



PRINCETON STUDIES IN INTERNATIONAL FINANCE, NO. 3

Speculative and Flight
Movements of Capital in
Postwar International Finance

Arthur I. Bloomfield

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PRINCETON STUDIES IN INTERNATIONAL FINANCE



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By Arthur I. Bloomfield

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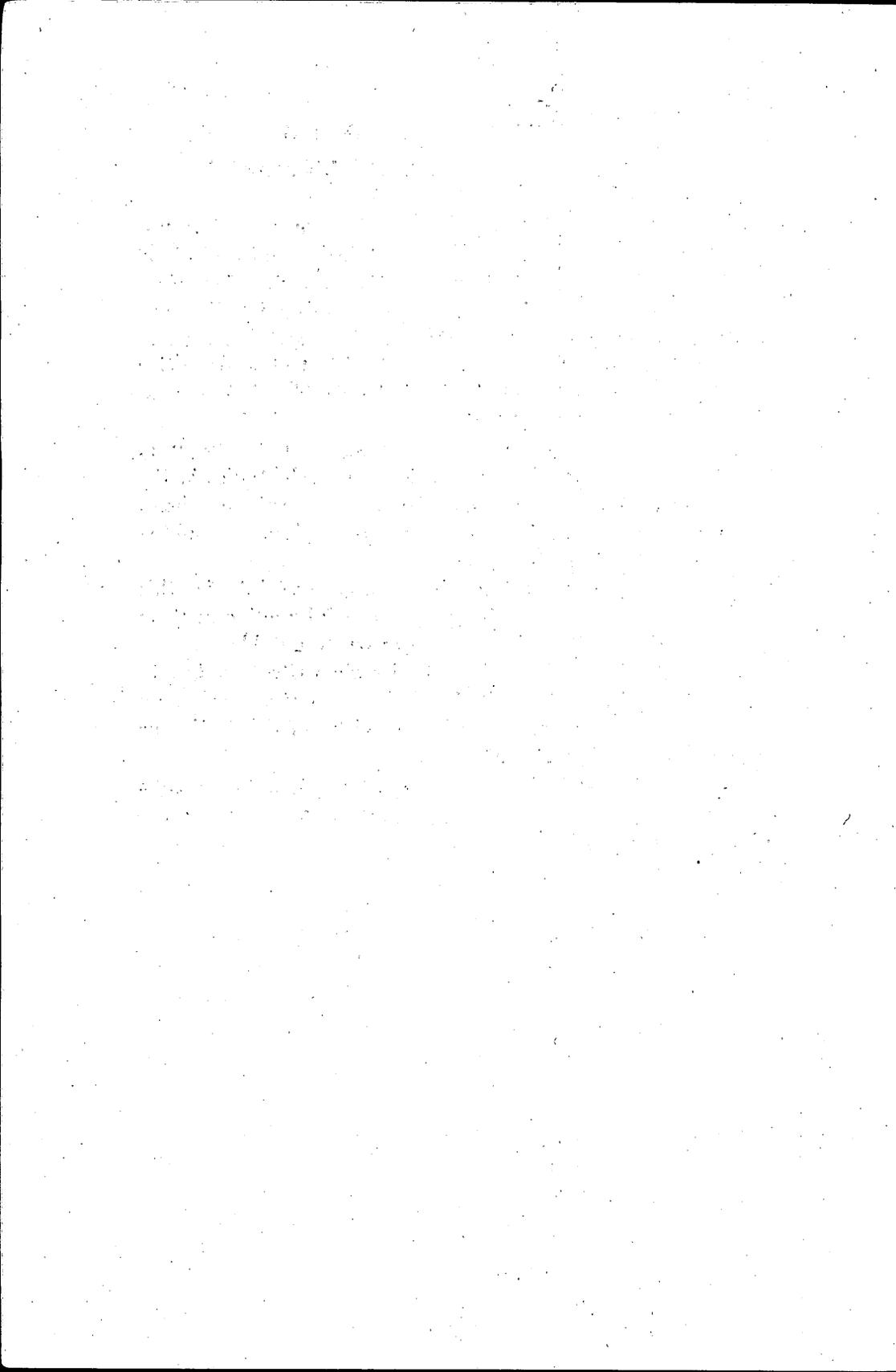
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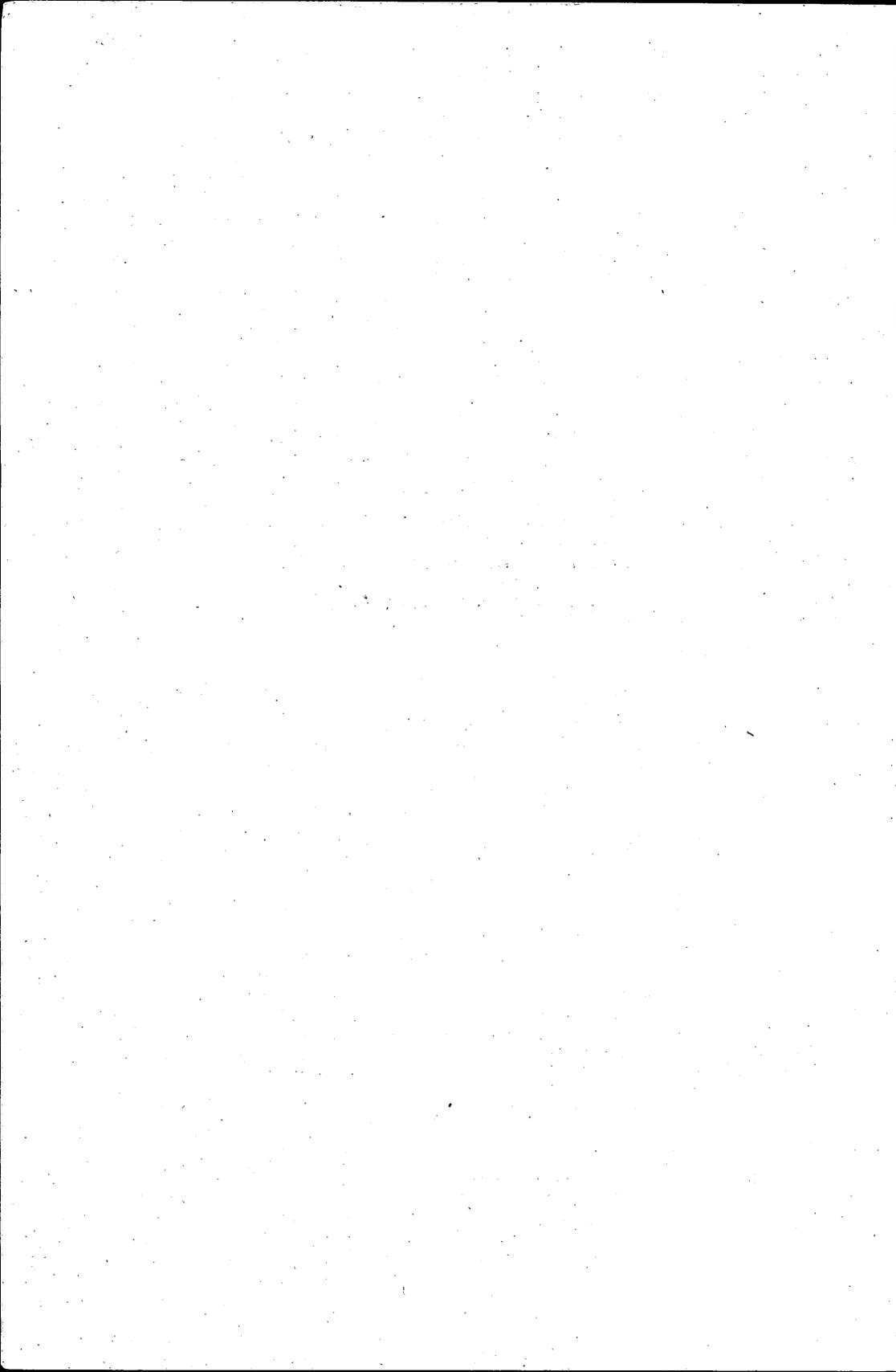
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GARDNER PATTERSON, *Director*
International Finance Section

Princeton University
October 1953



TO
JULIUS LEMPERT, M.D.
IN APPRECIATION



CONTENTS

| | | |
|------|---|----|
| I. | INTRODUCTION | 1 |
| II. | DEFINITIONS AND MEASUREMENT | 5 |
| III. | STRUCTURE OF POSTWAR CONTROLS OVER PRIVATE CAPITAL MOVEMENTS | 10 |
| IV. | MOTIVATIONS | 14 |
| | Speculative Movements | 14 |
| | Flight Movements | 17 |
| V. | MECHANICS | 21 |
| | Leads and Lags | 23 |
| | Forward Exchange Operations | 26 |
| | Overinvoicing and Underinvoicing | 28 |
| | Black Market Deals | 28 |
| | Smuggling of Domestic Bank Notes | 30 |
| | Private Compensation Deals | 32 |
| | Smuggling Out of Goods | 33 |
| | Exchange Irregularities | 34 |
| | Premium Gold Deals | 35 |
| | Triangular Exchange Deals | 36 |
| | Cheap Sterling Deals | 38 |
| VI. | ILLUSTRATIONS | 39 |
| | Movements between the Sterling Area and the Dollar Area | 39 |
| | France | 42 |
| | Intra-European Movements | 43 |
| | Canada | 46 |
| | South Africa | 52 |
| | Australia | 54 |
| | Uruguay | 56 |

| | |
|---|----|
| VII. EFFECTS | 58 |
| VIII. INDUCING THE REPATRIATION OF DOMESTIC CAPITAL | 62 |
| Unilateral Attempts | 63 |
| Cooperative Measures | 64 |
| IX. POSSIBLE SOLUTIONS | 67 |
| Tightening Controls | 68 |
| Cooperative Measures | 69 |
| Reducing Liquidity | 72 |
| Attacking the Motives of Hot Money | 73 |
| Fluctuating Exchange Rates | 77 |
| X. CONCLUSION | 85 |

I. INTRODUCTION

By the end of World War II there was already widespread agreement that continuing direct controls over private international capital movements, especially over disequilibrating transfers of the speculative and flight varieties,¹ would be desirable for the great majority of countries not only in the early postwar years (when the need for such controls was most obvious) but in the longer run as well. Interwar experience had clearly demonstrated that unfettered freedom to move private capital across national boundaries could involve major disturbances and damage to international and internal financial stability,² and it was recognized that relatively few countries could safely or wisely tolerate the luxury of such freedom in the future. This attitude was officially crystallized in the Articles of Agreement of the International Monetary Fund, which explicitly sanctioned the right of member countries to control capital movements and in fact made

NOTE: I wish to express my indebtedness to Dr. John H. Williams for the discussions which I have had with him on this and many other international financial problems. I also wish to acknowledge the assistance of Ernest Bloch, Adrienne Fousek, and John Reed in helping me assemble some of the factual materials underlying this study.

¹ For the purpose of this study, and without pretense at logical tidiness, the term "speculative capital movements" will be understood here to refer to those movements associated with or motivated by anticipations of a change in exchange rates. By "flight movements" will be meant those movements motivated by a desire to escape losses associated with such actual or anticipated phenomena as war, Communist insurrection, high taxation, capital levies, internal economic collapse or currency upheaval, anti-capitalist milieus, imposition or tightening of exchange restrictions, etc. Both speculative and flight movements in the postwar period have been predominantly of the disequilibrating variety in that they have characteristically accentuated rather than moderated balance-of-payments disequilibrium by taking place from countries with balance-of-payments deficits and/or to countries with surpluses. The term "hot money" will be used here to describe speculative and flight movements of capital of the disequilibrating sort.

² See, e.g., R. Nurkse, *International Currency Experience*, Princeton, 1944, passim; and A. I. Bloomfield, *Capital Imports and the American Balance of Payments, 1934-39*, Chicago, 1950, especially pp. vii-viii, 186-188, and 293-303. Other writers have called attention to the case for some measure of control over even the more "normal" varieties of capital movements on the grounds that interest rates or other rewards to individual capitalists are not always a reliable index of the social productivity of capital and that such movements, when unregulated, do not always lead to an optimum distribution of resources from a world point of view. See especially T. Balogh, "Some Theoretical Aspects of Post-War Foreign Investment Policy," *Oxford Economic Papers*, March 1945, pp. 93-110; and A. Henderson, "The Restriction of Foreign Trade," *Manchester School*, January 1949, pp. 26-28.

such controls obligatory under certain circumstances as a condition of obtaining aid from the Fund.

In the eight years that have elapsed since the conclusion of the war, the majority of countries have in fact exercised close restrictive controls over private capital movements within the framework of their over-all systems of control of international payments and receipts in general.³ In some instances, to be sure, these controls have permitted a considerable degree of liberality or even complete freedom with respect to various categories of capital transfers or with respect to transfers to specific countries or members of an associated monetary area. And a relatively small number of countries, most notably the United States, have permitted virtually unrestricted transfers of all categories of capital to and from all countries. But these exceptions do not seriously detract from the general rule that throughout the postwar period private capital movements, especially disequilibrating outward capital transfers of the speculative and flight varieties, have characteristically been subject to restrictive controls designed to keep such movements to a minimum. Even where no such controls have been imposed, moreover, monetary authorities have at times tried to discourage undesirable capital flows by indirect measures.

Although these controls have kept private capital transfers far below the level that they would otherwise have attained, it is still a melancholy fact that speculative and flight capital movements on a notoriously large and disturbing scale have been a prominent feature of postwar international finance. Practically every country in the world has been affected, as exporter, importer, or both, by these movements, a large proportion of which have represented deliberate and usually clandestine violations of the letter and spirit of existing exchange regulations. Experience

³ While the Articles of Agreement of the International Monetary Fund authorized the use by its members of exchange controls over current-account transactions during the "post-war transitional period" (Article XIV), it was envisaged, or rather hoped, that by the end of that period and thereafter such controls would be used, not in a restrictive fashion, but only as a means of making effective the control of capital movements. At the present time, however, the restrictive application of exchange controls on current-account transactions is still the general rule throughout the world. Since March 1952 the Fund, in accordance with Article XIV, has been carrying on consultations with the individual member countries still retaining such restrictive controls with regard to their continued retention.

has shown that no exchange control system can be airtight. These movements, the wherewithal for which has been greatly increased by the abnormally large supply of money and liquid assets inherited from World War II and fed by postwar inflationary financing and easy money policies,⁴ have been essentially a reflection of the widespread international payments disequilibrium and political instability of the postwar world. The economic and political confidence that was an essential requirement for the equilibrating short-term capital movements of earlier days has largely been lacking, with the result that the private short-term capital movements of the postwar period have been predominantly of a disequilibrating character.⁵ Beside involving creeping drains, throughout the period as a whole, on the hard-currency reserves of many countries least able to bear such drains, these hot money movements have powerfully accentuated the periodic balance-of-payments crises of Western European and other countries; magnified drains on monetary reserves at such times, and reinforced the need for tight restrictions on current-account payments. They have also had disturbing effects on the internal economies of the capital-receiving and capital-losing countries without yielding, even partially, any compensating benefits to the countries concerned or to the world as a whole. It is a highly regrettable fact, however, that no reliable statistical information is available regarding the over-all magnitude of these movements in the postwar period, and no such estimate will be hazarded here. Some statistical data regarding the movements to or from individual countries will, however, be presented later.

