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DEFICITS BENIGN AND MALIGNANT

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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International Finance Section

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INTERNATIONAL FINANCIAL INTERMEDIATION: DEFICITS BENIGN AND MALIGNANT

In an article "The Dollar and World Liquidity. A Minority View," published in *The Economist* of February 5, 1966, Emile Despres, Charles P. Kindleberger, and Walter S. Salant challenge what they call "the consensus": the belief that the payments deficit of the United States must be eliminated to recreate confidence in the international payments system, and that some way must be found of making the supply of world liquidity independent from a further growth of foreign-held dollar balances.

Despres, Kindleberger, and Salant consider the present preoccupation with the payments deficit of the United States exaggerated and even dangerous because it leads to wrong policies. They argue that a payments deficit is perfectly normal for a country playing the role of international banker. The deficit should not be eliminated; on the contrary, it can be expected to grow steadily and is, therefore, not a sign of international disequilibrium, as most observers believe. Attempts to remove the deficit would imply the application of undesirable domestic policies in the United States and harm the European countries by depriving them of the salutary economic effects of international financial intermediation. Also, it is not practical to remove the deficit through controls on American foreign investments, because any attempt to stop the outflow of American funds would only lead to a corresponding repatriation of European capital. "Such lack of confidence in the dollar as now exists has been generated by the attitudes of government officials, central bankers, academic economists, and journalists, and reflects their failure to understand the implications of this intermediary function" [1, p. 526].

The Minority View

According to the minority view of Despres, Kindleberger, and Salant, a balance-of-payments deficit of the United States is the perfectly normal result of America's role as international financial intermediary. The process of intermediation rests on an international flow of funds caused by the different interest structures in Europe and the United States. The European saver has a relatively high liquidity preference, which makes for low short-term rates. With short-term rates relatively low in Europe and long-term rates relatively low in the United States, European

investors borrow long in the United States, while European savers lend short to the United States. The resulting balance-of-payments "deficit" of the United States is more a matter of definition than of substance. "The United States is no more in deficit when it lends long and borrows short than is a bank when it makes a loan and enters a deposit on its books" [1, p. 527].

Once this fact is understood, confidence in the dollar will be reestablished and it will then be possible to rely on the international capital market to furnish automatically the needed international liquidity reserves. Thus the problem of confidence and liquidity would be solved, while, presumably, interest-rate differentials in the integrated capital market would take care of the adjustment process. According to the minority view, the "trade in financial assets has been an important ingredient of economic growth outside the United States" and can be compared with the mutually profitable trade in goods which rests on differing comparative costs. There is no need for the creation of liquidity "along the lines suggested by Triffin, Bernstein, Roosa, Stamp, Giscard, and others" [1, p. 526]. As Kindleberger puts it, "liquidity can be furnished, flexibly and in the requisite amounts, by the international capital market" [8, p. 11].

The arguments of Despres, Kindleberger, and Salant are not entirely new. New are the optimistic conclusions drawn and, in particular, the suggestion that a better understanding of international financial intermediation would make ambitious reforms of the international payments system unnecessary.

Triffin emphasized in 1960 that the gold-exchange standard makes additions to international liquidity "entirely dependent upon the willingness of the key currency countries to allow their net reserve position to deteriorate, by letting their short term liabilities to foreigners grow persistently and indefinitely at a faster pace than their own gold assets" [18, p. 9]; and Machlup stressed, in 1963, the position of the United States as world banker and pointed out that the balance-of-payments deficit *implicit in this situation* should not be completely eliminated before the present system's replacement by completely new arrangements [11, pp. 303-308]. However, Triffin and Machlup consider the present system dangerous and troublesome and are therefore probably to be included in the minority view's censure of academic economists whose failure to understand the implications of international financial intermediation have contributed to the present lack of confidence in the dollar.

Domestic and International Financial Intermediation

The *leitmotiv* of the minority view is the role of the United States as world banker. This role can best be understood by studying first the

process of domestic credit intermediation. The latter brings together the demand for and the supply of loanable funds. Without this credit market, savings as well as entrepreneurial initiative could easily run to waste. Ideally, investment must match saving at full employment. This requires, according to Salant, that "the amount of financial assets of specific types that savers are willing to hold and the amount of each type that 'capital-formers' are willing to have outstanding must be equal" [17, p. 178]. But, if the investors in real capital goods issue securities of a type that savers do not want to hold, or only at higher rates of interest than the rates compatible with investment levels at full employment, employment and income will fall. Therefore the financial intermediaries have the important task of creating a maximum of possible linkages between savers and investors.

