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Control of International Capital Movements

by Professor Otto Pfeleiderer, Stuttgart

As the periodic surges of international capital movements undermine stability, the question arises at what rate of priority the principle of unhampered international capital movements should be treated, and whether there are potential alternatives to replace this principle.

The economic system of the 19th century survived up to the rude shocks of the World War I. Though international trade, during this period, was largely subject to protectionist practices, virtually pure liberalism dominated then the field of international capital movements. This habit was based on the optimistic assumption that long-term interest rates were, essentially, the prime mover for directing capital flows into the hands of the "best managers": high interest rates indicated zones of highly productive capital investment and, overall, of particular urgency of making such investments. The effect was that countries which, during the 19th century, were still "underdeveloped", notably Russia and the United States, owed their further development largely to the differentials in interest rates, which directed their capital imports from the countries of Western Europe, where interest rates were relatively low.

As to short-term capital movements (which were even more so guided by the rates of interest), the prevailing optimism saw their main function in protecting national currency reserves against short-term fluctuations in the balance of payments, as such fluctuations were thought to be undesirable because of the regulations then in force about holding sufficient gold reserves.

Capital Flows and Rates of Interest

After World War I, public opinion became much more aware than under the optimistic assumptions of the 19th century how problematic international movements of capital could be.

In the first instance, it could be seen clearly that capital flows attracted by high rates of interest might, in important cases, conceal structural disequilibria of balances of payments, which would have better been made clearly visible. One particularly striking feature of this trend was the vast flow of both long and short-term capital to Germany during the late twenties. This gave the specious impression that German reserves were widely convertible whilst, because the ability of

Germany to pay was based on borrowed monies only, German prosperity was highly unstable. The moment of truth came during the worldwide slump which, starting in 1929, swiftly reached its climax during the breakdown of many banks in 1931. Only through long-term moratoria agreed to by foreign creditors was it possible to prevent a wholesale collapse of the worldwide network of capital relationships.

After World War II, the most important items of international capital flows were from the start not channelled by the rule of the interest mechanism. "Development aid", from now onwards, was largely regulated by government directed capital movements, including the Marshall Plan, the activities of the World Bank, the International Finance Corporation, the International Development Association, the European Investment Bank and many other forms of making available development credits from public funds, as well as fiscal concessions in favour of capital investments in LDCs, etc.

The Bretton Woods Convention

Meanwhile, the Agreement of Bretton Woods, leading to the formation of the International Monetary Fund, significantly provided only for liberalisation of commercial payments on current account but not for that of capital transfers, which means: member states pledged themselves to lift administrative controls only from those payments relating to the international exchange of goods and services, and to establish for them fixed exchange rates which were allowed to fluctuate within narrow margins. For the purpose of capital transactions, no such pledge was exacted from them.

From the fifties onwards, the use made of the US dollar as a reserve currency led to the accumulation of big dollar holdings by the monetary authorities of many countries, and this set up new and special problems for monetary policy. Most of these dollar holdings were invested in the American money market, especially for buy-

ing US Treasury Bonds. Seen from the USA, this was a kind of short-term capital imports that seemed to compensate for the structural deficits of the US balance of payments. For a long time, this movement masked the effective fall in the size of US currency reserves and made it possible to keep rates of interest low in the American money market — a policy which prevented a currency policy geared to the state of the balance of payments.

Should some countries attempt to use, besides or in replacement of the dollar, other national currencies (which they consider to be especially "hard") as reserve currencies, for example the DMark, this would lead to pressure on the German rate of interest and tend to a "softening" of the German currency that had, so far, been so "hard". At the same time, dollar reserves would only be switched from one creditor country to another one. When central banks move the funds which they hold in foreign bank accounts to other countries, this also may endanger stability.

