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Control of International Capital Movements

by Horst Werner, Cologne *

Since March 1973 virtually all major currencies or currency blocs have been floating. As a result — so it seemed — controls over international capital movements would become less important. But any hopes for a lasting liberalization of capital movements at flexible rates of exchange must be kept in check.

Since early 1974 at the latest the various reports on State regulation of external economic relations have been indicative of a tendency to dismantle the controls over international capital movements. This trend has proved those critics of more flexible exchange rates wrong who expected greater exchange rate flexibility to lead to more capital controls¹. But whether a lasting liberalization of international capital movements can be expected to result from more flexible exchange rates alone is a moot point. A cumulative de-liberalization such as would in all experience have occurred with fixed exchange rates has certainly been avoided in the last four years of world-wide recessive tendencies and incisive structural changes but the prospects for the future must be viewed with some scepticism.

The calls for a New International Economic Order in particular seem to entail a comprehensive administrative direction of international capital flows. The change to more flexible exchange rates has rendered some but not all motives for capital controls untenable or less potent. Under the Bretton Woods system of fixed exchange rates most governments used to react to crises as a matter of course by tightening the controls. This is why the authorities even today do not always

take enough care to examine whether there are cogent and incontrovertible reasons for imposing controls and whether such controls serve the aims of economic policy better than alternative measures. Accordingly foreign exchange authorities dismantled controls in many instances not because they realized that flexible exchange rates have removed the original *raison d'être* of the currency controls but the controls were on the contrary, with the exception of the US controls on capital exports, dismantled because capital inflows which prior to the oil price crisis had been regarded as "disequilibrating" were now deemed beneficial. They were now thought desirable as a means of financing current account deficits caused by the higher oil prices. That controls on the importation of capital seemed, for the time being, inexpedient was the "logical result".

The Lesson of Bretton Woods

The hopes for lasting liberalization of international capital movements at more flexible rates of exchange may also be checked by the significant exceptions from the liberalization trend which followed the world-wide floating of exchange rates². Switzerland for instance, which has been most successful in the pursuit of an autonomous stable money policy at flexible rates of exchange³,

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¹ Cf. e.g., Kurt Richebächer, *Überforderte Wechselkurspolitik (Overtaxed exchange rate policy)*, Tübingen 1974, p. 79. J. M. Keynes however pointed out already that a decision in favour of fixed exchange rates when national economic policies diverged was in fact a decision in favour of capital controls. Cf. Keynes' letter to W. Lück, in: W. Lück, *Monetäre Unabhängigkeit — Untersuchung der Vorschläge von J. M. Keynes für unabhängige nationale Währungssysteme (Monetary independence — a study of J. M. Keynes' proposals for independent national monetary systems)*, Leipzig 1939, Appendix. Milton Friedman argued in a memorandum in 1950 that flexible exchange rates are favourable for the dismantling of exchange controls and have therefore a less disintegrating effect than the alternative combination of fixed exchange rates and foreign exchange controls; cf. *The Case for Flexible Exchange Rates*, in: M. Friedman, *Essays in Positive Economics*, Chicago 1953.

² These exceptions do not of course include the capital controls which are introduced by countries belonging to a currency bloc in order to defend the officially agreed fixed exchange rates between the currencies inside the bloc. Cf. Josef Molsberger, *Hat das Floating versagt? (Has floating failed?)*, *Wirtschaftspolitische Chronik*, Cologne, No. 1/1976, p. 72. On the contrary, these cases are a clear exception from the system of flexible exchange rates. A more difficult question is: At which point of "voluntary" central bank intervention does it no longer make sense to speak of flexible exchange rates, at which point, that is, does "dirty floating" turn into "dirty exchange rate fixing".

³ By December 1975 Switzerland had managed to reduce the rise of consumer prices from nearly 12 p.c. in December 1973 (which was about the same as the inflation rate in Great Britain and Italy) to 3.4% compared with the level at the same time in the preceding year.

tightened the controls against capital imports once more from late 1974 onwards, after they had been relaxed briefly, because it saw its autonomous monetary policy endangered by inflows of capital. Great Britain did not add further to the far-reaching controls against capital outflows at flexible exchange rates but made a successful application to the Commission of the European Communities for deferment of the liberalization of certain capital exports (for direct investment and personal capital transfers) to the EC – which had been agreed for January and July 1975 – until the British balance of payments situation had improved. It followed logically that an alleviation of the British controls on capital exports became a live issue in the autumn of 1977 when the North Sea oil swang Great Britain's current account into surplus.