The domestic intermediation process creates a liquidity problem for the commercial banker, who borrows short from the saver and lends long to the business man. The saver may want his deposit to be money (demand deposits) or near-money (time deposits). The borrowing investor in real capital, on the other hand, will want to adjust his borrowing to the periods of production and amortization. The banker stands in between. He must be able to pay out money on demand, but, for reasons of profitability, cannot invest exclusively in liquid assets. Yet enforced liquidation of his earning assets can even endanger his solvency, that is, the requirement that the bank's assets be sufficient in value to cover the contractual liabilities.

The dismal history of commercial banking has shown how hazardous the position of intermediaries has often been. Eventually, however, modern credit systems developed, in which broad security markets permitted relatively easy "liquidation" of financial assets, while central banks with the power of money creation could come to the rescue of commercial banks in domestic liquidity crises. Today, with a high degree of perfection of domestic monetary, credit, and fiscal policies, it *ought* to be possible for all advanced countries to avoid a substantial underutilization of productive resources caused by insufficient linkages between domestic would-be savers and would-be investors.

According to the minority view, however, the European credit markets have not been able to channel all potential domestic savings into investment outlets. The unusually high liquidity preference of European savers, which is shared by European financial intermediaries, has led to a structure of interest rates which differs from that of the United States. This difference causes a short-term movement of loanable funds from Europe to the United States, a flow that parallels and compensates in part the flow of long-term funds from the United States to Europe. Additional factors that support the different European and American interest-rate structures are "a high degree of oligopoly in the financial

intermediary system of Western Europe" and the lower cost of intermediation services in the United States [17, pp. 182-183].

Lower service costs in the credit market of the United States are at least partially offset by the additional costs and risks involved in international transactions; and an explanation of high interest rates by monopolistic features of the European credit market is difficult to maintain in view of the extreme fungibility of the market object. Despres, Kindleberger, and Salant emphasize that money is "costless to store and to transport" and "the easiest commodity to arbitrage in time and in space" [1, p. 527]. They argue, correctly, that for these reasons government controls of international capital movements cannot work well. But then it must also be assumed that private attempts to compartmentalize the domestic credit market and to raise interest rates by monopolistic devices cannot be very effective.

Whatever the causes of the differences in interest structures between Europe and the United States, the minority view assumes that these divergencies give rise to a process of international financial intermediation, which results in a simultaneous flow of long-term and short-term funds in opposite directions. International financial intermediation aids the economic growth of Europe by providing for better linkages between domestic saving and investment. To stop this intermediation would mean to reduce investment in the European economies by raising interest rates. The intermediary, on the other hand, profits, we must assume, from his ability to finance balance-of-payments deficits by more or less automatic short-term borrowing at favorable rates when compared with the yields of his long-term foreign investments.

The Bank Example

In the following pages it will be argued that mere reference to the position of the United States as world banker is not sufficient to sustain confidence in the balance-of-payments position of the United States. The arguments for domestic financial intermediation are not applicable. Within a nation we deal with one currency only and enjoy the services of a lender of last resort. Internationally the situation is totally different.

The international monetary system is still an orchestra without conductor. We do not yet enjoy the benefits of a supranational bank which could perform on a world-wide basis the functions that a central bank performs on a national basis. We do not have an adequate international adjustment mechanism operating via pressures on the national members of the system, nor could the international financial mediator be instantly supplied with adequate amounts of an acceptable international medium of exchange if a world credit crisis should require such action. True, we have the International Monetary Fund, the Group of Ten,

multilateral surveillance, the General Arrangements to Borrow, the Basle Agreements, and various bilateral swap and borrowing accommodations. But these institutions and efforts fall far short of the situation that is characteristic for a modern national credit system based on one currency and dealing with a uniform national credit policy.

The international banker runs risks to which domestic intermediaries are no longer exposed. The commercial banker does not have to cope with exchange risks, is subject to strict discipline, enjoys the benefit of deposit insurance, and, most important, can turn to the lender of last resort in a liquidity crisis. The present international credit system, by contrast, cannot eliminate the risk implied in the existence of many currencies or in a possible demand for conversion of official dollar balances into gold. There are no firm guidelines that would coordinate the national credit policies of the participating countries; there are, in most cases, no gold-value guarantees. The net reserve position of the United States is getting weaker all the time, yet we cannot create international money or borrow it from an international institution.