Worldwide Inflation and Its Causes

During the fifties, the unhampered international transfer of funds has been restored, and from then onwards, short-term private funds have been driven more and more to quick switches by interest rate differentials. These movements have become progressively more disturbing, notably in cases of national governments adopting a monetary policy of "cheap money" and high liquidity of banks because of local underemployment of labour, to increase the number of available jobs, or of other governments keeping rates of interest high and liquid funds of the banks low, because of local overemployment and in order to keep their currencies stable. Such adverse effects became drastically conspicuous in cases of "paradoxical" movements of the balance of payments when, contrary to the classical pattern, underemployment coincided with balance of payments deficits, and overemployment with balance of payments surpluses. In either case, short-term flows of funds induced by interest rates undermined the national aims of credit policy — on the one hand, to create additional employment and, on the other hand, to secure economic stability.

The disequilibrium created in this way was further enhanced when international migration of capital was not so much caused by a differential in interest rates but by the expectation of changes in the rates of exchange. The inrush of capital then overwhelmed the highest dykes thrown up by central banks against unbalancing further their international payments accounts, by discouraging short-term investments of foreign funds

through low rates of interest; and even more vain was the attempt of central banks to prevent the influx of foreign funds by high rates of interest due to economic policy reasons and through restricting the liquid funds available to private banks. All such attempts at stabilisation inevitably failed.

A specially glaring factor of instability has been the Euromoney market, because its scope for creating new credit money is virtually uncontrollable by national monetary policies. In recent years, this market prevented the objectives of such policies from being reached, and it increased the worldwide inflationary trend.

Principle of Free Capital Movement

In a situation like this, the first problem to be solved is the question at which level of priority freedom of international capital movements should rank, and whether there are not other objectives of economic policy of higher importance. Admittedly, freedom of imports and exports of short and long-term capital is a not unimportant element of any free economy, and also a contributory factor to worldwide economic integration. And any reasonable system of international division of labour must, without doubt, include structural differences between long-term capital export from some countries and long-term capital import into other countries, i.e. developing countries.

Virtually unlimited freedom of international capital movements, it must be admitted, existed—up to the most recently imposed restrictions—almost only for two countries in the whole world, the Federal Republic of Germany and Switzerland. In view of the potential disequilibrium caused by international capital migrations, however, the question has to be answered whether there are not other, overriding economic considerations, including the stability of any given currency, or perhaps full employment, which are more important. If we think them more important, it will then be acceptable to return to the principles of the Bretton Woods Agreement which liberalised commercial payments on current account but did not exclude in principle capital transactions to limitations called for by more important policy aims.

Flexible Rates of Exchange

To abstain from national policies aiming at stability and/or full employment cannot be expected from national governments, at least not in the present situation. Thus, market conditions with incentives for destabilising and disturbing capital movements, as described above, are likely to continue.

Again and again, mainly representatives of economic theory have recommended, as a radical solution of the problems described, permanently and fundamentally flexible exchange rates between individual currencies. But even with complete flexibility, and particularly under its rule, speculative capital movements in anticipation of expected trends of the market can never be avoided as long as there is complete freedom of international payments, and its eventual effect would be a shift of conditions for competition. Then, the balance of trade would have to serve progressively as the balancing item in the balance of payments – quite contrary to the rule obtaining under the system of gold currencies, when (as was mentioned in the beginning) short-term capital movements served as balancing factors. It is true that a system of flexible exchange rates would suppress the secondary effects caused by fixed exchange rates on the liquid funds of the banks through intervention by the central banks in the foreign exchange market – which would cease, under pure floating conditions, by their very nature. But short-term capital movements, caused by interest rate differentials or by expectations of e.g. rising exchange rates, would not cease to remain potential causes of disturbance.

At the present time, any proposal for an all-embracing system of floating exchange rates is purely academic, and therefore it remains to discuss other alternatives, which may be broken down in three groups.

Modification of Market Conditions

□ Interventionist measures to modify market conditions: They include special taxes, e.g. the Interest Equalisation Tax of the USA, or the German Coupon Tax, which affect existing differentials in interest rates in a similar way as import duties modify price differentials existing in trade. Capital movements caused by rates of interest will be affected in a similar manner by the imposition of non-interest bearing cash deposits in the Central Bank on West German companies that borrow abroad. Finally, the same is true when in Germany, for example, banks have to hold higher minimum reserves for their foreign, than for their inland debts. The government may furthermore use the powers conferred on it by the Foreign Trade Act for forbidding the payment of interest on deposits made by foreign clients.