One might therefore wonder whether the majority of these capital controls at flexible exchange rates are not just a hangover from the Bretton Woods world of – at intervals – fixed exchange rates, abrupt parity changes and risk-free one-way speculation, a world in which the central currency reserves and monetary autonomy of a country seemed to be chronically threatened by currency speculation unless it happened to discover a great deal of North Sea oil or focused its stability policy on a medium level. Are these capital controls then a kind of premium which we must go on paying until governments, central and commercial banks, and business firms cease to confuse the floating with the late phase of the Bretton Woods system? Will the capital controls disappear when everybody has got used to the rules of a system of flexible exchange rates? Or will capital controls continue as an important instrument of economic policy under flexible exchange rates – to some a means of economic world disintegration which lessens the prosperity of all without bestowing the hoped-for national advantages on some, to others an indispensable instrument for any and all modern economic policies without the disintegratory effects alleged by Liberals with typical exaggeration.

The Argument for Administrative Intervention

To answer these questions we must first examine the principal arguments for capital controls at fixed and flexible rates of exchange. For this purpose it is assumed that the controls work. This assumption will later be checked in the light of the experience with capital controls under modern conditions.

⁴ Cf. Horst Werner, *Die Kontrolle internationaler Kapitalbewegungen* (The control of international capital movements), *Untersuchungen des Instituts für Wirtschaftspolitik*, No. 33, Cologne 1976, p. 143 ff.

Any argument in support of administrative intervention in the economic processes can in principle also be put forward in justification of capital controls. If the outcome of market processes is judged to be unsatisfactory, it can be changed by the means of economic policy in two ways: The conditions in the markets (e.g. the degree of concentration in an industry or the monetary system of a national economy) can be modified so as to enable the markets to function better. Or there may be direct intervention in the market by administrative correction of the relative prices (e.g. by interest equalization taxes) or by quantitative controls (e.g. an embargo on certain capital transactions) because of a basic distrust of the "untrammelled working of market forces".

If direct controls are advisable, there are no economic reasons to halt the controls at the national frontiers or to spare as important an area as the capital transactions. Controls of international capital movements seem in this case justified with fixed as well as flexible rates of exchange: If an adherent of a "modern" economic policy is afraid of the charge that he is putting his trust in market forces, it will be a matter of indifference to him whether it is the central currency reserves (at fixed exchange rates) or the exchange rate (under floating) which are – in the absence of controls – left at the "tender mercies of the exchange market".

Priority for Free Trade Exchanges?

There is a basic argument for capital controls which has proved especially effective because it set the mood for the Bretton Woods agreement, for the currency policy of the European Communities and for the proposals for a reform of the international monetary system⁴. Free international capital movements are assumed to be less important than free trade in goods. Hence capital controls are claimed to be less harmful than trade obstacles; at the very least, the liberalization of the exchanges of goods and services deserved to be given priority over the liberalization of international capital movements.

Sir Alec Cairncross⁵ has tried to defend this differentiation between the international flows of goods and capital explicitly by arguing that "private benefits and social benefits are more likely to coincide when goods are traded than when international flows of capital take place. Economic forces that can be relied to ensure a two-way trade in goods cannot be relied upon to en-

⁵ For the following quotations cf. Sir Alec Cairncross, *Control of Long-Term International Capital Movements*, Washington, D.C., 1973, p. 2 ff.

sure a two-way flow of capital". Hence "free trade in goods and services is quite compatible with equality between imports and exports, but free trade in capital, except by a fluke, is not". The stock of resources of the trading partners did not change when imports and exports of goods and services are in balance. "On the other hand, a net transfer of capital from one country to another increases the stock of assets in the second country and reduces it in the first." Besides "the exporter of goods deserves the thanks of those who live on imports, but the exporter of capital may merely make life a little harder for his compatriots if there is no compensating inflow of capital".