The cross-currents of these postwar hot money movements have been of a very diversified and shifting character. An indication of

⁴ It might also be noted that this abnormal liquidity, as such, probably provoked some outward capital flows, since, even in the absence of special stimuli, some part of this liquidity would have inevitably tended to overflow national boundaries.

⁵ A relatively small part of the speculative movements since 1945 have admittedly been of the equilibrating variety in that they have taken place in some cases from countries with surpluses in their balances of payments and/or to countries with deficits. This has occurred most notably in some instances where exchange rates have not been officially pegged and where exchange rate movements in one direction have tended to create expectations of movements in the other. The Canadian experience in 1952, for example, provides a good example of this. See below, pp. 50-51. In any case, our attention in this study will be centered on the disequilibrating form of speculative (and flight) movements.

their variety may be provided by the following illustrations of some of the major flows. For example, there have been heavy speculative outflows from the United Kingdom to the United States during the British balance-of-payments crises of 1947, 1949, and 1951-1952, followed in each case by some reflux. The United States has also been the repository of large and periodic hot money inflows from almost every other Western European country with the possible exceptions of Switzerland and Belgium; France, Italy, and Germany have undoubtedly been the major individual sources of such capital. There have been large movements of speculative and flight capital between Western European countries themselves, the largest importers being Switzerland and Belgium, although even they at times have been exporters of such capital to other European countries. A massive movement of private capital from the United States to Canada, in substantial part for speculative reasons, occurred in the third quarter of 1950. There were heavy movements of private capital from the United Kingdom to South Africa in 1947-1948 and to Australia in 1948-1950, the former being in part of a flight variety and the latter in part of a speculative character. Uruguay was the depository of a short-lived but marked inflow of European flight capital following the outbreak of the Korean war, and there were substantial two-way speculative movements of capital between Mexico and the United States in 1947-1952. Speculative and flight capital movements to the United States and certain Western European countries from the Middle East, the Far East, and South America have also occurred on a large but irregular scale throughout the post-war period. Some European flight capital has also moved to Canada in recent years.

Some of these hot money movements, especially those of the speculative variety, have tended, in part at least, to be self-reversing over the period as a whole. On the other hand, the bulk of the flight capital that has migrated abroad since 1945 does not appear to have been repatriated, in large part because of the generally persisting character of the disturbances or risks which prompted the original export of this capital. During the past year, however, there has been an apparently marked decline in the over-all volume of hot money outflows, especially from Western Europe, in

view of an improvement in the world payments position and an easing of international political tensions.

Despite widespread recognition of the disturbing role that speculative and flight movements of capital have played since 1945, little if anything of a systematic nature has been written in this field from an over-all point of view.⁶ It is the purpose of this study to assemble and analyze such information as is available regarding the causes, mechanics, control, and effects of these movements in the postwar world and to examine what measures may yet be taken to reduce their future magnitude and impact. While illustrations will be drawn from the experiences of a large number of countries (obviously excluding Iron Curtain countries), our attention will be directed chiefly to the phenomenon as a whole with a view to deriving principles and conclusions of a more general character.

II. DEFINITIONS AND MEASUREMENT

It may be well at the outset to attempt to make clear the kind of private capital movements that will be the main concern of this study and to examine the nature of the available statistical data.

Attention will be focused on those capital movements associated with changes in the foreign balances and other assets held by private persons and institutions (including commercial banks) of a given country when those changes are motivated by anticipated exchange rate movements and by flight considerations of the sort listed in footnote 1. We shall be chiefly concerned here with outward speculative and flight transfers of private *domestic* capital from a given country (which of course correspond to inward speculative and flight transfers of foreign capital from the viewpoint of the receiving country); and with the return flow of such capital, to the extent that it does return because an expected ex-

⁶ Indeed, even the published literature on the experience of individual countries is very sparse. The basic materials in this study have been drawn from a wide variety of scattered sources, including mainly: annual reports of central banks and exchange-control institutes; bulletins and reviews of central and commercial banks; newspapers; the *Economist*, *Statist*, and *Banker* (London); and the various annual reports and other published studies of the International Monetary Fund, the Economic Commission for Europe, the Organization for European Economic Cooperation, and the Bank for International Settlements.

change rate adjustment has occurred, because other considerations that prompted its original withdrawal have disappeared, or because official measures have been taken to encourage its repatriation. We shall also be concerned, but to a much lesser degree, with outward transfers of private *foreign* capital from a given country when these transfers are prompted by expectations of exchange adjustments or by political disturbances or other risks in that country. But no attention will be given, except incidentally, to those movements of private capital, legal or illegal, associated with the repatriation, as such, of blocked foreign assets in a given country.

It will be noted that in the above context we have defined "private" to include commercial banks. This is not to imply that commercial banks engage significantly in speculative transactions—indeed they most commonly maintain approximately covered foreign exchange positions—or in capital flight. Under exchange-control regimes, in fact, movements in the foreign balances of commercial banks in large part partake of the character of official monetary reserves in that such balances are usually subject to the close control and to the disposition of the monetary authorities (as indeed are the legally held and known balances abroad of other private parties), and characteristically move in "compensatory" fashion with respect to changes in the balance of payments. But at times, even under exchange-control regimes, changes in commercial bank balances abroad may reflect the speculative activities and even the flight capital operations of individuals. For example, the outstanding volume of commercial credits granted to foreigners by commercial banks may change significantly because of changes in the payments practices of foreign traders motivated by anticipated exchange rate adjustments; in some cases private individuals may hold balances abroad through commercial banks of their own, or usually of some third, country as a means of clandestine capital flight; and commercial banks' foreign balances may sometimes be built up through spot covering of their net forward sales of the foreign currency to individuals wishing to speculate on an appreciation of that currency. It is clear, then, that our concept must take account of changes in the foreign balances owned by commercial banks to the extent that such changes result from the activities of private persons speculating on an antici-

pated exchange rate adjustment or wishing to protect their capital from risks at home.

It is at once obvious that the type of private capital movement which we have in mind permits of no precise measurement. Apart from the well-known fact that the available statistical data on private capital movements in general are, for the great majority of countries, incomplete and subject to a wide margin of error,⁷ such movements are not and cannot be classified according to motivation. Statistics of private capital movements alone would not be adequate, since an unknown portion of these movements, especially of the long-term variety, are not motivated by speculative and flight considerations. And it is also clear that our type of capital movements cuts across the conventional classification of short-term and long-term capital movements. For, while the bulk of the speculative and flight movements undoubtedly fall in the short-term category (although not all short-term movements are of this sort), sometimes the assets involved include outstanding long-term securities and even direct investments.

An additional difficulty in attempting to measure speculative and flight movements lies in the fact that, under exchange-control regimes, a very large proportion of these movements by their very nature escape the statistical dragnet, since they commonly involve clandestine operations designed to circumvent the exchange regulations.⁸ In these cases, the foreign balances and other assets acquired are kept beyond the reach and without the knowledge of the authorities and do not, therefore, enter into the reporting systems of the capital-losing, and in many cases of even the capital-receiving, countries.

So far as illicit private capital transfers to the United States are concerned,⁹ it is frequently claimed that a rough indication of their order of magnitude can be derived from the "errors and omis-

⁷ This remains true despite the outstanding improvements in recent years in balance-of-payments data under the guidance of the International Monetary Fund. The limitations of the available statistics on private capital movements will be readily apparent to anyone who examines the individual country data (and descriptive notes on each) in the annual *Balance of Payments Yearbook* of the Fund.

⁸ For the mechanics of clandestine capital movements, see below, pp. 28-39.

⁹ Not all hot money movements from exchange-control countries are illicit in the sense that they involve violations of the regulations. One important example,

sions" item in the United States balance of payments. As is well known, that item has shown very large and fluctuating credit residuals throughout the postwar period,¹⁰ amounting to approximately 1 billion dollars in each of the years 1947 and 1948, about 750 million dollars in 1949, and over 500 million dollars in each of the years 1951 and 1952. It is, of course, usually recognized that these large credit residuals in part reflect errors in the estimation of various current-account items, most notably the values of exports and imports; inability, due to sheer technical difficulties, to record certain specialized current and capital transactions (even when the latter do not involve illicit operations by foreigners); and timing discrepancies in the debit and credit phases of certain individual transactions. But it is argued that these errors and omissions cannot account for more than a relatively small part of the large credit residuals that have appeared in our postwar balance of payments and that the bulk must represent private capital transfers to the United States that have, in most cases, represented illegal evasions of exchange controls abroad.

It is of course easy to see how illicit capital transfers to this country could, under certain conditions, cause a credit residual in our balance of payments. A common form of such transfers, for example, involves the deliberate underinvoicing by foreign exporters of their export shipments to the United States (with the collusion of the American importers) so as to enable them to acquire dollar balances in the United States that they can hold without the knowledge of their authorities. If the United States customs officials, however, *correctly* value such shipments, and if the foreign exporters hold the excess dollars which they have illegally acquired in an *American* name, a credit residual arises in our balance of payments, since aggregate recorded foreign dollar balances rise (as a result of official acquisitions) by less than the recorded value of our imports. Similarly, foreign importers (with the collusion of American exporters) might deliberately overinvoice their import shipments so as to enable them to obtain more

as we shall see later, is transfers associated with the so-called "leads and lags" in commercial payments. Some exchange-control countries, moreover, permit freedom of all private capital exports to specific foreign countries.

¹⁰ In a few quarters, however—e.g., in the fourth quarters of 1949 and 1950—there were small debit residuals.

exchange from their authorities than is needed to pay for the imports and thus to acquire dollar balances in the United States. If the United States exporters declare the *correct* value of their shipments on this side, and if the dollar exchange illegally acquired by the foreigners is held in this country in *American* names, a credit residual will again appear in our balance of payments, since aggregate recorded foreign balances in this country will decline (as a result of official payments) by more than the recorded value of the export shipments.¹¹

But it is also clear that many illicit capital transfers to this country need not cause any credit residuals in our balance of payments. In the case where foreign exporters undervalue their export shipments to the United States, no residual would appear if (1) our imports were correctly valued and the foreign exporters held the illegally acquired dollar balances in their own or some other foreign names, or if (2) our imports were incorrectly valued at the (lower) invoiced values and the illegally acquired balances were held in American names. Similarly, in the case of overvaluation of imports from the United States by foreign importers, no residuals would appear if (1) our exports were correctly valued and the excess dollar balances were held in foreign names, or if (2) our exports were incorrectly valued at the (higher) invoiced value and the excess dollar balances were held in American names.¹²

Although no information is available regarding the relative importance in actual practice of each of the cases discussed in the two preceding paragraphs (or indeed of other cases arising under other mechanisms of illicit capital transfers), it is clear that there is no simple relation between the residual item in our balance of payments and the volume of illicit capital transfers to the United States. The residual does, however, give an indication as

¹¹ In both of these illustrations, it will be noted, no residuals will appear in the balances of payments of the *foreign* countries concerned, since their official balances in the United States will rise or fall by the exact amounts of the incorrectly reported export and import values, and the illegal acquisition of private dollar balances by their nationals will not get recorded.

¹² See, e.g., *The Balance of Payments of the United States, 1949-51*, Washington, D.C., U.S. Department of Commerce, 1952, pp. 115-117; and J. H. Adler, "Clandestine Capital Movements in Balance of Payments Estimates," *Quarterly Journal of Economics*, August 1950, pp. 477-482. It will also be noted that again in these cases no residuals will appear in the balances of payments of *foreign* countries.

to the *relative* magnitude of unrecorded capital movements, illegal or legal, flight or otherwise, at different periods of time.¹³ Thus, it is undeniably significant that our credit residual has tended to be largest during periods of major balance-of-payments crises or political disturbances abroad, and that it has tended to decline or become negative when economic and political confidence abroad has strengthened.

III. STRUCTURE OF POSTWAR CONTROLS OVER PRIVATE CAPITAL MOVEMENTS

It was noted earlier that direct control over private capital movements has been the general rule throughout the postwar period. But there has been considerable diversity as *among* countries regarding the degree of severity in the application of these controls, as well as *within* countries regarding the degree of freedom permitted to private capital transfers of various categories or to various foreign areas. And a relatively small number of countries have permitted relative or complete freedom of private capital movements to and from all other countries. In this section we shall discuss in broad terms the various degrees and kinds of control over private capital movements that have been exercised by different countries during the postwar period.

It is clearly not our purpose here to examine the character of the over-all exchange controls of individual countries. So far as exchange-control systems are concerned, the general rule has been to subject all private capital exports (domestic and foreign)¹⁴ to the requirement of official approval, which, except in special circumstances, is usually not granted. In order to enforce this rule, as part of their over-all policies of husbanding foreign exchange resources and of allocating them to the most "essential" uses, most exchange-control countries have systems that in general involve: the licensing of exchange payments and the quantitative control of

¹³ The residuals in our balance of payments *vis-à-vis* individual major foreign areas include, in addition to "errors and omissions," transfers of dollar funds between those and other foreign areas.

¹⁴ Withdrawals or liquidations of foreign *official* balances have of course also been subject to various controls, but we are concerned in this study only with private movements. The terms "domestic" and "foreign" will be used interchangeably throughout this study with "resident" and "nonresident," respectively.

imports; the requirement that exchange proceeds from exports of goods and services and from capital imports must within a given period of time be surrendered to the authorities (in some cases part of these proceeds may be disposed of through so-called free exchange markets maintained as part of multiple rate systems); restrictions on the export and import of domestic and foreign bank notes, securities, and other valuables; the prescription of the specific currencies in which payments are to be received; control of transfers between the accounts of residents and nonresidents in the countries concerned; control (by declarations or licenses) of merchandise exports and other transactions producing foreign exchange; and other such measures.¹⁵ In most cases, moreover, the inflow of private foreign capital from abroad also requires the prior official approval of the exchange-control country.

Within the framework of exchange-control systems, the degrees of restrictiveness as applied to different categories of private capital movements have in actual practice varied widely.