Under these conditions, it is not safe to argue that the United States can play the role of world banker without having to be concerned about an increasing balance-of-payments deficit. Nor is it a convincing argument that domestic credit intermediation in Europe is so faulty that it must be strengthened via a simultaneous international exchange of long-term for short-term funds, which is open to substantial risks. This additional risk-taking contradicts the minority view's basic assumption that the whole problem originates with the high liquidity preference of the European saver and his banker, who both want liquidity in terms of their own money and not in dollars.

Behind the Monetary Veil

International financial intermediation creates a "circuit" of capital flows that excludes, by definition, a real international transfer of goods and services [Kindleberger, 7, pp. 6-7]. Lifting the "monetary veil," we see nothing happening in international trade, since the long-term funds that have been lent remain in the lending country as short-term balances. Real resources stay where they are; the long-term lender does not have to produce an export surplus and the short-term lender does not add, via imports, to his productive capacity. If the trade effect of international financial intermediation is nil, we must conclude that the European countries ought to be able to mobilize their own productive resources through their credit systems and their monetary and fiscal policies. The roundabout way of an international financial circuit, with its risks for the international banker, is basically unnecessary. It is unreasonable to expect to accomplish anything in terms of productivity

and growth that could not be realized more safely within the domestic economy.

Moreover, against the minority view's pessimistic appraisal of European credit intermediation must be held the fact that some European credit markets have developed particularly efficient relationships between saving and investment [Macmillan Report, 14, pp. 162-163]. In Germany, for instance, the commercial banker guides his depositors' funds directly into long-term investments, whereas in the United States the Banking Act of 1933 forced the commercial banks to divorce themselves from their investment-banking affiliates.

It is possible that international financial intermediation has lowered European interest rates and thereby stimulated investment. But why should not the same effect be achieved through domestic monetary policies, since no real resources are transferred? If international financial intermediation can lead to serious international payments problems, would it not be much better to limit capital flows to funds connected, directly or indirectly, with the real transfer of goods and services?

The Volatility of Short-Term Funds

John Maynard Keynes pointed out that the main danger of a highly sensitive international flow of capital under rigid exchange rates lies in "a high degree of short-period mobility of international lending, combined with a low degree of short-period mobility of international trade." He considered it "impracticable to bring about a change in the foreign balance [on goods and services] great enough to balance the change in foreign lending which even a small stimulus may provoke" and believed that any attempt to increase exports or decrease imports "tends to limit unduly the power of a Central Bank to deal with its own domestic situation so as to maintain internal stability and the optimum of employment" [6, p. 309]. In contradistinction to the minority view, Keynes would have concluded that the rate of short-term lending should be guided by various policies. He favored large international liquidity reserves to *offset*, and a widening of the margin between gold points as a means to *influence*, short-term capital flows [Halm, 3, pp. 26-32].

The potential interference of short-term capital flows with domestic monetary policies does not seem to worry the advocates of international financial intermediation, though we shall see that Kindleberger considers it a necessary corollary of a well-functioning system of international intermediation "that monetary policy in the outer countries is restricted to use in affecting the balance of payments, so that fiscal policy must be more fully developed for the maintenance of full employment and price stability at home" [8, p. 19; 9, pp. 615-616; 10, p. 224]. That the request for a clean separation of monetary and fiscal policies is addressed

to the "outer" countries rather than the "international banker" may have to do with the fact that the latter is supposedly able to finance his deficits automatically, which, incidentally, is the main complaint of his customers.

Complete separation of monetary and fiscal policies (if it were possible at all, considering the fungibility of money, on which the minority view lays so much stress) would be a rather high price to pay for results that could be more safely achieved by domestic policies. As far as the "international banker" is concerned, it is obvious that he cannot count on a one-sided, permanent, and ever-increasing flow of short-term funds from abroad. The flow of short-term capital can reverse itself suddenly for a number of reasons, making the deficit which the minority view considers entirely normal rather problematic. The world banker can suddenly be faced with a liquidity problem or even a liquidity crisis. Then he will have to be able to fall back on very large international reserves or be forced to use undesirable domestic policies, unless he decides on direct controls of international capital flows, which will violate the principles of the market economy.