The main objections to this line of argument are these:

□ With flexible exchange rates the capital account of a country must evidently always be in equilibrium if "economic forces" ensure equality between the exports and imports of goods and services. If however "economic forces" normally produce capital flows between two countries, their current accounts cannot be in balance either, for a country's balance of payments is one entity and the interdependence of the individual balance of payments items carries the connotation that, when there is no compensating inflow of capital, the exporter of capital — in the terms of Cairncross — may "deserve the thanks of those who live on exports of goods and services". The capital account reflects the time dimension of international goods movements: At some time or other every capital movement finishes up in a goods movement because somebody has eventually to pay for goods with other goods, on the international level as on the national one. Any international loans or capital earnings will at some time be used by somebody for international goods transactions⁶.

□ Whether social benefits and private benefits are most likely to coincide when the exports and imports of goods are in balance is uncertain. A thesis that social benefits and private benefits regularly diverge in the event of net capital movements would be similarly unwarranted: A deficit on the current account for instance — which (at flexible exchange rates invariably) entails a net import of capital — may be more appropriate in a certain stage of development or phase of the economic cycle than an increase of savings in the country concerned. The problem does not normally arise from a surfeit or shortfall of foreign investments but from a few mistaken investment

decisions — which in the present context means: from investment decisions in which private benefits and social benefits diverge. There is nothing to suggest that the authorities which control international capital movements are as a *rule* more likely to avoid such divergencies than are private investors.

□ The manifold interdependences between the current account and the capital account show up especially clearly when the exchange rates are flexible. But they exist also with fixed rates, a fact which explains why all controls of international capital movements have a — more or less direct — effect also on the volume and structure of international trade flows. Since any and every capital movement will eventually finish up in a goods movement (see above), free international capital movements are not less important than free exchanges of goods but the logical complement to free trade.

Extra-Economic Arguments

These three objections were based on balance of payments and economic benefits reflections. They showed that the arguments marshalled by Cairncross provide for the most part no justification for controls on grounds peculiar to capital movements. There are however specific, especially non-economic, grounds for capital controls because international capital movements generate effects which do not arise from international goods movements.

International capital movements invariably entail changes in the ownership of domestic assets which may lead to undesirable foreign control over entrepreneurial decisions, especially in the case of direct investments. International goods movements, it is true, also engender strong dependence on foreigners because they may, for instance, require an adjustment of the domestic production and employment pattern to changes in foreign supply and demand conditions. In the case of international direct investments however foreigners are in a position to exercise a direct influence on entrepreneurial decisions: If capital is imported, the foreign proprietor of an enterprise governed by the national laws of the country can exercise it, and if capital is exported, the foreign authorities are able to bring their influence to bear on firms in their country which are domestically owned. Capital controls may be appropriate if this foreign influence is undesirable, for instance on security, cultural or racial grounds, no matter whether the exchange rates are fixed or flexible.

Beside these general arguments there are a number of closely interlinked concrete points in fa-

⁶ Cf. Wilhelm Röpké, *Geld und Außenhandel* (Money and foreign trade), Jena 1925, p. 55 ff., and the same author's *International Economic Disintegration*, 3rd edition, Glasgow 1950, especially p. 17 f, and Chapter II.

vour of capital controls. Being so closely connected, they cannot be grouped categorically in relation to a few central problems. A clear attribution of the arguments is also difficult because the central problem depends upon changing currency situations ("data"). This central problem is the starting point for the argument in favour of capital controls.

The Balance of Payments Argument

A typical example is the balance of payments problem, as it is often called. The vast majority of the capital controls introduced since the twenties have been based on this argument. Explicitly or implicitly, it has been used right up to the present — for the Bretton Woods agreement, the EEC's liberalization policy and by various national governments — to justify the introduction, build-up and dismantling of capital controls.

While exchange rates were fixed, this argument had the very concrete force of a "threat to reserves" argument: If a national currency with a fixed parity tended to depreciate, the exchange authorities had to sell foreign currencies from their reserves in order to "defend" the officially guaranteed fixed parity of their own currency. It was however possible — so at least believed the governments — to overcome the depreciation-proneness with no or little loss of currency reserves if the authorities controlled capital exports by acting directly on the symptom — the "currency outflows" — through administrative imposts on or prohibition of certain capital exports.