1. Outward transfers of domestic capital have generally been restricted much more closely when destined for harder-currency, as contrasted with softer-currency, countries.¹⁶

2. Exports of domestic capital for "productive" long-term investments abroad have usually been approved more frequently than exports of other categories of domestic capital, although such investments themselves are generally restricted closely.

3. Commercial banks have in most cases been permitted to hold working balances abroad, but such balances remain under close official control and are at the disposition of the monetary authorities. Commercial banks have also been permitted as a rule to extend commercial credits to foreigners and to engage in other international banking operations involving an export of capital, but

¹⁵ For a useful, over-all survey of the various systems of exchange restrictions in the postwar world, see *First Annual Report on Exchange Restrictions*, International Monetary Fund, 1950, pp. 3-16. That report and subsequent ones also contain helpful, succinct descriptions of the types of exchange restrictions in effect in individual member and leading nonmember countries.

¹⁶ A good example of this is provided by Canada, which throughout most of the postwar period closely restricted exports of domestic capital to the United States dollar area, while permitting relative freedom of movement to the sterling area. Since October 1951, moreover, Belgium has permitted the free movement of domestic capital to other European Payments Union countries, while maintaining close restrictions on capital account *vis-à-vis* the dollar area.

such operations are subject to official regulation and supervision. Domestic business concerns are also permitted in some instances to hold working balances abroad when deemed necessary for the efficient prosecution of their overseas operations.

4. Flows of private foreign capital into exchange-control countries, while often requiring prior approval of the authorities, have been permitted relatively freely. Approval is sometimes withheld, however, where the incoming capital is not for "productive" purposes, involves a controlling interest in a domestic enterprise, or does not meet other related requirements. In some cases foreign capital is permitted to enter only through a free exchange market. In a few instances inflows of foreign capital from certain countries have been restricted quite closely. Thus, for example, Belgium imposed rather tight restrictions on capital transfers from other European Payments Union countries in October 1951.

5. Residents of countries associated in a common monetary area, e.g., the sterling area and the French and Belgian monetary areas, are given virtually complete freedom to transfer their capital to other parts of the same area, although they cannot freely transfer capital elsewhere. A few of the countries in the sterling area, such as India, Pakistan, Ceylon, Burma, South Africa, and Hong Kong, have at times maintained certain formal controls over capital movements to or from other parts of the area, but in nearly all cases these have been largely nominal. In the case of the French franc area, certain restrictions have been imposed on the transfer of capital from Indochina to France.

6. A number of countries have permitted relative or complete freedom of outward and inward domestic and foreign capital movement through the mechanism of free exchange markets maintained within the framework of their restrictive systems. During part or all of the postwar period this has been the case in Ecuador, Lebanon, Peru, Syria, Thailand, Uruguay, and certain other countries. In a few Latin American countries, moreover, freedom to move through free markets has applied only to foreign capital (of the "nonregistered" variety). It is, of course, clear that, except where certain noncapital transactions also pass through such free markets (legally or illegally) or where the authorities periodically intervene therein, the rates move to the point where the *net*

movement of capital through these markets is zero and no gain or loss of foreign exchange to the authorities occurs.

7. Many exchange-control countries have permitted transfers of contractual amortization on debts to foreigners, in some cases through free exchange markets. Emigrants have also usually been permitted to take a limited amount of capital with them.

8. Regulations regarding the repatriation of foreign long-term investments from given countries vary widely. In some cases repatriation is permitted (through official or free markets) only if the investments were made after a certain date, or have been in the countries concerned for a given period of years, or were originally registered with the authorities. In some countries repatriation is permitted only in installments over a number of years or in limited amounts in hardship cases. In other cases the local-currency proceeds from the liquidation of foreign investments can, along with other "old" blocked private foreign accounts, be used for a limited range of current-account expenditures in the countries concerned or can be sold by the owners on foreign markets to other nonresidents, who in turn can use the funds for investment or in some cases for specified current-account expenditures in these countries. Many categories of blocked foreign funds, e.g., "security sterling," "capital-account French francs," "Sperrmarks," and others, are sold in New York and other markets at discounts and provide a channel whereby individual owners can legally withdraw money invested or held in exchange-control countries. (There will, of course, be a *net* export of non-resident capital from the countries concerned only in those instances where the funds are used by the original owners, or by those to whom they are sold, for current-account expenditures in these countries.) Finally, it should be noted that the regulations of individual countries regarding the repatriation of foreign capital sometimes vary with regard to the countries to which the capital is to be repatriated. Within monetary areas, for example, or special groupings of countries (e.g., the UNISCAN group—the United Kingdom, the Netherlands, Denmark, and Sweden), repatriation is relatively or completely free.

In addition to countries maintaining systems of exchange control, there are a number of countries which throughout the postwar

period have been completely free of exchange restrictions on capital- (and current-) account transactions and which have consequently given unrestricted freedom to all categories of outward and inward capital movements. In this class have been the United States (except for its Foreign Funds Control), Mexico, El Salvador, Panama, and Guatemala. Honduras formally joined the list of exchange-control-free countries¹⁷ in 1950, and Canada removed all exchange restrictions in December 1951. A number of other dollar-area countries, including Cuba, the Dominican Republic, Venezuela, and Haiti, have also been completely or virtually free of restrictive exchange systems¹⁸ and have permitted freedom of capital movements. Switzerland has had only mild exchange restrictions and has allowed relatively complete freedom of capital movement throughout the postwar period.¹⁹ The Philippines were completely free of exchange restrictions until September 1949, when a heavy drain on their reserves necessitated the imposition of restrictions on current and capital account.

IV. MOTIVATIONS

Speculative Movements

Under the pre-1914 gold standard, with exchange stability taken for granted, fluctuations in exchange rates within the narrow limits of the gold points had, as is well known, characteristically set into motion speculative short-term capital movements of the stabilizing or equilibrating variety. But during the interwar period frequent and disorderly exchange rate movements, as well as other upheavals, destroyed this belief in the fixity of established rates. Exchange speculation took on predominantly an unstabiliz-

¹⁷ That is, those member countries of the International Monetary Fund that have formally accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement.

¹⁸ But they have not yet accepted the obligations mentioned in the preceding footnote.

¹⁹ Until September 1949, however, capital from the United States (including repatriated Swiss capital) could be converted into Swiss francs only through a free market (the so-called "finance dollar" market), since the Swiss authorities, in an effort to restrain domestic inflationary pressures, refused to buy the dollars and gold that were the counterpart of such capital inflows. Since December 1950 capital transfers exceeding 500,000 Swiss francs to and from countries with which payments are controlled require a license.

ing or disequilibrating character. At the first indications of an impending depreciation of a pegged rate, bearish speculation against the currency concerned would come into play; similarly, changes in a floating rate were usually regarded as a forerunner of further changes in the same direction.

During the postwar period there has continued to be a widespread lack of confidence in established exchange rates.²⁰ There has been a lively awareness of the overvalued character of many pegged rates, supported as they have been by tight payments and trade controls in the face of widely differing degrees of inflation at home and abroad; and there has been a high degree of sensitivity to the possibility of rate adjustments. Anticipations of rate changes have been greatly increased, moreover, by the wide swings in the postwar balances of payments of many countries and by the general inadequacy of monetary reserves at their disposal. To be sure, the majority of countries have relied more on a tightening of their trade and exchange restrictions than on exchange depreciation as the chief means of meeting major setbacks in their balances of payments. But many downward adjustments in official exchange rates have in fact been made, the most spectacular examples being provided by the exchange depreciations undertaken by a large number of countries in September 1949. In a few cases, official exchange rates have been adjusted upwards. Canada and Sweden, for example, appreciated their currencies in July 1946 as an anti-inflationary measure; the notion that exchange appreciation is an effective method of meeting specific inflationary situations has, incidentally, been popular in various circles during the postwar period.²¹ In other instances, exchange rates, where not officially pegged at given levels, have been allowed to fluctuate through a considerable range.

²⁰ The International Monetary Fund, it will be recalled, was never intended as a mechanism to assure an invariable *fixity* of rates, but was designed, among other things, to minimize the possibility of disorderly rate changes not justified by the existence of "fundamental disequilibria." It is doubtful, however, whether the existence of the Fund has to any significant degree prevented exchange adjustments that would have otherwise occurred from occurring, or reduced anticipations of the frequency of such adjustments.

²¹ For a discussion of this matter, see R. Hinshaw, "Currency Appreciation as an Anti-Inflationary Device," *Quarterly Journal of Economics*, November 1951, pp. 447-462.

Expectations of exchange rate adjustments, especially in a downward direction, have therefore been frequent throughout the postwar period. Such expectations have resulted in large-scale speculative capital flows, largely of the disequilibrating sort, motivated by a desire to make profits or to avoid losses from such anticipated movements. Where exchange rates are officially pegged (within very narrow limits)—and this has been the characteristic form of postwar exchange rate system—speculation in fact becomes a peculiarly “safe” form of activity when a country’s balance of payments is under pressure (or is unusually favorable), since the expected adjustment, if it occurs at all, can be in only one direction; the speculator is in effect presented with a “one-way option.”²²

A few illustrations of some of the many major cases of expected rate changes during the postwar period may be given here. Expectations of a depreciation of the pound sterling, for example, were in evidence just before and during the sterling convertibility crisis in the spring and summer of 1947; in January and February 1948 following the *de facto* devaluation of the French franc; in the spring and summer of 1949 prior to the devaluation in September of that year; and again in the latter part of 1951 and early in 1952. On the other hand, there were rumors of an appreciation of the pound in July and August 1946, following the Canadian and Swedish revaluations, and again in October 1950.²³ The French franc has been subject to even more frequent anticipations of exchange depreciation, notably in the last half of 1945;²⁴ in the winters of 1948-1949 and 1951-1952; and periodically in the last half of 1952 and the first half of 1953. Rumors of pending devaluations of many other Western European currencies were also rife in the spring and summer of 1949. The Canadian dollar, which had been subject to rumors of devaluation in the summer of 1947, came under the influence of strong rumors of appreciation in August and September 1950 and was in fact unpegged at the

²² For a discussion of floating rates as a possible mechanism for curbing disequilibrating speculative capital movements, see below, pp. 77ff.

²³ On each of these occasions it was of course anticipated that all or nearly all of the currencies of other sterling area countries would move downwards or upwards with the pound.

²⁴ These anticipations culminated in an actual devaluation late in December 1945.

end of the latter month. Rumors of an appreciation of the Australian pound have been strong throughout much of the postwar period, especially in 1948-1950 when it was believed that such a step would be taken as an anti-inflationary device. The Swedish krona was subject to alternating rumors of depreciation (in 1947 and 1949) and appreciation (in the first half of 1946 and in 1950-1951). The list, in fact, could be expanded almost indefinitely, since few countries have escaped rumors at one time or another of alterations in their official parities. Even the Swiss franc, one of the hardest of postwar currencies, was subject to a devaluation scare for a short period following the widespread devaluations of September 1949. But enough has been said to indicate the pervasiveness of anticipations of official exchange rate adjustments throughout the postwar period. In those cases where rates were permitted to fluctuate freely through a considerable range, expectations of exchange rate movements, whether in one direction or the other, were more nearly continuously present.

Expectations of adjustments in official exchange rates have naturally been much more frequent than the adjustments themselves. In some cases such expectations arose without any real justification in terms of the underlying situations in the countries concerned or, least of all, in terms of the intentions of the authorities. In those cases where there *was* a "logical" basis for the expectations, the authorities most commonly met the situations concerned, not by exchange adjustments, but by changes in exchange and trade restrictions or resort to other measures. But in all cases where market anticipations of rate adjustments have prevailed, they have brought into play speculative movements of capital of a sort most commonly tending to accentuate the international payments disequilibria. These movements, moreover, have tended to feed upon themselves in a self-inflammatory way in that, by leading to movements of international reserves, they have been inclined to strengthen the belief in the inevitability of an adjustment of the exchange rate concerned.

Flight Movements

Although the motivation of flight capital movements is usually much more complex and difficult to isolate than that of speculative

movements, it basically reflects a fear as to the safety of money principal and a desire to avoid the risk of its impairment, loss, or blockage.²⁵ The factors which have contributed to such fears and risks in the postwar period have been varied.

International political tensions and the fear of another world war have undoubtedly been the major cause of postwar capital flights. Owners of capital in countries most likely to be overrun by invading Communist armies and/or affected by bombing and other military operations have had an obvious incentive to seek means of safeguarding their capital against seizure or destruction by exporting it to "safer" countries. Large flights of capital motivated by such fears have undoubtedly taken place from many Western European countries, especially from countries like Western Germany on the frontier of the Iron Curtain. The capital has characteristically moved to the United States, Switzerland,²⁶ Canada, and certain Latin American and other countries. This movement appears to have been considerably accelerated in the period immediately following the outbreak of the Korean war, and it has indeed tended to be correlated with major international political crises. Large capital flights are also believed to have taken place at various times from Far Eastern countries because of localized wars or large-scale guerilla activities in this area of the world, notably in Indochina, China (up to the latter part of 1949), Malaya, Burma, the Philippines, and, of course, Korea. These military activities have also prompted capital flight from neighboring countries likely to be embroiled or overrun. References might also be made to the Arab-Jewish war in 1948-1950 and to the Pakistani-Indian dispute over Kashmir.

A closely related cause of capital flight has been the internal political instability that has prevailed in many countries during the postwar period. The examples of France and Italy, where the threat of Communist governments has at times been very strong, come immediately to mind. The internal political instability factor

²⁵ A flight of capital may, of course, involve also the acquisition of gold, and in some cases of goods on local markets, but we are mainly concerned here with the more usual form involving acquisition of foreign balances and securities.

²⁶ It has been reported that during the postwar period Switzerland has not been as "popular" a depository for funds seeking safety from a world war as it was in earlier days in view of a belief that if such a war broke out Switzerland would no longer be insulated from it.

has also been of undoubted importance in promoting capital flights from many Latin American, Middle Eastern, and Far Eastern countries with unstable governments. Working in the same direction have been government actions hostile to private enterprise, including the nationalization of property (foreign and domestic) and "anti-capitalist" policies in general—all of which have prevailed in a number of countries during the postwar period.

Capital levies have been popular with government authorities in postwar Western Europe and the fears of such levies have been widespread. Such levies have most commonly been imposed as part of, or as an outcome of, the many monetary-reform and currency-conversion schemes that have been carried out in that area.²⁷ Clearly there has been an incentive for owners of wealth who have anticipated the imposition of such levies to export their capital from the countries concerned. To take but one example: the drastic monetary reform in Western Germany in 1948 had been widely anticipated for several years, and many Germans had undoubtedly sought to escape its effects by placing part of their wealth abroad.²⁸

The extraordinarily heavy postwar burden of taxes in many Western European countries has also motivated a creeping flight of capital from many of these countries on the part of individuals and corporations anxious to evade such taxes or at least to reduce their total tax liabilities. Switzerland has long been a favorite depository of capital fleeing onerous taxation, but in the postwar years there has also been a growing interest in Liechtenstein, Tangier, Panama, and one or two South American countries, notably Uruguay, as depositories of this and other forms of flight capital.