Even if we ignore possible exchange risks and limit our assumptions to changes in interest rates, we are not entitled to look at the international flow of capital as an orderly system of parallel one-way streets. Short-term rates of interest have always been exposed to more pronounced variations than long-term yields and we must assume that the factors causing these changes may vary from country to country and from time to time. The author of the present essay suggested, many years ago, the following basic explanation for the more pronounced fluctuations of the short-term rates of interest. When short-term credits finance the production of fixed capital goods, the future supply of short-term funds will rest on the successful long-term financing of the purchase of these capital goods. If it is impossible to secure the necessary long-term funds, the short-term credits become frozen and this process of freezing reduces the normal supply on the money market. Therefore it is primarily the short-term money market that has to bear the impact of adverse changes in the long-term capital market. In the opposite case of an insufficient demand for long-term funds (owing to a decline in real investment), it is the short-term market to which the funds will flow. The result is a downward pressure on the short-term rate, particularly since the short-term market is "thinner" and, therefore, more sensitive to change [Halm, 2].

If we add to these market forces the influence of monetary policies, it becomes obvious that we cannot count on an international interest-rate pattern that guarantees to support rather than strain the reserve position of the world banker. Depending on the monetary policies of his custom-

ers, the financial intermediary may have to defend his reserve position by measures not conducive to high employment. Far from being innocuous, a deficit that permits sudden and massive outflows of short-term funds may become dangerous. The Bernstein and Lederer definitions of the deficit of the United States are not basically wrong when seen in the proper context, though they should not, of course, monopolize our thinking or give the impression that a deficit is always in need of correction. (The Bernstein Committee defines the deficit as the balance financed by increases in *official* claims on the United States, plus gold losses; the Lederer definition adds increases in foreign-held *private* short-term claims).

Exchange-Rate Speculation

In the present international payments system, members of the International Monetary Fund can change the par value of their currencies, with the concurrence of the Fund, in case of a "fundamental disequilibrium." This adjustable-peg arrangement is exposed to disequilibrating speculation once the holders of a given foreign currency consider its devaluation possible or probable—owing, for instance, to a growing balance-of-payments deficit and, in the case of a key-currency country, to a deteriorating net reserve position. Speculative outflows of short-term funds may even themselves precipitate a crisis of confidence. A particularly obnoxious feature of these disequilibrating capital flows under the adjustable-peg system is their perfect safety from the speculator's standpoint: if the devaluation does not materialize, the cost of his operation has been slight; but if it does come, he will reap a large profit.

Resting their case for international financial intermediation on the present system of fixed but alterable exchange rates, Despres, Kindleberger, and Salant cannot exclude the possibility of frequent disequilibrating capital movements before a near-perfect coordination of national economic policies has been achieved.

The minority view rejects a system with flexible exchange rates, probably because it is not thought to be an appropriate foundation for a well-functioning international capital market that would furnish international liquidity automatically in the desired amounts through equilibrating capital flows. Yet Kindleberger admits the possibility that private international capital movements may become "destabilizing and dysfunctional" and says that "it is readily agreed that a system of fixed exchange rates and an international capital market limits national sovereignty in the monetary sphere" [9, pp. 615-616]. But with these admissions the whole argument for a reinterpretation of the deficit of the United States loses much of its strength. When private capital movements can become

destabilizing, the deficit can become dangerous; and when monetary policy must exclusively be used to guide international capital flows, domestic economic policy is robbed of one of its major instruments.

The advocates of flexible exchange rates argue that greater exchange-rate flexibility would eliminate disequilibrating short-term capital movements and permit monetary authorities greater freedom in domestic economic policies. It can be shown that moderate flexibility of exchange rates is more likely to lead to equilibrating short-term capital movements than the present system of rigid but not unalterable exchange rates. At rigid parities, interest-rate differentials between countries will cause capital movements from the low-interest to the high-interest country and these movements may interfere with domestic monetary policies. A high rate in *S*, the surplus country, which is supposed to dampen an inflationary expansion, will attract funds from deficit country *D*, which tries to stimulate domestic investment through low interest rates. This short-term capital flow is undesirable because it increases the imbalance of payments and interferes with the proper domestic economic policies of both partners. If, on the other hand, the rate of exchange were permitted some degree of flexibility, a gradual increase of the price of *S*-currency in units of *D*-currency would act as a counterweight to the interest differential and the disequilibrating capital flow could be slowed down or stopped, and national economic policy would gain greater freedom.