This argument was only available to the so-called "deficit countries" and made only sense when there were good grounds to reject flexible rates of exchange, for when the rates are flexible the authorities need, in principle, only relatively small currency reserves⁷ to even out transient market fluctuations. Other balance of payments considerations are therefore put forward as an argument against flexible exchange rates and for capital controls to safeguard fixed rates of exchange: If in the absence of capital controls a currency is devalued, it can happen, if the export and import elasticities are very small, that the current account of the devaluing country worsens (further). In that case the balance of payments will, with flexible exchange rates, regain equilibrium automatically as a result of rising capital imports⁸, and this will be at a worse rate of exchange. Because of the unfavourable conjuncture of export and import elasticities this must further be expected to lead

to a worsening of the terms of trade. As a result, the international indebtedness of the country will grow and in turn impose a burden on the current account and domestic incomes in subsequent periods because of the interest payments to be made to other countries. A country could avoid all this by guarding its balance of payments against depreciation tendencies through imposition of capital export controls.

With flexible exchange rates these elasticity considerations cannot be relevant as a balance of payments argument or as a terms of trade argument if the predicated anomalous reaction of the current account or alternatively the unfavourable conjecture of elasticities is not empirically significant. There is however no empirical evidence pointing to very small elasticities in the medium and long term when goods and capital can move fairly freely. It is at any rate extremely unlikely that such an unusual elasticity situation has existed in all the countries which introduced controls on balance of payments grounds. The real cause of the current account deficits of these countries and their susceptibility to currency depreciation was the prevalence of inflation.

The "motivated balance of payments theory"⁹ which has been very influential since the twenties is turning this causality into its opposite: Balance of payments deficits and proneness to depreciation are according to this often refuted theory the cause, and inflation is said to be the effect. Consequently (so the argument continues) inflation is not countered by a domestic policy of stability which would act as a brake on the worsening trend of the balance of payments and the tendency towards devaluation. Instead, controls are introduced, for instance on capital movements, in order to reduce the currency losses and thereby eliminate the tendency towards depreciation which is the alleged cause of the inflation. If the balance of payments argument is still playing an important

⁸ Jürg Niehans is among those adhering to this thesis. He argued that a current account deficit arising at flexible exchange rates because of low short-term elasticities leads necessarily to a surplus on capital account which is needed to finance it. He assumes that capital movements will take place contrary to the international differentials between interest rates and contrary to the current exchange rate expectations. The reasons he gives to make the necessary attitude of capital importers (exporters) plausible carry little conviction however. Cf. Jürg Niehans, Some Doubts about the Efficacy of Monetary Policy under Flexible Exchange Rates, in: *Journal of International Economics*, Vol. 5 (1975), p. 275 ff.

⁹ For a critique of this theory cf. Walter Eucken, *Kritische Betrachtungen zum deutschen Geldproblem* (Critical reflections on the German money problem), Jena 1923, p. 10 ff. and 29 ff.; Gottfried von Haberler, *The Theory of International Trade*, London, Edinburgh 1936, p. 31 f. and 57 ff.; Howard S. Ellis, *German Monetary Theory 1905-1933*, Cambridge (Mass.) 1937; and Hans Willgerodt, *Die "motivierte Zahlungsbilanztheorie"* — Vom "schicksalhaften Zahlungsbilanzdefizit" und der Unsterblichkeit falscher Inflationslehren (The "motivated balance of payments theory" — on the "fated balance of payments deficit" and the immortality of false inflation theories), in: H. Gröner and A. Schüller (ed.), *Probleme der Weltwirtschaftsordnung*, Stuttgart 1978 (to be published shortly).

⁷ A different view is taken by Sir Roy Harrod who however compares flexible exchange rates in crisis situations with fixed exchange rates in the special situation of a gold standard under optimum conditions such as was more or less the case prior to World War I. Such a comparison is of very little relevance to economic policy.

role in economic policy at the present time with its flexible exchange rates, not the least important reason for this is the fact that those who are in charge of or advising on economic policy adhere to this fallacious theory which most of them do not even know in its explicit formulation.

The Speed of Adjustment Argument

With flexible exchange rates the balance of payments argument is apt to appear in the guise of a "speed of adjustment argument". If the exchange rates are flexible and the authorities do not intervene in the foreign exchange market, the national money supply is not determined by the development of the balance of payments (see below). Without balance of payments-induced changes there will be no automatic interest rate-induced capital movements, which with fixed exchange rates would compensate at least partially for (for example) a (growing) deficit on the current account, either. Capital inflows will in this case obviate the necessity of equilibrating the current account in too short a time while relatively small withdrawals only are made from the currency reserves. The burden of adjustment per unit of time can be reduced by slowing down the adjustment process.