In some cases, fears as to the imposition (or tightening) of exchange restrictions on the outward flow of private capital have provoked capital outflows, by nationals and foreigners alike, from the countries concerned. Such fears were responsible, for example, for flights of capital from Mexico in 1947, from the Philippines

²⁷ For a recent survey of postwar monetary reforms in Europe, see J. G. Gurley, "Excess Liquidity and European Monetary Reforms, 1944-52," *American Economic Review*, Vol. XLIII (1953), pp. 76-100.

²⁸ Currency conversions have also been undertaken in other parts of the world, e.g., Japan, Indonesia, Taiwan, and Korea, and, where anticipated, have prompted capital flights.

in 1949, and from Guatemala in 1951.²⁹ A fear that tighter controls would be imposed on domestic capital outflows also caused a heavy flight of capital from Argentina in the first half of 1947. In all of these instances expectations of exchange restrictions stemmed from deteriorating balance-of-payments positions.³⁰ There have also been periodic fears, especially in 1947, that Britain would impose restrictions on movements of private capital to other parts of the sterling area, and such fears appear to have contributed to these movements at such times.³¹

There can also be no doubt that the very existence of exchange restrictions themselves has encouraged some exodus of private capital that would not otherwise have occurred. For one thing, it has created an incentive to build up balances abroad for future use in the event that a license for needed exchange is denied at some later date. Second, the existence of restrictions implies a malaise which, as such, may frighten some residents of the countries concerned and make them anxious to export capital which they would not otherwise have exported. Finally, there is always a small minority of people who derive a peculiar form of satisfaction from the very act of evading regulations of any kind.³²

The marked inflationary movements that have taken place in many countries during the postwar period (leading in some cases, like those of Greece and China, to actual hyperinflations) have also prompted many individuals to convert their money into foreign currencies (or into goods, industrial shares, or gold) in an attempt to safeguard its purchasing power. Underlying the flight into foreign currencies is of course the implicit assumption that inflation will lead to an external depreciation of the currency; this assumption has always been deeply rooted in the public mind in many

²⁹ These fears were usually coupled with expectations of exchange depreciation.

³⁰ Anticipated imposition or tightening of controls over imports of goods and services has likewise stimulated importers to speed up their foreign purchases. But this does not, of course, involve capital outflows.

³¹ A somewhat special example is provided by the ill-fated sterling convertibility experiment in mid-1947. The widespread belief that the dollar convertibility privileges would be short-lived undoubtedly contributed to the conversion into dollars of some official sterling balances that might otherwise have been content to remain in London.

³² Foreign holders of balances or other assets which are not freely convertible, or are not convertible into dollars or other hard currencies, also have an obvious incentive to seek means of removing their holdings in one way or another.

European countries. This type of movement, then, is closely allied to what we have termed speculative movements of capital.

Persecution of minority groups in certain countries has also prompted some capital flight on the part of the groups affected, often in anticipation of, or in conjunction with, their migration to foreign countries. Some capital flight of this kind is believed to have been effected by Jews from Iraq and other Middle Eastern countries, especially up to 1951. Some of the capital movements between India and Pakistan were probably also of this sort.

Although we have itemized the major individual causes of post-war capital flight, it is evident that from the viewpoint of the individual capital exporters many of these causes have often simultaneously entered into their calculations. Frequently, in fact, the capital exporter may have no clear-cut, "logical" reason in his own mind for his action, only vague fears and uncertainties as to the safety of his capital based on unsubstantiated rumors, hunches, or ill-defined and "irrational" premonitions. Indeed, the subject of the motivations of capital flight is a highly complex one perhaps more suited to analysis by the psychiatrist than by the economist.

V. MECHANICS

It seems necessary to examine some of the more common methods by which hot money movements have been effected in the post-war period. Clearly no special problem of mechanics arises in those cases where private capital is free to move to foreign countries in general or to specific overseas areas. Private persons and institutions wishing to export their capital can do so legally through regular channels. This does not mean that the capital is always exported *openly* in these cases. In some instances, such as where tax evasion is involved, or where the owners fear that at some later date the authorities may requisition the assets of nationals held abroad, capital exporters may keep their foreign holdings in such forms as to cloak the true ownership of their holdings or to minimize the possibility of their being detected.

Attention will be focused here on the more interesting technical problem of the mechanics of speculative and flight capital movements from exchange-control countries desirous of curbing them.

For the most part, these mechanics have involved violations of exchange regulations, although in some cases they have, strictly speaking, been legal within the framework of the existing regulations. While many of the methods used in the postwar period have had their precedents in the interwar period, a summary of the major ones may be worth while. Obviously, no attempt can be made here to list all of the many ways in which capital has been illegally exported, some of them, in fact, being of so highly complicated and ingenious a nature as to be known only to the operators themselves.

Clearly not all illegal acquisitions of foreign exchange are motivated by a desire to export capital for speculative or flight reasons. In many cases the object is merely to buy goods and services abroad for which the necessary exchange is not legally available. In other cases the exchange is illegally acquired so as to profit from its early or immediate resale at fancy black market or legal free market prices at home. In some instances the motive may even be simply a "normal" desire to take advantage of superior, higher-yielding, long-term investment opportunities abroad when exchange is not legally forthcoming for this purpose. But whatever the exact motive involved, the methods used are commonly the same.

The ease with which private capital can illegally escape from exchange-control countries is of course closely related to the efficiency of the administration and the tightness of the control system itself. In many countries, especially in underdeveloped parts of the world, capital flight is often notoriously easy because of poorly constructed exchange-control systems, lax administration and policing due to inadequately trained or insufficient personnel, or the susceptibility of control officials to bribes. And the extent of illegal private capital exports from any given exchange-control country depends not only on the strength of the motives prompting such exports, but also in part on the severity of the penalties for transgression and on the law-abiding character of the people. But even under carefully devised and efficiently managed systems of exchange control there inevitably are many loopholes for evasion which make the enforcement problem at best a difficult and burdensome one.

In many cases where domestic capital is illegally exported, the balances and other assets accumulated abroad tend to be held by the owners under the names of individuals in the foreign countries concerned or through banks in third countries, rather than under their own names, so as to minimize the risk of subsequent detection by the authorities of the capital-exporting countries. Before the war the principle of the inviolability of banking secrecy had been deeply rooted, but during the postwar period it has been subjected to some severe shocks. The United States government, for example, has, as we shall see later, cooperated with many foreign governments in enabling them to recapture some of the assets held illegally by their nationals in this country by turning over to these governments the names of the individuals holding such assets.

Leads and Lags

The most important form of speculative movements of capital since 1945, especially in the case of countries with restrictions on the outward flow of capital, has been that arising out of the so-called leads and lags in commercial payments, i.e., the accelerated or retarded settlement or collection by traders and merchants of commercial obligations and claims in foreign countries because of expected alterations in exchange rates. Although by no means insignificant before 1939,³³ this phenomenon has gained in relative importance in the postwar period in view of the fact that in most countries outright speculative transactions through the spot and forward markets are forbidden.

The mechanics of leads and lags are simple enough. At any moment of time, traders and banks in a given country have outstanding claims on and liabilities to traders and banks in other countries arising out of commercial transactions. Whenever the amounts of these claims or liabilities shift, there is by definition a movement of capital. While such shifts sometimes merely reflect changes in the volume of exports and imports, they often result also from changes in the terms of commercial payments motivated by expected exchange rate movements. Within limits fixed by ex-

³³ For references in the interwar literature, see, e.g., C. R. Whittlesey, *International Monetary Issues*, New York, 1937, pp. 126-128; and F. A. Hayek, *Monetary Nationalism and International Stability*, London, 1937, p. 67.

change-control systems, exporters and importers have freedom to accelerate or retard the collection and repatriation of commercial claims abroad and the payment of commercial obligations abroad; and they take advantage of this flexibility when exchange rate adjustments are expected. The leads and lags which have occurred, as well as the movements of capital associated with them, have thus usually involved no formal violations of exchange regulations. They have, nevertheless, been of a sort which have accentuated the swings in a country's balance of payments.

To illustrate this point, let us assume that the official parity of the pound sterling is expected to be lowered in terms of the dollar. This would tend to have the following leads and lags effects:

1. Where British imports from the United States must be paid for in dollars, some British importers will accelerate repayment of their outstanding commercial liabilities to the United States, resulting in a reduction in the volume of such liabilities. Likewise, some will tend to pay in advance for future imports,³⁴ i.e., to make payment before the goods have been transferred from American to British ownership, which will involve an increase in British dollar claims on the United States. In both cases there will be a movement of capital from Britain to the United States.

2. Where British imports from the United States must be paid for in sterling, some American exporters will seek to speed up the collection of their outstanding commercial claims on Britain and the repatriation of the proceeds, and will demand payment on sight instead of on credit terms for current exports.³⁵ As a result, the outstanding volume of British liabilities to the United States payable in sterling will decline.

3. Where British exports to the United States must be paid for in dollars, some British exporters will tend to defer collection of their outstanding claims on the United States and repatriation of the proceeds (within the time limits permitted by British regulations), to lengthen their terms of credit for current exports, or to sell on credit instead of on sight terms. As a result, the volume of outstanding British commercial claims payable in dollars will rise.

³⁴ Other British importers may use the facilities of the forward market. See below.

³⁵ Indeed, they may seek to shift to payment in dollars instead of sterling.

4. Finally, where British exports to the United States must be paid for in sterling, American importers will tend to delay repayments of outstanding commercial liabilities to Britain, to borrow in London to repay credits falling due, and to seek longer terms of credit for current imports from Britain. Consequently, outstanding British claims on the United States payable in sterling will tend to increase.

As a result of this commercial payments pattern associated with an expected depreciation of the pound *vis-à-vis* the dollar, Britain's commercial claims on the United States will tend to rise and her commercial liabilities to the United States to fall, i.e., there will be a movement of capital from Britain to the United States. This movement may be designated here as a speculative one, since it results directly from an expected adjustment of exchange rates.³⁶

Such a capital movement cannot of course go on indefinitely in one direction, since practical limits tend to be set by the amount of British commercial debt to the United States outstanding at the time the leads and lags effect comes into play (cases 1 and 2 above), and by the British regulations regarding the time limits for repatriation of export proceeds and the maturities of permissible trade and other credits that can be granted by British exporters and banks to foreign importers (cases 3 and 4). But, as British and French experience has shown, the amounts of capital involved can be very substantial. On the other hand, a movement of capital of this kind need not necessarily be self-reversing, for the new terms of payment may "stick" even after the expected exchange adjustment has occurred. But generally there is some tendency, once confidence has been restored, for the original terms of payment to reassert themselves, with the result that at least some of the capital returns.

It was noted earlier that marked changes in the outstanding

³⁶ Expectations of a sterling depreciation may lead to speculative pressure on the pound, not only by inducing capital movements via shifts in the terms of trade payments, but also by influencing the volume of exports and imports themselves. Thus, United States importers of goods that must be paid for in sterling are likely at such times to hold back from buying, whereas British importers of goods that must be paid for in dollars are likely to accelerate their buying (within the limits of existing import restrictions).

volume of commercial claims on and liabilities to foreigners may sometimes merely reflect sudden shifts in the volume of exports and imports. Likewise, prepayments for imports may sometimes simply reflect fears of shortages and of rising prices on world markets and a corresponding desire or need to place orders, backed up by cash payment, as far in advance as possible. This happened on a considerable scale following the outbreak of the Korean war when many Western European countries placed large advance orders for raw materials. The well-known German crisis in the European Payments Union in the first year of its operation, for example, in substantial part reflected the large volume of prepayments by German importers following the outbreak of the war at a time when German exporters, to get back into business, had to extend relatively long-term credits to their overseas customers.³⁷

Forward Exchange Operations

Importers and exporters may react to an expected exchange rate adjustment, not by shifting the terms of commercial payments, but by operating or refraining from operating in the forward exchange market. Thus, in the example cited above, some British importers of goods that must be paid for in dollars might, if a depreciation of sterling is expected, buy dollars forward when they have not previously done so; and some British exporters of goods that must be paid for in dollars might refrain from selling dollars forward when they have previously kept a covered dollar position.³⁸ At times of an expected depreciation of sterling, more-

³⁷ The shift in outstanding German commercial claims and liabilities, however, was also partly the result of expectations of an appreciation of sterling relative to the Deutsche Mark in the last quarter of 1950. See W. Diebold, Jr., *Trade and Payments in Western Europe*, New York, 1952, p. 113.

³⁸ In the example cited above, moreover, American exporters of goods that must be paid for in sterling might sell sterling forward when previously they have kept an uncovered position, and American importers of goods that must be paid for in sterling might refrain from buying sterling forward when they have previously done so. Besides, with a free forward exchange market in New York, speculators in the United States will tend to sell forward sterling outright. All these result in net selling pressure on forward sterling in the New York market and, through the customary mechanism, induce American banks to withdraw their spot balances held in "American accounts" in London (which they are free to do) and/or to borrow sterling in London (to the extent that they are able to do so) for sale on the spot market. These operations, of course, involve a movement of capital from Great Britain to the United States.

over, there would be an incentive for some British importers to try to buy more forward dollars than justified by their strict commercial requirements, and for outright speculators, not engaged in foreign trade, to try to buy forward dollars under the guise of commercial hedging. Although Britain (and other exchange-control countries) permits transactions in forward exchange only when connected with bona fide commercial transactions, there is likely to be some illegal buying of forward exchange for speculative purposes at such times. The fact that, at least until quite recently, the Bank of England (and many other central banks in exchange-control countries) stood ready to sell forward dollars and other currencies for commercial transactions at fixed rates only very slightly above the spot rates tended to encourage purchases of forward exchange for speculative (and hedging) purposes on these occasions. In those cases where no exchange control exists, then of course outright speculation through the forward market can be done quite openly.

At times of an anticipated depreciation of a given currency, then, forward purchases of foreign currencies by traders and speculators tend to exceed forward sales. When the central bank is the sole dealer in forward exchange, it is thus forced to assume a short position in forward exchange, which means that an equivalent amount of its monetary reserves must in effect be earmarked to meet the contracts when they fall due. When the business is in the hands of the commercial banks, however, the net forward buying pressure by their clients will tend to induce an outflow of capital, since the banks, within the limits permitted, will build up their spot balances abroad to keep a covered position; i.e., monetary reserves will be transferred from the central bank to the commercial banks. During the past few years a number of Western European central banks, largely as a means of discouraging one-sided pressures on the forward market at times of strain, have turned over their forward exchange business to their commercial banks, permitting them to deal with their customers and overseas banks in forward exchange at rates freely determined by market forces and allowing them within limits to engage in covered interest arbitrage operations.

