divided on the right analysis and prescription for what the United States should do. Incidentally, in this connection I do not know whether the latest definition of an economist has reached these shores yet. If it has, I apologize for mentioning it again. But the American Ambassador in London recently told me that an economist is a man who, if you have forgotten your telephone number, will estimate it for you.

Anyway, I do very much agree with Gabe Hauge about what the United States can do in the way of further pushing research and development and thereby increasing productivity. It would be very churlish of anyone coming from Britain to deny the importance of that. I only wish that he would come over and tell us the same thing over there.

As for the role of incomes policy in the United States, here again it is very difficult for anyone coming from Britain to say very much about that, because this is a very much debated subject in my own country. As you know, it is a fact that by some miracle we have succeeded, over a relatively limited period admittedly, to achieve some results with jawboning, social contracts, statutory controls, and one thing and another, but whether in the long term this can be an integral part of macroeconomic management is still very much of an open question. I would personally feel that this has not yet been exhausted, at any rate, as a means in the United States and might conceivably still play a useful part here.

But at this point, of course, we very much come into the area which Erik Hoffmeyer has been discussing, and he very wisely puts his remarks within the framework of asking questions rather than offering answers. I am tempted to tell you another old story but I will not, because time presses on. But we all know that in economics the questions are always the same; it is only the answers that differ from time to time.

Erik Hoffmeyer essentially discusses three problems—the breakdown of the Bretton Woods system, the present exchange system, and the need for stability and how this is to be brought about. As far as the history is concerned, it differs not very much from that given by Gabe Hauge in his paper except that he, perhaps rightly (I indulge in a little personal hero worship), points to some of the might-have-beens if the Keynes of those days had been more followed than he was. As you know, the pressure on the part of Keynes for a full-scale central bank or, at the very least, equal pressures on deficit and surplus countries did not succeed, and all that was left in the Articles of the Fund was the scarce currency clause which, in fact, was not really ever invoked. And I always believed that the Bretton Woods agreement as far as the Fund was concerned would never have really got off the ground, as it eventually did under Per Jacobsson's leadership, but for the auxiliary mechanism of the Marshall Plan and the OEEC and in the liberalization under the GATT and under the OEEC. This was really the thing that took the burden off the immediate postwar period and allowed the Fund, after a period of inactivity, to get going under Per Jacobsson. Well, Erik Hoffmeyer reminded us of this era of liberalization both in terms of goods and services and in terms of capital movements.

When he comes to the present system (or rather its breakdown—the Smithsonian Agreement) and its collapse after one year and so on, I think he has once again reminded us (although he did not use the old Horatian tag) that you may chuck nature out with a pitchfork but it will come back. And this has, in fact, happened. He says that he has no nostalgia for the old system and there I agree, because nostalgia does not really serve. But then what? And here, at this point, he plunges into (or perhaps plunges for a central banker is too daring a word) he puts a toe into treacherous waters of current controversy and talks about restrictions, both inward and outward restrictions, the different pressures on surplus countries and the adjustments that are required, and that the system, despite the earlier failure to arrive at a symmetrical system, in fact almost by the pressure of market forces, became more symmetrical than it set out to be.

And at this point he sets out what he regards as an ideal system. Namely, one which has three characteristics: World financing—I take it he means that financing by the private banking and capital markets should be possible but should not be so easy as to make adjustment unnecessary. Second, exchange rate movements should influence the adjustment process but not so much that they result in pressures for restriction in surplus countries and pressures for inflation in deficit countries. And third, that exchange rate and reserve movement do influence economic policy measures but not so much as to create deflation and inflation. Well, so say all of us.

I can only say if you could only find an apothecary's scale which would measure the dosage of these three things accurately enough; if you then can find me a man with the courage and the power to apply these doses in the right way, well, in Hamlet's words, "I will wear him / In my heart's core, ay, in my heart of heart."

Erik Hoffmeyer set out the ideal. How do we get to that? Well, he examines what has actually happened in a very masterly fashion. He even refers to his own country at one point and about its ability to borrow and its relationship to the adjustment process, which I must say was very courageous on the part of a central banker. And he refers, although to my mind he rightly rejects, the theory that borrowing has been too easy and has therefore prevented a return to some degree of equilibrium in international payments. I also do not believe that borrowing has been all that easy; and this really links up with the whole question of discipline in financial markets to which Gabe Hauge referred. I was glad to see that a central banker, and as distinguished a central banker as Erik Hoffmeyer, agrees with the view of a commercial banker that the market itself has up to now applied a sufficient degree of discipline.