If this deferment of the adjustment is not achieved through *free* capital movements — which with fixed exchange rates is the exception but with flexible rates allegedly the rule — capital controls are to be used in order to facilitate an adjustment at minimum cost to the national economy. The speed of adjustment argument thus does not rule out an adjustment of the balance of payments by market forces as a matter of principle, as does the "normal" balance of payments argument, but the pace of the adjustment is to be set by capital controls. This argument is not only important because it can camouflage a policy of actually preventing an adjustment but it gains more and more weight the longer necessary adjustments are deferred (often by use of this argument) and the more anomalous capital movements are brought about by capital controls and trade obstacles because such anomalous capital movements make adjustment more difficult¹⁰.

Pleas for capital controls based on balance of payments arguments can with fixed exchange rates also be founded on the supposition of a "threat to monetary policy". If the balance of payments

situation of a country with fixed exchange rates necessitates the sale (or purchase) of foreign currencies in defence of these fixed exchange rates, the central bank by this very act liquidates (or creates) money and thus alters the national central bank money supply. With fixed exchange rates the development of the balance of payments therefore determines the scope for the national economic policy, especially in regard to the monetary policy.

This "threat to monetary policy" argument in favour of capital controls does not hold good with flexible exchange rates because the central banks need no longer intervene in the foreign exchange market if the rates are flexible and because they can control the national money supply regardless of the balance of payments situation without resorting to capital controls. It follows that capital controls instead of flexible exchange rates could be justified as means of shielding the national monetary policy against the outside world only on the general grounds available against flexible exchange rates (see above). Doubts could also be expressed about the efficacy of monetary policy under flexible exchange rates, but it would have to be proved in this case besides that capital controls insulate a country more efficiently and at lower costs than flexible exchange rates and that the efficacy of monetary policy is higher with capital controls¹¹.

The Misuse-of-Resources Argument

Arguments based on the balance of payments or a threat to monetary policy can therefore under flexible exchange rates be advanced only in exceptional cases which are of no great practical importance. The "misuse of resources" argument on the other hand retains its validity in principle also with flexible exchange rates. According to this argument a country loses resources if capital is exported. It is assumed that capital which is exported for private profit motives would otherwise have been invested at home, that the economic repercussions of the export of capital include employment and growth shortfalls, more particularly in the poorer regions which allegedly will in any case suffer a cumulative outflow of capital to domestic and foreign growth centres if capital movements are unrestricted, and that the relatively smaller domestic investments would

¹⁰ On the functions of international capital movements and the problem of anomalous capital movements cf. Horst Werner, *Ordnungsprobleme internationaler Kapitalmärkte* (Problems relating to the order of international capital markets), in: *Probleme der Weltwirtschaftsordnung*, *ibid.*, I and II. On the basis of the speed of adjustment argument cf., *inter alia*, J. E. Meade, *The Balance of Payments*, London — New York — Toronto 1962, p. 295 ff. and L. B. Yeager, *International Monetary Relations*, New York — London 1966, p. 122 f.

¹¹ On the efficacy of monetary policy at fixed and flexible exchange rates cf., in addition to the articles by Molsberger and Niehaus referred to already, Egon Sohmen, *Wechselkurs und Währungsordnung* (Exchange rate and monetary order), *ibid.* On the alternative capital controls — dual exchange markets — forward exchange rate support — flexible exchange rates cf. Horst Werner, *Die Kontrolle internationaler Kapitalbewegungen*, *ibid.*, p. 10 ff. and 45 ff. and the following articles in the IMF Staff Papers: J. M. Fleming, *Dual Exchange Markets and Other Remedies for Disruptive Capital Flows* (Vol. 21, 1974), W. H. L. Day, *Dual Exchange Markets Versus Exclusive Forward Exchange Rate Support* (Vol. 23, 1976).

prevent the real wages in the country from rising. The relative scarcity of the factor capital would besides alter the functional distribution to the detriment of the factor labour.