Of course, one can think of a situation in which, at fixed exchange rates, the capital flow would tend to be equilibrating, as when the surplus country *S* is suffering from depression, lowers the short-term rate of interest, and permits a capital outflow which aids the deficit country *D*. However, in a system with flexible exchange rates, exchange-rate variations would support this capital flow which was engendered by the interest-rate differential. The slightly depreciating currency of *D* would be bought by *S* in anticipation of a rebound. This has been pointed out by several writers, including James Meade [15].

One must doubt that short-term international capital flows in the present system of the adjustable peg will permanently and increasingly finance the deficit of the international banker, in spite of the implicit deterioration of his net reserve position. Nor should one assume that it will be possible to achieve these flows by using monetary policy exclusively for keeping the intermediation process properly irrigated, while employing only fiscal policies for domestic purposes. The fungibility of money would not permit such clear-cut division between monetary and fiscal policies, quite apart from the fact that interest rates cannot be dispensed with in their important role in the allocation system of a market economy.

The Role of Central Banks

The minority view rests its case on the high liquidity preference of European savers and bankers. This liquidity preference, supposedly, is the main cause of differences in interest-rate structures and of international financial intermediation.

The liquidity preference of the saving public and the private credit institutions in Europe is a strictly domestic phenomenon and, originally, entirely unconnected with the problem of international liquidity reserves. "Savers typically want liquidity in their own currencies, and so do banks. If household and commercial banks want to hold liquid assets at home rather than securities or liquid assets in dollars, the counterpart of foreign borrowing by industry must be held by the central bank of their country in dollars, or converted into gold. This implies a deficit for the United States even on the Bernstein Committee's definition." The minority view sees in these dollar holdings of European central banks the means of providing the country with external liquidity, while the dollar balances are, simultaneously, "a necessary counterpart of the intermediation which provides liquidity to Europe's savers and financial institutions." Despres, Kindleberger, and Salant believe that "recognition of this fact would end central bank conversions of dollars into gold, the resulting creeping decline of official reserves, and the disruption of capital flows to which it has led" [1, p. 528].

The problems of domestic and international liquidity merge in this case. Indeed, we can imagine a situation in which a central bank does not dare to create greater *domestic* liquidity lest it lack the needed *international* liquidity with which to meet the balance-of-payments effects of domestic expansion. It is for this very reason that so many experts are afraid of an insufficient growth of world reserves. Throughout the period of the so-called dollar shortage it was true that the United States provided the Europeans with both kinds of liquidity.

But this connection between domestic and international liquidity ends as soon as the latter is no longer the precondition of the former. Today we cannot maintain that the *unwelcome* dollar holdings of the European central banks are "a necessary counterpart of the intermediation which provides liquidity to Europe's savers and financial institutions." The truth of the matter is that, on the contrary, the central banks' purchases of dollars create the phenomenon of the so-called imported inflation. In purchasing dollars, European central banks create more domestic liquidity than they consider safe. They do not buy dollars because they believe in the advantage of the financial circuit. They buy in spite of the great inconvenience of having to compensate for the expansionist domestic effects of these purchases by undesirable domestic monetary and fiscal policies (for instance, increased tax rates to avoid inflation).

The reason for a central bank's willingness to buy dollars even in embarrassingly large amounts is not the desire to close the financial circuit but the present system of free convertibility of currencies at fixed rates of exchange, which implies a readiness on the part of the central bank to maintain an infinitely elastic demand for dollars.

Kindleberger does not agree when Machlup calls the official dollar holdings of central banks "involuntary lending" [13]. He argues that lending is not involuntary as long as there are alternatives. The alternatives he mentions are lending long abroad "thereby forestalling the international circuit of financial intermediation" or the conversion of dollars into gold by the central bank. However, this latter choice "is not really open to it, economically, if it wants to support a system of joint international capital markets in a world of differences in national liquidity preference" [8, p. 10]. Concerning the undesirability of a general conversion of dollar balances into gold there is little difference between the minority and majority views. But this leads us right back to the concept of involuntary lending, whether long or short.

The Transfer Problem

When long-term foreign lending by the United States leads to increasing official dollar balances in Europe, the domestic monetary circulation in European countries will tend to expand. The central banks' dollar purchases increase the reserves of the commercial banks, thus permitting a process of multiple credit expansion. The price and income effects of this process would help adjust the trade balance through increasing imports. Only when the trade balance cannot be adjusted will it be necessary to match, to that extent, foreign long-term borrowing by foreign short-term lending in the form of privately or officially held dollar balances. This matching is automatic. The central banks are not conscious of closing an international financial circuit. They exchange domestic for foreign money and increase their international liquidity, a process they consider perfectly normal as long as their dollar balances are not considered excessive.