Overinvoicing and Underinvoicing

The overinvoicing of imports and the underinvoicing of exports have long been standard methods of illegally acquiring foreign exchange, and there is good reason to believe that these devices have been widely used by foreign traders throughout the postwar period. In the first case, of course, the importer is enabled to purchase more exchange from the control authorities than he needs to pay for the import shipments, and in the second case the exporter is enabled to avoid surrendering to the authorities (or having to sell on a free market) all of the exchange that he acquires from his exports. These practices are commonly difficult to detect and to control and have been a favorite channel through which capital has illegally escaped from a country.

It should be noted that overinvoicing of imports may subject the importer to greater customs and other internal duties than would otherwise be the case (if the duties are levied on the invoiced values), and in some cases underinvoicing of exports may mean smaller tax rebates or other reimbursements for the exporter.³⁹ In those instances where the added duties or the foregone refunds are relatively large, the individuals concerned may find it more attractive to export capital illegally through other channels.

The processes of under- and overinvoicing may work in reverse when traders who have previously accumulated balances abroad wish, for some reason or other, to repatriate these balances through official channels without being detected. Thus, for example, exporters may *overinvoice* their exports so as to be able to sell to their exchange-control authorities a greater amount of exchange than they have currently acquired from their exports.⁴⁰

Black Market Deals

A common method whereby residents of a country can illegally acquire foreign exchange, whether for capital export or other purposes, has been to purchase it on black exchange markets at home. Such markets, on which harder foreign currencies are

³⁹ On the other hand, where export duties are imposed on invoiced values, the exporter may have an additional incentive to underinvoice his exports.

⁴⁰ It is reported that Belgian exporters to the sterling area resorted to this technique early in 1947 as a means of repatriating sterling illegally held in London.

quoted at premiums compared with official (or free) exchange rates, invariably spring up, in varying degrees of organization, scope, and official toleration, in exchange-control countries. Foreign bank notes and travelers' checks are usually the main staple, but bank balances abroad, transferable by check, are also traded against the local currencies. The United States dollar, the Swiss and Belgian francs, and the pound sterling are generally the main foreign currencies traded. Black market rates are of course highly sensitive to political and economic developments at home and abroad and to speculative influences associated with expectations of changes in exchange rates.

These markets are chiefly fed by incoming tourists, businessmen, and other foreign visitors or temporary residents who are attracted by the discounts at which they can acquire the local currencies in exchange for their own, despite the illegality of such exchange.⁴¹ Other sources of supply are the offerings by domestic residents of foreign exchange, illegally or legally acquired at some earlier date, which they wish to repatriate clandestinely and at a favorable price; and remittances by foreigners through the mail of foreign bank notes or checks to relatives or friends resident in the countries concerned.

Foreign servicemen, a variety of foreign "tourists," have also been important suppliers of foreign exchange on black markets in a number of European and Far Eastern countries where they have been stationed in large numbers in the postwar period. United States military personnel, for example, have made use of the black market in Western Germany, Austria, Japan, and Korea in satisfying their local-currency requirements in view of the wide spreads usually prevailing between official dollar exchange rates, on the one hand, and the black market rates for dollar currency ("greenbacks") and for Military Payment Certificates, on the other.⁴² Although these certificates, which are the medium in which Ameri-

⁴¹ Experience has shown, however, that as long as the discounts on black market exchange rates do not exceed 10 or 15 per cent of the official rates, most of the foreign exchange brought in by tourists, etc. is sold to the authorities at the official rates. See *Annual Report of the Bank for International Settlements, 1948-49*, Basle, 1949, p. 132.

⁴² To some extent also United States military personnel abroad have met their local-currency needs by sale of cigarettes and other supplies at favorable prices on local markets.

can military personnel in nearly all foreign countries have been paid since 1946, cannot legally be used outside of United States military establishments,⁴³ a ready demand has existed for them in local black markets for hoarding purposes, for conversion by devious means into dollar balances, or for illegal acquisition of Post Exchange and other Army supplies. This demand does not appear to have been seriously affected by the fact that on several occasions outstanding issues of Military Payment Certificates have been called in on short notice and converted into new issues through official Army channels.

Smuggling of Domestic Bank Notes

Another device by which residents of exchange-control countries, especially in Western Europe, have illegally obtained foreign exchange has been the smuggling out of domestic bank notes in person or through the mail for sale on markets abroad. Zurich and New York are the most important markets for foreign bank notes, which can be freely bought and sold in these centers. Since the bulk of the notes circulating in these and other free markets (e.g., Tangier, Beirut, and Hong Kong)⁴⁴ have been smuggled out of their countries of origin and must be smuggled back in again, they are characteristically quoted at discounts, which fluctuate according to supply and demand.⁴⁵ The chief purchasers of notes in these markets are persons planning to travel to the coun-

⁴³ They may of course be used by American personnel, through Army channels, to make remittances to the United States or to purchase local currencies at official rates or dollar travelers' checks. Greenbacks cannot legally be used by United States military personnel abroad (except in Latin American countries), but substantial amounts have apparently been brought in by them through the mail or in person for sale on the local black markets. Greenbacks invariably command a higher premium than Military Payment Certificates. For an account of the role of greenbacks and certificates in Korean capital flight, see my "Report and Recommendations on Banking in South Korea," *Monthly Statistical Bulletin of the Bank of Korea*, June 1952, pp. 60-62.

⁴⁴ A number of Western European countries have in recent years authorized their banks freely to buy and sell foreign bank notes at rates determined by supply and demand, but these markets operate within the framework of the regulations regarding the legal import and export of such notes.

⁴⁵ Most exchange-control countries place strict limits on the amount of domestic bank notes that can legally be taken out or in by resident and nonresident travelers. In recent years there has been a tendency towards liberalization in both directions. It might also be noted that the smuggling out of securities for sale on foreign markets is another avenue for the illegal acquisition of foreign exchange.

tries concerned or to make remittances and certain other payments therein, and who are attracted by the discounts at which the notes can be acquired relative to the official rates of exchange. Other purchasers are speculators hoping to make a profit by anticipated increases in the price of these notes, and agents (especially in Switzerland) who carry on an organized business of smuggling them into their countries of origin in order to make payments on behalf of clients in outside countries. In some cases the discount on a country's bank notes abroad is so substantial that tourists from that country find it worth while to use the bulk of their allotted travel exchange to purchase these notes on outside markets and to smuggle them home at a profit; this has apparently been the case with many French and certain other European travelers visiting Switzerland.

During the past few years, a number of Western European countries, notably Belgium, France, and Italy, have permitted incoming nonresident and resident travelers to bring in domestic bank notes without limitation, although limits have continued to be maintained upon the amount of notes that resident and nonresident travelers can legally take out with them. The logic of this procedure has been primarily to keep down the size of the discounts at which the domestic bank notes are quoted on overseas free markets, notably Zurich, wide discounts in themselves being considered a potent cause of capital flight because of their adverse effect upon confidence in the currencies concerned. It was recognized that freedom for travelers to bring in domestic bank notes without limitation would involve some loss of foreign exchange to the authorities, but it was believed that this loss would be more than offset by the reduction in capital flight associated with the decrease in the discounts at which domestic bank notes were quoted abroad. There is some doubt, however, as to whether this has in fact been the net result in all cases. Free importation has of course kept the discounts lower than they would otherwise have been and has to some extent strengthened confidence in the currencies concerned. But the narrowing discounts appear to have encouraged increased smuggling of domestic bank notes abroad because of the smaller losses from the sale of these notes, thereby

feeding overseas markets with fresh supplies that could be freely imported.

In addition to permitting the free importation of domestic bank notes by travelers, Belgium went further by authorizing Belgian banks in March 1949 to open so-called "bank note accounts" on behalf of foreigners to be credited with the value of such notes sent in by foreigners; and balances in such accounts could be used to make *any* payments to Belgium, could be transferred to other foreigners, or could be freely repatriated to the foreign countries concerned. The narrowing of the overseas discounts on Belgian bank notes, however, not only made it more attractive for residents to smuggle out notes in excess of the legal limits, but also made it possible, by triangular operations, for residents of third (European) countries, anxious to acquire dollars or Swiss francs illegally, to do so more cheaply through this than through other channels. Because of the resulting pressure on Belgium's balance of payments *vis-à-vis* Switzerland and certain other countries, a number of changes were subsequently made in the "bank note accounts" system and by June 1951 it was abolished altogether.

Private Compensation Deals

Foreign exchange has also been illegally acquired by residents of a country, for capital flight or other purposes, via the transactions sometimes referred to as private compensation deals or inland payments. In the simplest form, a resident of country X agrees to make a payment or to hold balances in X on behalf of a resident of country Y with whom he is in contact, in return for which the resident of Y agrees to hold balances or to make a payment in Y on behalf of the resident in X. At least one of the countries concerned has an exchange-control system, and both might have it. More frequently, the process is institutionalized into an organized international business, the individuals concerned dealing only with brokers who have contacts with brokers in other countries. Thus, for example, a resident of X pays local currency to a broker in X in return for which the latter, through his foreign contacts, makes a payment on the former's behalf to a person whom he designates in Y; and a resident of Y pays local currency to a broker in Y who makes a payment on the former's behalf to a

person whom he designates in X. The rates of exchange at which these inland payments are effected tend of course to quote the softer (or less hard) currencies at a discount relative to the official rates.

A large part of this business is centered in Switzerland in the hands of business houses, small banks, and agents of all kinds who arrange private compensation transactions not only between Switzerland and individual foreign countries but also between foreign countries themselves. Thus, a resident in country X might transfer funds to country Y by paying local currency to a broker in X who in turn arranges the payment in Y through Switzerland, which acts as a clearing center. A market of this kind for inland payments in various foreign countries is also centered in New York in the hands of various exchange dealers, who regularly quote rates for the different currencies involved.⁴⁶ An American, who has a remittance or certain other payments to make to an exchange-control country abroad and who is attracted by the favorable "inland rate" on that currency, will pay his dollars to a New York dealer, who credits the dollars to his contact abroad; and the latter makes the payment to a designated foreign beneficiary. The dollars in New York are in turn paid over to some party here designated by a client of the foreign contact, thereby providing a channel whereby foreigners can illegally acquire dollars to build up balances or to make unauthorized expenditures in this country. Substantial payments through this channel have apparently been made by Americans during the postwar period to France, Italy, Greece, Austria, Germany, and sterling area countries.

Smuggling Out of Goods

In a number of countries, especially those with weak border controls or long, unguarded frontiers, the smuggling out of goods to neighboring countries so as to avoid the surrender of the foreign exchange earnings to the authorities⁴⁷ has been an important avenue for the escape of domestic capital. Contraband exports are

⁴⁶ See A. H. Von Klemperer, "Present Foreign Payments Practices in the United States," *International Monetary Fund Staff Papers*, April 1952, pp. 210-211. The type of sterling traded in New York for this purpose usually goes under the name of "resident sterling."

⁴⁷ Or the forced sale of such earnings on local free exchange markets.

reported to have been of considerable importance during the post-war period in such widely separated countries as Western Germany, Colombia, Indonesia, and Iraq.⁴⁸ In some cases this traffic is tied in directly with contraband imports.

Exchange Irregularities

Domestic capital has sometimes illegally escaped, even from countries with efficient systems of exchange restrictions, because of the failure of residents to turn over to the authorities exchange which they have earned from certain *invisible* transactions. While control of the proceeds of merchandise exports usually presents no major problem (if exception is made for underinvoicing and smuggling) because of border controls, customs regulations, licensing, etc., the capturing of the proceeds, in whole or in part, of certain invisible transactions is often technically difficult because of the nature of the transactions themselves, which cannot so easily be subjected to official supervision. Remittances from relatives and friends and receipts from foreign tourists have already been mentioned, but other examples would include payments by foreigners to residents of fees, commissions, and royalties, and in some cases even of interest and dividends, shipping charges, and certain capital payments.

Foreign exchange has at times been illegally acquired from the authorities at official rates, even under systems of exchange control managed with relative efficiency, by faking documents, etc. that have no counterpart in actual or contemplated authorized transactions; by "padding" valid requests for exchange, e.g., for travel, charitable remittances, etc. (the special case of overinvoicing of imports has been referred to earlier); or by other such devices. Exchange-control administrators have long been aware of the facts that the precise dividing line between "legitimate" and "illegitimate" requests for foreign exchange is often hard to draw

⁴⁸ General Clay reported early in 1949 that goods smuggled out of Western Germany amounted to as much as 25 per cent of total exports. Apparently the bulk of the smuggling occurred between the French Zone and the Saar. See *Journal of Commerce*, February 14, 1949. For the case of Colombia, see *The Basis of a Development Program for Colombia*, Washington, D.C., International Bank for Reconstruction and Development, 1950, pp. 332-333. For Indonesia, see the Report of Hjalmar Schacht to the Indonesian Government in October 1951, released in English translation by the Consulate General of Indonesia, New York, 1951, p. 24.

in actual practice, and that unauthorized capital transactions can sometimes masquerade under the guise of permissible current-account ones.⁴⁹

Premium Gold Deals

Many individuals wishing to protect themselves against anticipated depreciations of their currencies or to hedge against internal political and social upheavals have, instead of building up foreign exchange balances abroad, bought gold on local or on overseas gold markets where such exist. A speculative desire to profit from anticipated increases in the price of gold has been another factor in private gold demand; and in some Far Eastern countries gold hoarding is part of the normal saving patterns. The manifold disturbances of the postwar period have created an exceptionally strong hoarding demand for private gold; it has been estimated that from 1946 to 1952, inclusive, no less than 1.8 billion dollars of gold found its way into private hoards.⁵⁰ The chief gold markets of the world are located in various Far Eastern and Middle Eastern centers, such as Beirut, Bombay, Alexandria, and

⁴⁹ Typical examples of some of the difficulties encountered in these particular respects by exchange-control administrators are provided by the following quotation from the *Administration Report of the Controller of Exchange of Ceylon* for 1950, Colombo, 1951, pp. 10-11:

"Persons intent on evading the control adopted many new ways and means of doing so. The following were some of the devices: alteration of passport endorsement of exchange releases; removal of pages of the passport bearing endorsement of exchange releases; the import from India of V. P. letter packets valued at amounts ranging from Rs. 25 to Rs. 100 each containing nothing of any value; remittances to India against bogus invoices in respect of alleged imports of books and periodicals; export of various commodities as gift parcels, the contents of such parcels being grossly undervalued; false medical bills supporting requests for medical treatment abroad; forged employers' certificates in respect of the income of applicants. All these devices were resorted to by temporary residents in Ceylon who wished to transfer funds to India.