As regards exchange rate movements, here again I agree with him. He says that the effect of exchange rate movements on costs, on prices, on international competitiveness, on domestic inflation, and so on is not always what the textbook would expect them to be. And he asks the question, do exchange rate movements sometimes overshoot? The answer that he comes to is that they do despite intervention and despite the operation of markets.

He concludes that exchange rate movements have been called upon to bear an excessive part of the burden of the adjustment process. I would go a little further. I think we must accept that exchange rate movements are often at best too slow in their effect on the underlying economic situation and indeed at times perverse. Therefore, one cannot rely on exchange rate movements (as unfortunately many people do—still remembering the textbook theories of how a metallic standard works) to do it all by themselves. Obviously, exchange rates have an important part to play, but I agree with Erik Hoffmeyer that they cannot bear as large a share of the burden as they have done recently.

Finally, about economic policy. And there he distinguishes three forms of action—declarations, market intervention, and economic policy measures. He dismisses declarations, and I am afraid, for all practical purposes, one has to agree with him. There are perhaps moments of high tension; moments when the political power is such and the predisposing situation of the populus is such that declarations can carry a certain amount of weight for a limited period of time. But to rely on them as a permanent policy instrument is highly hazardous.

Second, as regards market intervention, both he and Gabe Hauge went through that at some length. We have seen that although intervention can at times be effective, and certainly much more effective than declarations, again their role must be a limited one. Therefore, Erik Hoffmeyer comes down to the position of confrontation between market forces and the authorities.

At this stage, both Gabe Hauge and Erik Hoffmeyer have more or less reached the same point and the question, therefore, that remains for us to ponder is what is the answer. With the utmost respect to the two speakers, I do not think we got a final answer. I did not really expect it and anybody would be very bold indeed if he attempted to give a final answer.

Erik Hoffmeyer concluded by saying that the alternative to the present system is not a return to the system of fixed parities but a reversion to restrictionism. If I have understood him right (I hope I have), I do not believe he meant to say that these are alternatives in terms of desiderata, in other words, that is what we should aim at, but rather that in practical terms, since a fixed rate system is out of the question, the only alternative to the present system, if it cannot be made to work, is a reversion to restrictionism. I think I know what his answer would be—and all our answers would be—if that were indeed the prospect that was staring us in the face.

He and Gabe Hauge talked about the need to harmonize economic policies. Anyone can be forgiven for being slightly cynical about that in the light of the experience in the last 15 years as regards the attempts to harmonize economic policies, particularly in the industrial countries of the world let alone between those and other countries.

Is there any hope of a reform of the monetary system itself? Gabe Hauge gave a modified welcome to the attempts now being made in Europe at something that would introduce a greater degree of stability into exchange rate movements. But he listed a number of very important conditions which he hoped would be fulfilled in that system. It would have been interesting to hear a little more from both of them about snakes and baskets and snakes in baskets or baskets without snakes or whatever. But perhaps this is hardly to be expected from a prudent central banker at this stage of the game, especially from a country which is a member of the nine. But I think perhaps Gabe Hauge, as, in Shakespeare's words, a "chartered libertine," might be prepared to go a little further.

Let me say personally a word about this (and I do not know whether either of the speakers would agree with me). As one who has always been deeply devoted to the principle of greater European integration and European unity, I am naturally very much impressed with the view of those in Brussels and elsewhere, who being equally concerned for European integration, believe that progress on the monetary front can be a very powerful instrument toward consolidating and pushing further European unity. So I approach any proposal of that kind with the utmost sympathy and respect.

On the other hand, I must confess that I have always thought that monetary matters are, *par excellence,* matters which should be resolved on a worldwide and not on a regional basis, and I find myself, therefore, in an acute dilemma in this regard. I must regretfully conclude today that, for good reasons or bad, it seems very unlikely that progress in establishing some degree of order (in what I regard as the monetary chaos in the world today) on a wider basis, that is to say including primarily the dollar, is possible in the near future.

The practical question therefore seems to be: Is a regional European system possible of achievement? The answer to that I think must be yes.

But, second, is it likely to be one which will not only reduce instability within the countries taking part in it, but will it also be of an open character and therefore capable of enlargment at a moment of time when it is possible for the U.S. authorities to join in?

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MR. MARTIN: I am confident that both Randy Burgess and Per Jacobsson would have been very pleased, if they had been here today, to see the attention that has been given to the lectures and the commentary for two hours. I think it really shows the subject has been well handled.

I want to point out that Eric Roll's excellent discussion of the subject will be included in the printed version. I cannot help but comment on Gabe Hauge's remark about the central bank—that we all recognize in him the Man of La Mancha who dreams the impossible dream.

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