However, the international financial circuit accounts for only a part of the official dollar balances. The sellers of dollars to European central banks are not only private European long-term borrowers from the United States who really want domestic money; they include all private parties who are net receivers of dollars. To the extent that trade is multi-lateral (resting on fixed exchange rates and currency convertibility), all the financial transactions of the United States with other countries can lead to a dollar flow to European central banks. The official dollar balances, therefore, need not rest at all, or will rest only in part, on the completion of the financial circuit in the narrower meaning of the minor-

ity view. Rather, they are caused by the fact that the central banks must purchase any excess supply of dollars for the purpose of maintaining the exchange value of their respective currencies vis-à-vis the dollar. Triffin has shown that "the accumulation and retention of dollar reserves by European central banks has helped the United States finance its gifts and investments in the rest of the world far more than in Europe itself, and well beyond what this country could have done if Europe had accumulated its monetary reserves entirely in gold" [19, p. 13].

What we are watching today are the side-effects of a massive "transfer problem" [Machlup, 12]. To the extent that economic and military-aid expenditures could not be transferred by correspondingly large export surpluses of the United States, a dollar glut had to develop. Since this dollar glut has the effect of excessive liquidity in Europe and threatens "imported inflation," we have moved far away from the original assumption of the minority view that the position of the United States as financial intermediary finds its original explanation and justification in a high European liquidity preference and correspondingly high interest rates.

We must assume, of course, that Despres, Kindleberger, and Salant are well aware of this dollar-glut situation, which has arisen because of huge payments of the United States that greatly overtax the international adjustment mechanism. However, we cannot isolate individual strands of this complex picture, segregate a beneficial circuit from the rest, and then plead for a new interpretation of the whole balance-of-payments situation because of the position of the United States as international banker. Understandably, the Europeans select a different strand and hold their unwelcome dollar balances against American foreign policies, which they have to finance in spite of their disapproval of the war in Vietnam or the "take-over" of European industries by American direct investments.

An International Central Bank

In a postscript to "The Dollar and World Liquidity," *The Economist* points out that an international intermediation system would need the support of an international institution with the power to create international cash, just as, domestically, a central bank has the function to ward off the threat of a run through the creation of liquidity. "It is the view that America can, even at this late stage of the day, perform all its old international financing functions without such international support that we have termed 'the new nationalism'" [1, p. 529]. *The Economist* interprets the minority view correctly as implying that a deficit in a real sense does not exist and that, therefore, a supranational bank is not necessary. One could also argue that as long as international reserves consist predominantly of dollars and gold, a supranational bank cannot

operate and that all that is needed in times of crisis is an arrangement between central bankers not to exchange dollars for gold. Gold-value guarantees extended by the United States might strengthen the system [Halm, 4]. But Kindleberger rejects gold-value guarantees as unworkable, because they "would be an unlimited liability on the part of the guarantor, and would excite the movement of short-term funds" [8, pp. 16-17]. No explanation is offered for these assertions.

Considering the minority's rejection of all plans which would lead to the creation of a new international asset, it is hard to understand why Kindleberger agrees with *The Economist's* request for a world central bank [8, pp. 14-15]. Obviously, such a bank can create neither gold nor dollars. The world, therefore, must either accept a dollar standard or create some kind of new international reserve money that can readily take the place of dollar balances. It would hardly be possible to combine ever-growing deficits of the United States (as result of an integrated capital market) with an institution that could stem a run on gold through the creation of Special Drawing Rights, as suggested in Rio. Kindleberger argues against the creation of "owned reserves" and wants the world central bank to have "the powers of discount, subject to subsequent repayment and with no set quotas" [8, p. 15]. However, it is not clear what funds the supranational bank would be using, unless its liabilities were accepted as monetary reserve.