"It is regrettable to record a growing tendency on the part of Ceylonese to assist actively in the evasion of exchange control. Many cases were detected during the year in which Ceylonese had obtained their basic ration for travel to India in circumstances which made it most likely that the intention was to make this exchange available in India to persons who had been unable to obtain permits for transfer of funds to India."

Another common device in a number of countries in the Middle East has been to organize bogus pilgrimages; the exchange is made available, but the pilgrimages do not take place.

⁵⁰ See *Annual Report of the Bank for International Settlements, 1952-53*, Basle, 1953, p. 149.

Hong Kong, and private gold markets also exist in a number of Western European and Latin American countries. In most of these cases, private gold hoarding and domestic gold trading are perfectly legal, although restrictions are usually imposed on the import and export of gold on private account. Prices in these markets most commonly range in excess of official gold prices, even when the former are converted into dollars at free or black market exchange rates.

These premium prices have naturally tended to draw gold (which is usually smuggled in) from gold-producing countries and even from the official reserves of foreign countries.⁵¹ Since payment generally has to be made in dollars, which are not made available for this purpose by local exchange-control authorities, importers who smuggle in the gold must obtain dollars illegally and do so by one or another of the various illegal devices mentioned earlier in this section. Where payment is accepted in local currencies, the foreign sellers must convert the proceeds back into dollars and do so through similar illegal channels. International gold transactions at premium prices naturally involve a loss of official monetary reserves to the importing countries—and in this respect they are similar to capital flight or other unauthorized exchange expenditures—and also deprive monetary authorities in general of gold which they might otherwise have acquired; they also directly or indirectly produce exchange transactions at depreciated rates. Premium gold transactions have, obviously, been of continuing concern to the International Monetary Fund.

Triangular Exchange Deals

Individuals in exchange-control countries wishing to obtain *dollars* or other specific currencies that are denied them by their authorities may sometimes find it easier or more advantageous to do so through third countries. Thus, for example, the broad facilities of the black market in France and the free dollar market in Switzerland have prompted some residents of other European or outside countries to acquire their dollars indirectly by first acquiring French or Swiss francs, illegally or otherwise. An appar-

⁵¹ In a few cases, gold markets have been supplied *internally* from local gold production or official reserves.

ently commoner variety of this type of operation in the postwar period has been for residents of a country in a given monetary area, within which private capital transfers are free, to shift funds to other parts of the area where laxer exchange-control administration permits an easier conversion into dollars than at home. A substantial amount of British and French capital, for example, is believed to have migrated to outlying parts of the sterling and franc areas, respectively, for this specific purpose. In the case of the sterling area, moreover, a free dollar market exists in Hong Kong which, at least until the imposition of controls over sterling transfers, enabled some British capital to escape into dollars through this particular channel.⁵²

Profitable opportunities for exchange arbitrage often result from the wide spreads existing between official exchange rates, on the one hand, and black or free market rates, on the other, and provide an incentive for evading the controls. Exchange is thus sometimes illegally acquired at official rates so as to profit from its resale at black or free market rates at home. But more complicated deals involving three or even more currencies have often occurred. One of the many such examples is provided by Indochina before the devaluation of the Indochinese piastre in May 1953. Until that date, the piastre was officially pegged at 17 French francs to the piastre, equivalent to about 20.5 piastres to the dollar. The black market rate for dollars in Saigon just before the devaluation, for example, was about 50 piastres to the dollar. It was, therefore, profitable to buy dollars on the black market in Paris at about 400 francs to the dollar, transfer the dollars to Indochina where they were sold at 50 piastres to the dollar, and then convert the piastres back into francs at the official rate of 17 francs to the piastre (a process facilitated by lax exchange controls in Indochina). Handsome profits were made on these deals by the arbitragers; the black market in Saigon was fed with fresh

⁵² For example, in July 1948 a regulation provided that all transfers of funds between Hong Kong and the rest of the sterling area in excess of 500 pounds would require specific authorization. In June 1950, moreover, the British imposed restrictions on the freedom with which the sterling assets of residents of Hong Kong could be used. The purpose of these restrictions was not only to close a loophole through which capital could escape from sterling into dollars but also to prevent overseas countries from obtaining sterling at subparity rates for the purchase of sterling area products.

supplies of dollars; and the Indochinese authorities suffered direct drains on their franc reserves.⁵³ Sometimes the facilities of the Hong Kong free market were used in that dollars were sold in Hong Kong for piastres at the rate of about 50 piastres to the dollar; the piastres were transferred to Indochina and there converted into francs at the official rate. The francs were then used to buy dollars on the Paris black market and the circuit was recommenced.

Cheap Sterling Deals

References have already been made to several categories of "cheap sterling" traded in New York and other centers, including "security sterling," "resident sterling," and sterling bank notes. There is, however, a far more important variety of cheap sterling which, while not directly related to the subject matter of this study, deserves brief mention in passing. This comprises "transferable-account" and "bilateral-account" sterling acquired by a large number of specified countries as a result of their current transactions with the sterling area. While this sterling has a substantial measure of transferability, either automatically or by administrative decision of the Bank of England, into other currencies for current expenditures, it cannot legally be converted into dollars. Nevertheless, *de facto* convertibility into dollars at depreciated rates is made possible through complicated deals involving the concealed transshipment to the United States of sterling area goods purchased with such sterling. The foreign owner of the sterling (or his agent) is in this way enabled illegally to obtain dollars to convert into his local currency at fancy black market prices or with which to buy goods and services in the United States that would not otherwise be obtainable; in some cases, moreover, the dollars are held in the United States for purposes of capital flight. The Americans who purchase the cheap sterling are enabled to acquire goods and services in the sterling area more cheaply than if they had bought sterling at the official rate; and the sterling area loses dollars that it would otherwise have ac-

⁵³ The writer cites this particular example because he had the opportunity of observing the process at work during a short mission to Indochina in the spring of 1953.

quired. During the past year, however, the volume of cheap sterling deals has fallen off sharply and the rates for cheap sterling have strengthened very considerably.

VI. ILLUSTRATIONS

In this section we will give illustrative examples of some of the major speculative and flight movements of capital that have occurred during the postwar period and assemble some of the limited statistical material available.

Movements between the Sterling Area and the Dollar Area

It would be superfluous here to emphasize the strategic importance in international trade and finance of the transactions between the sterling area and the dollar area. Suffice it to say that the pattern of the balance of payments between these two areas, and between Great Britain and the United States in particular, has at times been greatly affected by disequilibrating movements of capital which have served to accentuate the payments swings on current account between the sterling and dollar worlds. The bulk of these movements appear to have been of the speculative variety, especially in the spring and summer of 1949 and in the fourth quarter of 1951 and first quarter of 1952, when widespread expectations of a depreciation of sterling led to heavy speculative outflows from the sterling area to the dollar area primarily via the leads and lags effect and operations in the forward market. Expectations of a depreciation of the pound also played a part during the sterling convertibility crisis of mid-1947 and likewise prompted some speculative outflows of capital, but the disequilibrating capital outflows that took place at that time seem to have been motivated mainly by a desire to take advantage of the convertibility privileges while they lasted and to have involved primarily the conversion of foreign *official* balances held in London.

On certain occasions the net flow of liquid funds was in the opposite direction. Thus, following the 1949 and 1951-1952 crises there was some reflux of capital to the sterling area in view of a restoration of confidence in sterling, e.g., commercial payments practices reverted more to normal, and traders and others who

had gone short on sterling covered their requirements. In late 1950, moreover, there was a modest speculative capital movement from the dollar area to the sterling area in view of an expected appreciation of sterling as against the dollar.

Unfortunately, statistical information regarding these movements is exceedingly meager and their magnitude can be arrived at only indirectly. A number of writers have, for example, resorted to the residual method, i.e., they have computed the residuals between the payments balances and the balances on trade and other known accounts between the sterling area, on the one hand, and the United States and Canada, on the other; and they have attributed unusually large shifts in these residuals to the influence of speculative capital movements.⁵⁴ A similar though less reliable method is to follow the changes in the "residual item" in the balance of payments of the United States with the sterling area, as computed by the United States Department of Commerce. These various calculations, rough as they are, tend to bear out what is generally known regarding the direction and probable order of magnitude of the speculative capital movements between the sterling area and the dollar area (or the United States alone) in that unusually large shifts in the calculated residuals, and in the expected directions, have tended to occur on those occasions when these movements were known to have occurred on a large scale. But the calculations are subject to so substantial a margin of error that there is no point in presenting them here.⁵⁵

Theoretically, if the statistical coverage were complete, the effects of leads and lags and of forward exchange operations on the movement of capital should show up in the monthly capital movements data of the United States Treasury Department. During the 1947, 1949, and 1951-1952 sterling crises, for example, it would be expected, in keeping with our analysis in an earlier section, that the short-term sterling and dollar claims of the United

⁵⁴ See, e.g., J. J. Polak, "Contribution of the September 1949 Devaluations to the Solution of Europe's Dollar Problem," *International Monetary Fund Staff Papers*, September 1951, pp. 28-32; and S. I. Katz, "Leads and Lags in Sterling Payments," *Review of Economics and Statistics*, February 1953, pp. 75-80.

⁵⁵ But see Polak, *op.cit.*, pp. 30-31. He concludes on the basis of his calculations that the speculative outflow from the sterling area to the dollar area in the third quarter of 1949 may have amounted to about 150 million dollars and that a reverse movement of about 100 million dollars may have occurred in the following quarter.

States on Great Britain (consisting chiefly of claims arising out of foreign trade, and, in the former case, of some sterling deposits) would fall, and that short-term sterling and dollar liabilities (including in the latter case the dollar deposits held only for nonbank British parties) would rise.⁵⁶ Likewise, one would expect the opposite pattern during the periods of restored confidence in sterling or of expectations of an appreciation of sterling. The statistics during the relevant periods, however, reveal no major movements in short-term *dollar* claims and liabilities of the sort that might have been expected.⁵⁷ On the other hand, short-term *sterling* claims and liabilities were generally much more responsive at these periods and moved in the expected directions.⁵⁸ However, it seems reasonably clear that the coverage of the statistics is not complete and that a large part of the speculative movements of capital between the United States and the sterling area have found their way into the residual item in the United States balance of payments with that area.⁵⁹

The periods of major speculative interest in sterling, it might be noted, are clearly indicated by the movements of the forward pound rate in the New York market. In periods when the pound was expected to depreciate against the dollar, net selling pressure by commercial interests and speculators led to widening discounts

⁵⁶ We refer here only to the short-term claims and liabilities of reporting American banking institutions, since the claims and liabilities of American foreign traders and commercial concerns (when not held through such institutions) are published only annually.

⁵⁷ Except, perhaps, during the 1951-1952 crisis when private nonbank British deposits in the United States rose by 50 million dollars (between August 1951 and March 1952).

⁵⁸ Thus, for example, the sterling claims of American banks (all figures in dollars) declined by 19 million in the five months ending August 1949, while their sterling liabilities rose by 11 million; in September and October 1949, on the other hand, claims rose on balance by 55 million and liabilities declined by 19 million. During September and October 1950, when appreciation of sterling was expected, claims rose by 98 million and liabilities declined by 12 million; in the subsequent three months, with the subsidence of this rumor, claims declined by 57 million, although liabilities continued to decline. Finally, from June 1951 to January 1952, claims fell by 75 million, while from September 1951 to February 1952 liabilities rose by 78 million; liabilities declined sharply thereafter, and claims rose slightly.

⁵⁹ This is admitted by the U.S. Department of Commerce in its *The Balance of Payments of the United States, 1949-51*, pp. 8 and 117. Curiously enough, however, the Department implies that the leads and lags effect applies only to those short-term claims and liabilities of foreign traders and commercial concerns which are *not* held through banking institutions.

on the forward pound; when appreciation was expected (as in July-August 1946 and in September-October 1950), net buying pressure resulted in the emergence of small premiums on forward sterling. At all other times, the forward rate remained very close to the spot rate, although it was customarily at a discount. A study of the interesting developments in the pound-dollar forward market in New York and, after December 1951, in London would, however, be outside the scope of this paper.

France

Probably no country in the world better illustrates the operation in actual practice of the various motives and mechanics of flight and speculative capital movements, as outlined in earlier sections of this paper, than France. No major country has, over the years, suffered more from wars and from continuous internal and external depreciation in the value of its money. As a result, the French people have long since become exceedingly conscious of and sensitive to these developments and rumors of such; and the tradition has been firmly established of keeping substantial funds abroad, and of hoarding gold, to ensure against such contingencies. In such a psychological atmosphere, every little development that would seem to presage inflation, exchange depreciation, or war is sufficient to provoke a flight of capital.⁶⁰

The major financial and political disturbances that have occurred in France during the postwar years, including inflation, exchange depreciation, internal political instability, and war scares, have perpetuated and indeed intensified this capital flight sensitivity on the part of the French people. Not only has there been a creeping exodus of private capital from France during most of the postwar period as a whole, but the exodus has been

⁶⁰ "Inflation is not something which is new to the average French citizen. More times than he cares to remember, he and his parents have seen the value of savings virtually swept away by successive falls in the value of money. . . . He is, therefore, apt to react decisively even to comparatively small indications of a repetition of such experiences and to seek to change his wealth into forms which have more lasting value." See *The Internal Financial Situation*, Report by a Group of Independent Experts, Paris, Organization for European Economic Cooperation, 1952, pp. 21-22. In this connection one might recall the famous "psychological theory" of foreign exchange of Professor Aftalion, which was clearly developed in the light of French experience.

powerfully accentuated during major French balance-of-payments crises, notably in the winters of 1948-1949 and 1951-1952. The bulk of this capital has apparently gone to the United States and Switzerland. That such capital movements, as well as the flight into gold, have been exceedingly large is a notoriously well-known fact, but no reliable statistical information is available. Unofficial estimates, of uncertain value, generally place the total of French postwar capital flight into hard currencies and gold at between 400 million and 600 million dollars a year.⁶¹ On a number of occasions there was a net repatriation of French capital from abroad⁶² (and some inflows of private foreign funds), but for most of the period the net movement of private capital has been conspicuously outward.

Intra-European Movements

Large speculative and flight movements of capital have taken place between the various countries of Western Europe during the postwar period.⁶³ These movements have been associated with periodic expectations of changes in Western European exchange rates *inter se* and with the fact that certain of these countries, notably Switzerland and Belgium, have been regarded as good places of refuge for flight capital escaping from others.⁶⁴ Move-

⁶¹ See *Economic Survey of Europe in 1951*, Geneva, Economic Commission for Europe, 1952, p. 87n. For a careful study of the role of disequilibrating capital movements in the French crises of 1948-1949 and 1951-1952, with some useful statistical estimates, see H. C. Eastman, "The Role of Speculation in French Foreign-Exchange Crises," *Journal of Political Economy*, June 1953, pp. 209-220.