Another type of government intervention which modifies market conditions is the much-debated broadening of the margins for rates of exchange – a proposal made already dozens of years ago by J. M. Keynes: he advocated a stretching of the distance between gold points.

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- B. Die Entwicklungshilfe europäischer Länder (Belgien, Dänemark, Frankreich, Großbritannien, Italien, Niederlande, Norwegen, Österreich, Portugal, Schweden, Schweiz).
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Already then this was to be done to reinforce the independence of national currency policies against disturbances pressing on them from abroad. It is true that wider margins—in a similar way as the completely free movement of exchange rates—will also lead to changes in the basis of purely commercial payments, but only within very narrow limits. The true purpose of wider margins is to increase exchange rate risks mainly for short-term capital movements, especially when—as has recently been agreed within the European Economic Community—central banks must not intervene between the upper and lower points of intervention.

Limited Freedom of Capital Movements

☐ Physical controls of capital movements, by statute or by administrative order: Forbidding, or making subject to licensing, all or some capital transfers abroad is certainly a major step away from the system of free markets towards dirigisme. But it must not be forgotten that there is not a single country nowadays which leaves market developments in monetary or credit affairs completely free of intervention, nor could they be left so. Therefore, it is advisable to examine these problems more from the utilitarian than from the purely theoretical standpoint. Absolute prohibition of all, or of certain types of, capital transfers is out of the question, for more than one reason: in a world economic system whose very foundation today is international cooperation, complete suppression of capital transactions would be unacceptable.

The only acceptable method will be that of making capital transfers subject to licensing, which has recently been made mandatory in the Federal Republic of Germany under paragraph 23 of its Foreign Trade Act. But such licensing requires much additional bureaucratic work that slows down, to a greater or lesser extent, all operations; and moreover, it poses the fundamental question where to draw the demarcation line between permissible and impermissible transactions — a borderline between those interested parties who may go up to the heaven of the just while expecting their reward in the form of licences, and those who have to sweat it out in hell, where prohibition is their lot. That each individual application for a licence raises delicate legal problems is self-understood, and restrictive ordinances, moreover, will never be free of holes in the net of prohibitions which everybody will be tempted to creep through.

☐ Splitting of Foreign Exchange Markets: In Europe it is mainly Belgium and France which operate a division of their foreign exchange markets in two. According to its basic concept, this

split is intended to afford purely commercial transactions the benefits of fixed parities (within relatively narrow margins), whilst financial transfers are exposed to the parity risks of a free market in which central banks will not intervene. But where to draw the line between commercial and financial operations is a question to which it will never be easy to give a satisfactory answer. In theory, all transactions which enter into the balance of current accounts should take place in the official market.

Criticism against the principle of splitting the foreign exchange market—whose fundamental elegance and utility is undeniable—is mainly focussed on the fact that, in practice, it would require examination of the myriads of individual payments across national frontiers whether to transact them via the official or the free markets. Actually, the basically free regimen of international payments makes an absolutely watertight control of foreign payments impossible. But the same is true of all other statutory or administrative prohibitions and restrictions, including mandatory cash deposits, the coupon tax, and the suppression of interest payments. A system of basically free international payments offers innumerable chances for circumventing rules and regulations, notably also the alternative of choosing different forms of business operations which remain unaffected by restrictions. Numerous illustrations for the truth of this observation could be supplied from recent years.

Practical Relevance

In practice, none of the methods discussed for shielding a national economy against the dangers to its stability arising from capital movements will be applicable unless the competent authorities can rely on the understanding and the willingness to cooperate on the side of the business community, especially the banks. Banks must be willing to share responsibility for the national monetary system. This responsibility must make them concerned for preventing the influx of foreign credits without the debtors being made aware of the obligation to make cash deposits, or to apply for a credit import licence, or again—where a split market exists—to direct their transaction away from the channels of the official market. By and large, it will be sufficient for banks to scrutinise larger transactions only, for which it is easy to ascertain the true basis of any given business operation. Provided the banks and the wider business community are willing to act with understanding, as cooperative partners of the central bank, any of the methods described is practicable. It then remains to the competent authorities to decide which of them or which combination of several of them appears most useful.