"Let the Gold Go"

Since official foreign dollar balances are convertible into gold (and private into official dollar holdings), the present key-currency system is exposed to the possibility of a run on gold and, therefore, even to an eventual breakdown. Despres, Kindleberger, and Salant do not deny that a wrong interpretation of the deficit of the United States could have this deplorable consequence, but they rather incline to the optimistic belief that, faced with the depreciation of the dollar, the European central banks would decide to hold the dollars they were unwilling to hold before [1, pp. 528-529]. Kindleberger predicts that this would probably be the case "long before the present \$12 billion of United States gold is gone" [8, p. 19], which almost amounts to saying that the worse the net reserve position of the United States, the greater is the willingness of the Europeans to hold dollars. In this somewhat exaggerated hope, Kindleberger rejects the proposal that the United States, while it will sell gold freely, will not buy it back. This proposal was made by several economists, for example, Machlup [11, p. 306], Fellner, Friedman, and Johnson [16]. Kindleberger rejects it because he feels that this "highly nationalistic approach may bring down the system around our ears" [8, p. 18]. Yet this proposal would have the advantage

of making it clear to the rest of the world that it is not gold convertibility that maintains the value of the dollar but rather the willingness of the United States to buy gold at the price of \$35 an ounce that maintains the value of gold. However, it is true that halting the purchase of gold could mean, in practice, the change-over to a system of exchange-rate flexibility, a system which the minority view does not consider compatible with joint international capital markets. Obviously, then, the dollar would have to move into the full and unchallenged position of *the* international unit of account of a world dollar standard.

Joint Monetary Policies

The theory of international financial intermediation has had a stimulating effect on the discussion of the international payments problem, but it shares the weakness of other one-sided approaches: in segregating one problem from the rest, it overemphasizes the effects which a solution of this one problem would have on the functioning of the whole system.

Despres, Kindleberger, and Salant reinterpret the deficit of the United States and hope that a better understanding of the financial-intermediary role of the United States would lead to a fuller appreciation of the part that an integrated world capital market can play in international payments. As this view is applied to different problems and policies concerning the dollar, gold, and international liquidity, there emerges the picture of a better future, which finds a concise expression in the following statement by Kindleberger:

Given international capital and money markets, joint (not merely joined) monetary policies, and an understanding of the process of international financial intermediation, the system would work as follows: real transfer would be brought about under fixed exchange rates, by adjustment of national price levels; short-term adjustment to ephemeral disturbances would be achieved in the balance of payments through short-term capital movements, in employment through fiscal policy; monetary policy would be made jointly, apart from the small differences needed to attract or repel funds; differences in national liquidity preference would initially be offset by lending long and borrowing short on the one hand, and lending short and borrowing long on the other; there would be little or no need for a new international reserve unit; gold might or might not gradually lose its monetary functions, dropping out of the system as it has done in the United States for circulation outside the Federal Reserve System, or being retained for use in something equivalent to an Inter-district Settlement Fund; with fixed exchange rates, the world would have in effect, one money and one monetary system. The problem would be to evolve the mechanisms to make the decisions it requires [9, p. 617].

The postulate of joint monetary policies is a premise under which any consistently constructed international payments system would work well. In the present case, it is even doubtful whether the system would still be international since with joint monetary policies and the dollar as international unit we would indeed have established a "new nationalism" as *The Economist* suggested. However, an internationalization of the monetary policy of the United States as proposed by Kindleberger [10, p. 224], is politically not very probable.

Conclusion

The solution suggested by the minority view suffers from several weaknesses, which make it unlikely that it can supplant or even decisively influence the majority view. The following are some major points of contention.

(1) Naturally, it is important to recognize that the deficit in the balance of payments is to a large extent a matter of definition and need not be an indication of disequilibrium, weakness, illiquidity, or insolvency. Nevertheless, for a key-currency country with gold convertibility, payments deficits can become dangerous. Only via far-fetched assumptions (concerning joint monetary policies and the demonetization of gold) can we come to the conclusion that the needed domestic and international liquidity will be automatically furnished through an integrated capital market.

(2) The connection of domestic liquidity preference with international liquidity is important. Differences in national liquidity preferences may lead to international financial intermediation. Not all international short-term capital flows, however, are equilibrating or conducive to economic growth. Since the European central banks have become reluctant holders of dollars, excessive international liquidity has severely interfered with European monetary policy ("imported inflation") instead of creating additional domestic linkages between saving and investment.

(3) Official dollar balances can be the result of long-term capital flows that are still in the process of materializing in the form of import surpluses for the borrower. However, these balances may be also the unwelcome result of a payments deficit of the United States caused by large unilateral payments not (or not yet) offset by real transfers. Involuntary short-term lending is resented by Europe on political and economic grounds, because it finances American policies of which Europe disapproves, can cause domestic inflation, and may interfere with domestic economic policies.