⁶² For French attempts to encourage the repatriation of French capital illegally held abroad, see below, pp. 63-64.

⁶³ Other, more normal, private intra-European capital movements have consisted of amortizations and redemptions of securities, repatriations of long-term foreign capital, and a small amount of security flotations and direct investments. For a discussion of such capital transactions and the regulations governing them, see *Intra-European Investments*, Paris, Organization for European Economic Cooperation, 1951.

⁶⁴ One writer has described the characteristics of postwar intra-European capital movements (normal and abnormal) as follows: capital has tended to move from the most inflated to the least inflated countries; from countries with suppressed inflations to those with open inflations; from soft to hard currency countries; and from countries engaged in large-scale nationalization programs to countries not so engaged. See M. L. Hoffman, "Capital Movements and International Payments in Postwar Europe," *Review of Economics and Statistics*, November 1949, p. 262. While some exceptions come immediately to mind, these characteristics may be broadly conceded.

ments of this kind have been facilitated by the large volume of economic intercourse between these countries (e.g., foreign trade and tourist travel), by their geographical proximity (which facilitates the smuggling of goods and bank notes), and by the special payments arrangements and sometimes more lenient exchange restrictions among them (which often provide loopholes whereby capital can escape more easily). Speculative and flight movements have characteristically accentuated intra-European payments imbalances and have posed troublesome problems for European currency managers.⁶⁵

An extremely rough indication of the direction (and even the order of magnitude) of private intra-European capital movements may be obtained by a comparison of the intra-European trade balances and payments balances (under intra-European payments schemes) of the various individual European countries; the relevant statistics are readily available from the beginning of 1949.⁶⁶ Although the differences between an individual country's balance of trade and its payments balance with all other Western European countries as a group reflect a miscellany of many items, including service transactions and private capital movements in general, unusually large changes in the size of these residuals over short periods are apt to indicate the existence of outward or inward hot money movements, especially of the leads and lags sort, which have found their way into the payments balances.⁶⁷

Despite their obvious limitations, these statistical series, supple-

⁶⁵ See, e.g., *First Annual Report of the Managing Board of the European Payments Union, 1950-51*, Paris, Organization for European Economic Cooperation, 1951, pp. 37-38: "... capital movements are taking place towards the stronger [EPU] currencies, with a tendency to increase the creditor position of such countries. This poses a serious problem. . . . Fundamentally, this problem arises because, though all members of the EPU are working towards the same end, some of them are much nearer to convertibility than others. . . ."

⁶⁶ See *Annual Report of the Bank for International Settlements, 1951-52*, Basle, 1952, p. 245, where the figures are given on a quarterly basis for 1949-1951, inclusive. The monthly figures since June 1950 are available in *Foreign Trade*, a monthly publication of the Organization for European Economic Cooperation. The figures for Belgium, France, the Netherlands, Portugal, and the United Kingdom apply to the whole monetary areas of these countries.

⁶⁷ The statistics indicate that trade surpluses were characteristically accompanied by even larger payments surpluses, and trade deficits by even larger payments deficits. This pattern is a strong indication of the disequilibrating character of intra-European capital movements.

mented by other information, suggest the following conclusions as to the probable direction of some of the major intra-European hot money movements since the beginning of 1949:

1. In the third quarter of 1949, heavy speculation against the pound in view of expectations of its devaluation relative to other European currencies apparently led to a heavy movement of capital from Great Britain (and the sterling area as a whole) to the Continent, especially to France and Italy. In the fourth quarter of 1949, however, part of this capital appears to have returned, after the realignment of exchange rates had occurred.

2. In the third quarter of 1950 there was evidence of a large outflow of capital from Germany associated with that country's crisis in the European Payments Union, which led to rumors of a devaluation of the Deutsche Mark.

3. A very heavy net inflow of foreign capital into Great Britain in the fourth quarter of 1950, and especially in October of that year, was associated with strong rumors of a pending appreciation of the pound. The inflowing capital came chiefly from Belgium, Germany, Italy, the Netherlands, and France, and mainly reflected the leads and lags effect and operations in the forward market.

4. In the last half of 1951 and the first half of 1952 there was a massive movement of capital to Western Europe from the sterling area as a result of the British balance-of-payments crisis and expectations of a depreciation of the pound. Switzerland, Italy, Belgium, and Sweden appear to have been the main recipients of this capital. The statistics also point to a large net capital outflow from France in the last quarter of 1951 in keeping with that country's payments crisis.

5. The statistics for the last quarter of 1952 suggest large capital outflows from Germany and France and inflows to Great Britain.

6. Over the period 1949-1953 as a whole, Switzerland and Belgium were large net importers of flight and speculative funds from other Western European countries. Smaller amounts of capital went on balance to Portugal (apparently mainly flight capital) and to Sweden.⁶⁸

⁶⁸ Great stress has been laid in the Swedish banking literature on the importance

7. Capital movements between Italy and the rest of Western Europe show an alternating pattern. In the first nine months of 1949 there were apparently substantial net capital movements to Italy, chiefly associated with the weakness of the pound and certain other European currencies; from July 1950 to March 1951 there was a considerable capital efflux associated with heavy advance payments for imports following the outbreak of the Korean war and with the rumors of an appreciation of sterling; and from April 1951 through most of 1952 there appears to have been a marked reflux of capital connected with the weakness of sterling and the French franc and with the working off of the advance payments for imports that had been made in the preceding period.

Corresponding data are not available for the earlier postwar years, but some of the major hot money movements of this period comprised a flow of funds from Belgium to Great Britain in 1946, a reverse flow in 1947-1948,⁶⁹ a capital flow from France to Great Britain in 1948, and a general movement to Switzerland and Belgium from other Western European countries during this period as a whole.

Canada

A spectacular net movement of private capital from the United States into Canada, amounting to almost 1 billion Canadian dollars, occurred in 1950. This movement, the largest in Canada's history, was concentrated mainly in the months of August and September and was chiefly associated with strong expectations of an appreciation of the Canadian dollar. Part of the capital inflow, however, represented long-term American investment in Canadian industry and natural resources in continuance, although on an accelerated scale, of a trend that had been going on for many years.

When the Canadian dollar was devalued by 10 per cent in Sep-

of alternating leads and lags effects in Sweden's postwar balance of payments. See, e.g., E. Westerlind, "Sweden's Balance of Payments," *Quarterly Review of Skandinaviska Banken*, July 1949, pp. 67-69.

⁶⁹ For example, Hoffman, *op.cit.*, p. 262, refers to the "steady, unwanted and apparently unstoppable capital flow [from Britain to Belgium], first repatriation of Belgian funds and later expatriation of British funds."

tember 1949 from its parity with the American dollar, there were many even then who felt that, in view of Canada's strong external and internal position, it would only be a matter of time before the former parity would be restored. Expectations of an appreciation of the Canadian dollar crystallized rapidly after the outbreak in mid-1950 of the Korean war, which generated strong inflationary pressures and which strengthened the belief in some quarters that Canada would upvalue its currency as it had, under similar circumstances, in July 1946. Much more important, however, were the favorable underlying long-run prospects for the Canadian economy and its balance of payments in view of the recent, rich discoveries of oil, iron ore, and other natural resources and of the great development boom that was going on in that country.⁷⁰ Sparked by these considerations, capital poured into Canada from the United States in order to profit from an expected exchange appreciation and from the attractive investment opportunities. The resulting rapid enlargement of Canada's international reserves served to strengthen the expectations of appreciation and to spur further speculative capital inflows in a self-inflamatory fashion.

During 1950 as a whole the aggregate net flow of capital into Canada from the United States (exclusive of changes in official Canadian holdings of United States dollars) amounted to 961 million Canadian dollars, the major components of which consisted of: net United States purchases of outstanding Canadian securities, largely Dominion of Canada bonds (362 million Canadian dollars); an increase in Canadian commercial indebtedness to the United States (203 million); an increase in American holdings of Canadian dollar balances (89 million); United States direct investments in Canada (200 million); and net repatriation by Canadians of direct investments in the United States and capital invested in American securities (109 million). Included in the total were large new issues and retirements of Canadian securities

⁷⁰ In 1950, however, Canada's over-all balance on current account had actually moved into a substantial deficit position of 334 million Canadian dollars, as compared with a surplus of 177 million in 1949, as a result of the virtual disappearance of Canada's surplus with the sterling area. Its current-account deficit with the United States alone actually declined by about 200 million.

in the United States (210 million and 263 million, respectively), but these were largely offsetting.⁷¹

Some of these components were unrelated to expectations of an exchange adjustment. American direct investments in Canada, for example, were of this sort, as were Canadian issues and retirements of securities in the United States.⁷² But the other components were undoubtedly influenced heavily by the anticipations of appreciation. The heavy net purchases of outstanding Canadian securities were unquestionably motivated predominantly by the exchange rate factor rather than by relative yields;⁷³ the large increase in Canadian commercial indebtedness to the United States points clearly to the leads and lags effect, with Canadian importers holding back payments in anticipation of a drop in the American dollar; the increase in American balances in Canadian banks probably represented mainly covering operations by American banks against their net sales of forward Canadian dollars to American clients stimulated by expectations of an appreciation of the Canadian dollar;⁷⁴ and some of the repatriation of Canadian capital in the United States may have also reflected the influence of the exchange rate factor. Altogether, then, it may safely be concluded that the aggregate net movement of capital to Canada from the United States in 1950 was predominantly of a speculative variety.

Under the impact of this massive capital movement to Canada, the unofficial rate for the Canadian dollar in the New York market⁷⁵ was quickly pushed up to the level of the official rate early

⁷¹ All these figures are taken from *The Canadian Balance of International Payments, 1952*, Ottawa, Dominion Bureau of Statistics, 1953, pp. 19-20. See also the *Annual Report of the Foreign Exchange Control Board for 1950*, Ottawa, 1951, pp. 13-15.

⁷² The timing of some of the Canadian corporate issues in the American market, however, may have been partly influenced by the exchange rate factor.

⁷³ Especially since in the three preceding years such net purchases had been negligible. In 1946 there had been large net purchases amounting to 241 million Canadian dollars, but yield considerations predominated in that year.

⁷⁴ The rate for the forward Canadian dollar, which had formerly been at a discount, went to a premium in the New York market in the summer of 1950 under the influence of heavy forward buying by Americans.

⁷⁵ From September 1939 until September 1950 there existed in New York an unofficial market for the Canadian dollar through which Americans could sell to other Americans, at rates freely determined, their Canadian dollars resulting from the liquidation or redemption of their holdings of Canadian direct invest-

in 1950, and the capital thereafter entered Canada through the official market, thereby swelling Canada's official reserves of United States dollars and gold markedly. Between June 30 and September 30, 1950, official reserves rose by no less than 696 million Canadian dollars (including a small increase in sterling holdings).

Faced with this self-inflamatory inflow of speculative capital which, far from benefiting Canada, added to internal inflationary pressures and to Canada's gross foreign debt and annual service charges, the Canadian authorities finally decided to let the Canadian dollar go free on September 30, 1950.⁷⁶ At first, Canada's foreign exchange regulations remained essentially unchanged, but on December 14, 1951, these regulations were abolished entirely and even domestic capital was thenceforth free to move out of the country. In announcing the abolition of exchange control, the Canadian Minister of Finance pointed out that Canada would rely on the general handling of its domestic economic situation to keep Canada in reasonable balance with the rest of the world and the Canadian dollar at an appropriate relationship over the years with foreign currencies.

Since September 30, 1950, Canada's policy has been to allow its exchange rate to be determined freely by market forces; the au-

ments and internal Canadian securities, and from certain other capital transactions; and through which Americans could acquire Canadian dollars, usually at a discount, for new investment in Canada, for tourist outlays, and for certain remittances to Canada. Only to the extent that tourist expenditures and remittances were settled through the unofficial market did that market's facilities enable a net export of American capital from Canada to take place or deprive Canada of international reserves that it might otherwise have gotten. For some capital transactions, e.g., redemption and sinking-fund payments to Americans on their holdings of Canadian securities denominated in U.S. dollars, American exchange was made available at the official rate.

⁷⁶ An alternative would of course have been to move the Canadian dollar back to parity with the United States dollar. But as Canadian Minister of Finance Abbott pointed out in announcing the decision: ". . . such a change in the exchange rate would not necessarily be justified by fundamental conditions and might be found to require reversal or further adjustment within the not-too-distant future. To move the Canadian exchange rate to any other fixed point than parity with the United States dollar would be open to the same objections. . . . In short . . . no person can determine in advance with any reasonable assurance a new level at which to fix the par value of the Canadian dollar, and for this reason the Government feels that the rate of exchange should be left to be determined by market forces."

One consequence of the freeing of the rate was the disappearance of the previous unofficial market in Canadian dollars.

thorities have intervened only to smooth out excessive short-run fluctuations in the rate and to ensure orderly conditions in the market. Since the authorities have neither accumulated nor decumulated monetary reserves on any substantial scale in an attempt to control the rate, net capital movements to or from all countries have tended to equal Canada's current-account balance with all countries, this equality being achieved through fluctuations in the rate for the Canadian dollar *vis-à-vis* foreign currencies. And yet these fluctuations have been relatively small.

With the freeing of the rate on September 30, 1950, the Canadian dollar immediately moved up to about 95 United States cents and remained at approximately that level, with minor fluctuations, until the end of 1951, when it again began to move steadily upwards. By mid-January 1952 it had reached parity with the American dollar and continued thereafter to rise to a premium of over 4 per cent by September 1952. A receding tendency followed, and by early 1953 the Canadian dollar had declined to about parity, around which level it has since remained.

A large net capital inflow into Canada from the United States, amounting to 554 million Canadian dollars, again occurred in 1951, but this was of an essentially different character from the inflow in 1950, since it consisted almost entirely of direct investments of 270 million and large net Canadian issues in the United States (i.e., new issues minus retirements) of 245 million. Some of the Americans who had exported capital to Canada in 1950 in anticipation of an appreciation of the Canadian dollar undoubtedly liquidated their holdings in order to take their profits, but such repatriation was more than offset by the new capital inflows from the United States for productive purposes. The large aggregate net capital inflow from the United States in 1951 (the net capital inflow from the rest of the world was negligible) was approximately offset by a Canadian deficit on current account with all countries of 517 million Canadian dollars.