All this can indeed happen but the practical importance of this line of argument for capital controls is often overrated, for the growing scarcity of the factor capital and the relative depression in the capital-exporting country will tend to curb the export of capital. Besides, it is uncertain whether the resources would really flow into domestic investments if the capital were not exported. Moreover, exports of capital are also capable of promoting employment and growth because (in the longer term also when the exchange rates are fixed) the adjustment of the balance of payments has to be achieved through an improvement on the current account, which has an expansionary effect.

With flexible exchange rates the outflow of capital will be hampered further by the depreciation-proneness of the currency of the capital-exporting country. This being so, controls on capital exports could be demanded on the ground that the stimulating effect of goods exports on employment and growth has often to be paid for by a temporary worsening of the terms of trade which makes the real transfer burden more onerous. This can happen in particular in countries which are still engaged in developing an efficient industry. In a situation of this kind the "misuse of resources" argument may be as sustainable as the "infant industry" argument in trade policy. It is however a fact that up to now almost all the developing countries have been (over the longer term) net importers of capital. Developing countries must take special care to avoid that controls on capital exports lead to a falling-off of their capital imports.

It must be borne in mind that there are measures, especially in regard to employment, structural and regional policies, by which set objectives can be attained more securely than by capital export controls which have largely unpredictable repercussions on the national economy as a whole. This makes an *ex-post* judgment in the light of experience of the actual success of appropriate capital controls and thus of the "misuse of resources" argument correspondingly difficult.

The actual experience with capital controls may be a better guide to a true appraisal of the capital controls which are demanded on balance of payments grounds or because of a threat to monetary policy. These two arguments are not concerned with the prevention or diversion of certain capital movements but with the overall effect of controls in relation to the objective as shown by the an-

swers to two questions: Have the controls significantly eased the pressure on the balance of payments? And: Have the controls made an autonomous national monetary policy possible? That both these objectives can be achieved by controls has been proved by the experience with controls in Germany before and during World War II and in Great Britain in the wartime economy. It needs pointing out however that these capital controls were only *one* element of a system of *total* currency controls; no responsible politician would like to go back to these today¹².

No Spectacular Successes

There is not a single empirical example of capital controls having brought lasting relief to the balance of payments or created substantial scope for monetary policy in any country under the conditions of modern markets and *partial* capital controls designed to impair the international trade as little as possible. All the abortive attempts to achieve these two objectives by capital controls have ended either in discretionary parity changes or in flexible exchange rates. They have also led to a realization that adjustments which were temporarily held back by controls proved ultimately unavoidable; in the end they were more difficult to execute than would have been a gradual adjustment within systems of greater exchange rate flexibility¹³. If no more had been needed than the prevention or diversion of certain capital flows, some capital controls — such as the US interest equalization tax, the German cash deposit law, or the British exchange market division for the regulation of portfolio capital movements — would have been effective. With such a modest objective the only question would have been: How necessary are these controls? One may well wonder whether Sir Alec Cairncross' dictum about the benefits of capital controls is not also applicable to these "successful" controls: "Such is the perversity of a world of controls that the more they are needed, the less likely they are to work, and the less they are needed, the more likely they are to work."¹⁴

¹² A return to total foreign exchange control and bilateralism would, if at all, be welcomed only by economists who explain their demand for "managed or planned movement of capital" in the framework of a New International Economic Order in the way in which Eiji Ozaki, the economic adviser of the Bank of Tokyo, recently did so: "I cannot see much sense in the free private capital movements between many countries responding to the change of interest rates in different countries." Quoted from "The Exchange Rate of the Yen", in: *Außenwirtschaft*, No. 2/1977, p. 186 and 187.

¹³ On the details of the experience with capital controls cf. R. Hasse, H. Werner, H. Willgerodt, *Außenwirtschaftliche Absicherung* (External economic screening), Frankfurt 1975; A. K. Swoboda (ed.), *Capital Movements and their Control*, Leiden 1976; the articles on: *International Capital Movements and Integration of Capital Markets*, in: Fritz Machiup (ed.), *Economic Integration: Worldwide, Regional, Sectoral*, London 1976; Sir Alec Cairncross, *ibid.*

¹⁴ Sir Alec Cairncross, *ibid.*, p. 13. Cf. also L. B. Yeager, *ibid.*, p. 122 and 130 f.