(4) Involuntary short-term lending is implied in an international payments system in which fixed exchange rates are maintained under conditions of currency convertibility. Understandably, the European

central bankers are not willing to interpret the position of the United States in this context as that of an international banker who sees to it that his customers enjoy the correct amounts of domestic and international liquidity.

(5) As long as international financial intermediation merely matches opposite short-term and long-term capital flows, no transfer of goods and services takes place. A purely financial circuit which leaves international resource allocation unchanged cannot be of substantial economic importance.

(6) The argument for an automatic supply of correct amounts of international liquidity through integrated capital markets takes it for granted that fixed exchange rates are maintained. The argument is wrong, as shown by the present accumulation of unwanted dollars in Europe together with the frantic attempt in the United States to solve balance-of-payments problems through direct controls. The source of these difficulties is the fixing of exchange rates while national economic policies are not coordinated through a properly working adjustment mechanism.

(7) Joint or even reasonably well-integrated policies would have to be the result of some form of international economic cooperation. The existing International Monetary Fund and the Basle arrangements are not good enough for this purpose. Nor is there a reliable lender of last resort. Too much "ad hocery" [Harrod, 5, p. 88] is involved. The system of international financial intermediation as envisaged by Despres, Kindleberger, and Salant, would make a lender of last resort inevitable. But in a dollar standard as it would emerge, the lender of last resort would be none other than the Federal Reserve itself, possibly working under an Open Market Committee with international membership—a political fantasy hardly worth pursuing.

(8) Kindleberger argues against a system which would create and distribute "owned" reserves. It is to be assumed, therefore, that the creation of Special Drawing Rights (SDR's) would, in his opinion, not decisively improve the system. Indeed, the SDR scheme lacks an adjustment mechanism through which the International Monetary Fund could insist on adjustments in national monetary policies. There must be a conductor of the international orchestra and the rest of the free world will not necessarily acquiesce in seeing the first violinist take over by default.

(9) On domestic monetary and fiscal policies the minority view shares the modern optimism that these policies can be used separately for the achievement of differing and sometimes even contradicting ends, for instance, that high rates of interest can correct the international flow of capital while fiscal policies increase employment. Were this separation feasible, it would be possible to integrate national monetary policies with-

out having to give up national sovereignty in employment policies. Actually, however, monetary and fiscal policies are intricately intertwined and nearly as inseparable as Siamese twins. A gigantic operation "twist," in which monetary policy raises interest rates without affecting investment, and deficit spending stimulates aggregate spending without causing negative balance-of-payments effects, may have only very moderate success and possibly very bad side-effects because of contradictory price signals.

In a market economy, interest rates are more than an instrument of monetary policy. They are prices of strategic importance that guide loanable funds into proper investments. It is the main weakness of fixed exchange rates that they force market economies into artificial changes of interest rates. The resulting misallocation of productive resources cannot be corrected by fiscal policies, because the latter concern income and employment levels but not capital allocations to individual firms and industries. The next step would have to be planned allocation via investment controls.

It is fascinating to ponder that, while the market economies come close to sacrificing the proper allocation of investment funds through a comparison of correct interest and profit rates, the centrally planned economies are about to discover the basic importance of interest rates in the allocation process.

(10) Where the minority view criticizes interest-equalization taxes and other direct controls, it emphasizes correctly the fungibility of money, which condemns these attempts to at least partial failure. But if the fungibility of money is used to explain leaks where government policies try their best to plug them, we can assume that the same fungibility will make for well-integrated domestic credit markets and render international financial intermediation superfluous.

(11) The minority view criticizes the proposals of Triffin, Bernstein, Roosa, and others, but does not offer a really constructive suggestion for the setting-up of a framework in which the integrated capital markets could perform their task. A proposal which can lead to such high hopes as Kindleberger's vision of joint (and not merely joined) monetary policies, must be embedded more securely in a set of precise assumptions concerning the functions of the International Monetary Fund, the codification of the Basle arrangements, the weathering of the present dollar crisis, and the precise nature of the suggested dollar standard.

(12) The fine-tuning of international financial intermediation through adjustments of interest rates in a joint monetary policy suggests a very high degree of confidence in the pricing process. Yet it rests on fixed exchange rates and, thus, on a major violation of the very price mechanism on which it wants to rely. With fixed exchange rates, diverging

domestic economic policies, and gold convertibility, we cannot expect capital flows to solve our international payments problems. If we want to use market forces, we have to free them first from the inconsistency of rigidly fixed parities.

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