Speculative movements of capital again came into play on a large scale during 1952, but in the opposite direction. As the Canadian dollar rose above parity, there were increasing anticipations that the rate movement would reverse itself, in part because of the deep-rooted belief that the "normal" relationship with the

United States dollar was in the close vicinity of parity. As a result, there was an increasing tendency during that year for Canadian importers to settle outstanding debts in the United States, to speed up payments for current imports from the United States, and to buy American dollars forward; and for Canadian exporters to delay the repatriation of their American dollar earnings. The slight forward premium prevailing on the American dollar during the year, in conjunction with higher short-term interest rates in the United States than in Canada, also made it attractive for Canadian banks to buy American dollars spot against forward sales. There apparently was also some profit-taking by Americans who had earlier moved capital to Canada in anticipation of an appreciation of the Canadian dollar. All of these factors combined to lead to a large net speculative outflow of capital from Canada. Canadian commercial indebtedness in the United States, for example, declined by 193 million Canadian dollars, while Canadian bank balances and other short-term funds in the United States (excluding official Canadian reserves) rose by 236 million. This net outflow more than offset a net inflow of long-term capital associated with continuing American direct investments in Canada and net Canadian issues in the United States, and resulted in an aggregate net capital outflow of 75 million Canadian dollars to the United States. Thus the speculative outflow of private capital from Canada in 1952 was of an equilibrating character in that it served to restrain and indeed to reverse the upward movement in the Canadian dollar resulting from net long-term capital inflows and from the current-account surplus of 151 million Canadian dollars which emerged in Canada's balance of payments with all countries in that year.⁷⁷ Provisional data for the first half of 1953, which show a swing back to an over-all current-account deficit, likewise point to an equilibrating mechanism at work in the form of speculative *inflows* of short-term capital induced by the decline of the Canadian dollar to the vicinity of parity.

Despite the large and sudden shifts that have occurred in Canada's current-account transactions and in some of its long-term capital movements during the past few years, the Canadian dollar

⁷⁷ For some comments on the equilibrating mechanism in floating rates, see below, pp. 79ff.

has moved within only a relatively narrow range. Strong centripetal forces, in the form of equilibrating short-term capital movements induced by relatively small fluctuations in the exchange rate, have tended to keep the Canadian dollar in the neighborhood of parity with the United States dollar and have thereby obviated the need for any large-scale official intervention in the exchange market in support of the announced policy of maintaining orderly conditions.

South Africa

In 1947 and 1948 there occurred a heavy net movement of private capital to the Union of South Africa, amounting to about 275 million pounds, of which a substantial part was of the capital flight variety.⁷⁸ The bulk of this movement originated in Great Britain, but some of the capital also came from Egypt, India, and other countries. These net capital inflows were accompanied by even somewhat larger deficits on current account which clearly could not have occurred on such a scale if capital of this magnitude had not simultaneously been pouring in.

A combination of factors had the effect of provoking a considerable flight of capital from Great Britain in 1947 and 1948: the uncertainty and pessimism created by the fuel crisis in the spring of 1947 and the sterling convertibility crisis in the summer of that year, the nationalization program and the talk of a capital levy in Britain, the fear that Britain might impose restrictions on capital exports to other parts of the sterling area, the Communist coup in Czechoslovakia and the renewed fear of a war with Russia, and the political troubles in the Middle East.⁷⁹ All of these factors created an atmosphere of uncertainty which prompted British capitalists to shift funds outside the country in the interests of safety. South Africa was chosen as a main place of refuge because of the political security which it seemed to offer, because of its booming economic conditions and attractive investment opportunities, and because of the complete freedom with which British capital could be transferred to that country. After mid-1948, however,

⁷⁸ Most of the inflow in 1948 occurred in the first half of the year.

⁷⁹ See, e.g., G. L. Sadie, "Funk Money and Its Aftermath," *South African Journal of Economics*, June 1951, p. 160.

the net movement of capital declined sharply, largely because of the political uncertainties created in the Union by the election at that time of the Malan government, and perhaps also because of the imposition by the South African and British authorities of certain restrictions on the movement of capital to South Africa.⁸⁰

Speculative movements of capital from Great Britain to South Africa apparently constituted only a minor fraction of the total flow. To be sure, there were rumors of a devaluation of the pound in the summer of 1947 and again in February 1948, but it seemed to be generally recognized that if sterling were devalued the South African pound (and other sterling area currencies) would probably follow *pari passu*.⁸¹

Part of the movement of funds to South Africa, probably somewhat less than half, was productively invested in industrial and mining (especially gold-mining) enterprises,⁸² and the remainder was held in bank balances, stock-exchange securities, and other liquid assets. This does not mean, however, that the part that was productively invested was devoid of any capital flight elements. On the contrary, some of the capital in this case undoubtedly was both attracted to South Africa by superior investment opportunities and repelled from Great Britain because of the considerations

⁸⁰ In March 1948 South African banks were instructed by the Union authorities to sell South African currency for sterling, other than for current-account transactions, only for certain "approved" capital transactions. Since the latter included, among others, the purchase of South African securities, British residents were able to transfer capital to South Africa in that form and then liquidate the securities in the Union at will. This loophole was closed in July 1948 by a new regulation which specified that all South African securities purchased by sterling area residents (outside South Africa) had to be lodged with an authorized dealer in the Union and, if the securities were sold, the proceeds had to be repatriated or reinvested within twenty days. In April 1948 the Bank of England itself placed restrictions on the switching by nonresidents of the sterling area from British to South African securities.

⁸¹ In the *Annual Report of the South African Reserve Bank, 1947-48*, p. 9, however, it is argued that a large part of the capital inflow was apparently associated with fears of an early depreciation of sterling relative to the South African pound.

⁸² For example, it has been estimated that of the 400 million pounds of net capital inflows in 1946-1950, inclusive, about 100 million went to meet the needs of industrial development and about 100 million was invested in mining. See A. R. Conan, *The Sterling Area*, London, 1952, pp. 127-128. The ratio of productive investments was doubtless lower in 1947-1948 alone. By concluding that the hot money component was included entirely in the residue of 200 million, however, Conan overlooks the fact that some of the productive investments themselves in part incorporated capital flight elements.

noted above; it is obvious, however, that the relative importance of the "attracting" and "repelling" factors cannot be assessed.

In 1949-1952 there were continued, though reduced, net private capital flows to the Union of some 210 million pounds. The inflows of capital in these years were chiefly for mining and industrial development and were large enough to more than offset any repatriation or transfer to third countries that might have occurred in the case of the capital that had been imported in 1947-1948.

Australia

Throughout the postwar period as a whole Australia has been the recipient of large inflows of private foreign capital, of which the greater part was probably of the speculative variety based on anticipations of an appreciation of the Australian pound (which has been officially quoted at a discount of 20 per cent below the pound sterling). In the seven years ending June 30, 1953, the aggregate net capital inflow on private account amounted to over 650 million Australian pounds, of which well over half was concentrated in the two years ending June 30, 1950. Most of this movement consisted of British capital.

Much of this inflow was undoubtedly of a "normal" variety representing productive long-term investment in Australian industry and natural resources based on the attractive postwar investment opportunities in that country. Of the aggregate net inflow on private capital account of about 450 million Australian pounds in the three years ending June 30, 1950, for example, it has been officially estimated that some one-third was of this sort;⁸³ and the corresponding ratio for subsequent years has undoubtedly been much higher. Over the postwar period as a whole, however, the movement has been heavily influenced also by a widespread belief that the Australian pound would be appreciated, perhaps even to a parity with sterling. As far back as the end of 1946, there had been rumors of an appreciation in view of Australia's strong balance-of-payments position at that time and of the fact that Australian prices had been kept down relative to British prices during World War II and in the early postwar period. These rumors became especially strong and widespread in 1948-1950 when, as a

⁸³ See *Annual Report of the Commonwealth Bank of Australia, 1949-50*, p. 28.

result of the inflationary upswing in Australia, it came to be believed that appreciation would be resorted to as an anti-inflationary measure. The rumors were strengthened by the rapid rise in Australia's international reserves, resulting from the inflow of capital itself and from moderate current-account surpluses,⁸⁴ by the added stimulus to the inflation caused by the capital imports, and perhaps by the fact that in August 1948 the New Zealand pound was appreciated to parity with sterling. Although the Australian authorities persistently denied that appreciation was contemplated, and in fact permitted the Australian pound to depreciate *pari passu* with sterling as against the dollar in September 1949, these rumors persisted until as late as the middle of 1951.⁸⁵

Whatever their logic, rumors of an appreciation of the Australian pound led to heavy speculative movements of capital to Australia, largely from Great Britain.⁸⁶ Much of this incoming capital went into deposits in Australian banks pending an anticipated repatriation at a profit when the appreciation occurred; some of the funds were also placed in government bonds and industrial shares in order to yield an additional return pending the expected exchange adjustment. The leads and lags effect was likewise in evidence. For example, Australian importers tended to delay their payments abroad for as long as possible (although in July 1951 the authorities finally took steps to limit this practice); while foreign importers tended to pay for Australian exports in advance. Other foreign importers covered their exchange requirements in the forward market.

The rumors of an appreciation of the Australian pound, which had become less widespread by the spring of 1951, virtually disappeared in the late months of that year with the dramatic de-

⁸⁴ In the year ending June 30, 1950, Australia had a slight deficit on current account, but this was more than offset by the inflow of capital, with the result that reserves continued to rise.

⁸⁵ The authorities also tried to discourage the inflow of foreign funds by calling attention to their legal right, under regulations dating back to the thirties, to prevent the repatriation of such funds. But these implied threats were not effective.

⁸⁶ Americans do not appear to have taken seriously the rumors of an appreciation of the Australian pound, except in the last few months of 1950, when American importers rushed to cover their requirements in the forward market and when there were some outright speculative purchases of Australian pounds forward in the New York market.

terioration in Australia's balance of payments on current account and in its international reserves. There continued, however, to be net inflows of private capital in 1951 and 1952, but these were on a reduced scale as compared with earlier years and seem to have predominantly reflected long-term productive investment. Some repatriation by individual foreigners of funds that they had sent to Australia in expectation of an exchange adjustment undoubtedly occurred, and commercial payments practices tended to revert to more normal patterns (involving some reversal of the earlier leads and lags effect), but such outward movements were more than offset by new capital inflows. There is reason to believe, moreover, that holders of some of the foreign capital that had moved to Australia in earlier years in anticipation of exchange appreciation may have decided to keep it in Australia, in more permanent forms of investment, when the rumors of appreciation had subsided. (It is probable that a similar shifting of motives also occurred to some degree in the case of the foreign capital that had moved to Canada and South Africa.) In the first half of 1953, however, there was an apparently small net outflow of private capital from Australia.

Uruguay

In the period immediately following the outbreak of the Korean war, the emergence of acute fears of another world war set into motion a considerable volume of capital flight from Western Europe. While much of this capital moved to the United States and Switzerland, some of it sought other centers because of a belief that, if a world war broke out, the United States would again block the dollar assets of European countries and Switzerland would this time get involved in the war. One of the centers chosen was Uruguay, and during the summer of 1950 there was an apparently substantial movement of capital, including European funds already held in the United States, to that small country. (Smaller amounts of European capital moved to other Latin American countries, notably Mexico, Venezuela, Panama, and Cuba.)

Uruguay, "the Switzerland of the Western Hemisphere," was selected as a place of refuge for a number of reasons. It had a free exchange market through which capital could freely come

and go or be converted into dollars, other currencies, and gold. It was far from possible involvement in a war or enemy attack. It enjoyed reasonable internal political stability and was generous in its taxation and supervision of foreign long-term capital. Finally, it was in the midst of an economic boom associated with soaring wool prices following the outbreak of the Korean war.

No reliable estimates are available regarding the magnitude of the aggregate flow of capital to Uruguay during this period, especially since most of the capital passed through the hands of exchange brokers and private banks in the free market rather than through official channels. Unofficial estimates have ranged from 125 million to 450 million dollars, but the correct figure was probably closer to 200 million. Not all of this, moreover, represented a true movement of capital in the sense of the acquisition of Uruguayan pesos, since part is known to have taken the form of deposits by foreigners of gold and securities in local safe deposit boxes. In some instances, in addition, Uruguay served merely as a transit station, in that dollar accounts were opened through Uruguayan banks by Europeans who preferred to hold their dollars under Uruguayan rather than European names (since Uruguayan dollar balances would be less likely to be blocked by the United States if a world war broke out). Only a small part of the European capital that was placed in Uruguay was invested on long term, since investment opportunities in that country were limited and in any case the owners wished to keep the funds in liquid form for quick repatriation or transfer elsewhere if the situation so warranted.

Under the impact of the capital inflow, the free peso rate rose sharply from about 2.85 pesos to the dollar in mid-June 1950 to about 2 pesos in January 1951. Part of the incoming exchange was purchased on the free market by the central bank in an effort to restrain too rapid a rise in the rate.

The movement of capital to Uruguay was short-lived, being chiefly concentrated in the three or four months following the outbreak of the Korean war. In fact, in the spring of 1951, with the subsidence of fears of another world war and with the collapse in wool prices and the rapid deterioration in Uruguay's international payments position, the flow of capital began to reverse itself.

In the year that followed, most of the European refugee capital that had entered Uruguay in 1950 appears to have been withdrawn.

VII. EFFECTS

The large-scale hot money movements that have occurred since 1945 have had, as already suggested in various sections of this paper, a number of highly disturbing results, both external and internal. These may be summarized briefly in this section.

Although the major international payments imbalance of the postwar period, especially that prevailing between the dollar and nondollar worlds, has undeniably been reflected predominantly in current-account transactions, there can be no doubt that hot money movements, in view of their disequilibrating character and their magnitude, have served to accentuate that imbalance considerably over the period as a whole. Speculative movements, moreover, have magnified the periodic swings in the current-account balances of individual countries and areas, notably in the case of the sterling area and France. Although some of these hot money movements, particularly the speculative ones, have, in part at least, been self-reversing, the flight capital that has sought refuge abroad has most commonly not returned to its countries of origin. Unfortunately, the whole problem cannot be cast in a statistical mold because of the inadequacy of available data.

Countries from which speculative and flight capital movements have on balance occurred have not only lost additional monetary reserves, thereby accentuating the general inadequacy of their reserve holdings, but have also been forced to maintain tighter restrictions on current-account expenditures over the period as a whole than would have otherwise been necessary. At times of periodic setbacks in their current-account balances, moreover, they have had to tighten these restrictions more sharply and suddenly than would have otherwise been the case. The progress that these countries might have made towards general trade and payments liberalization has, therefore, to that degree been reduced, to the detriment of the countries themselves and the world as a whole. The very fear of sudden, sweeping outflows of capital, especially at times of deterioration in their current-account bal-

ances, has, moreover, further discouraged countries with low monetary reserves from moving in the direction of liberalization, since part of their available reserves must in effect be earmarked to meet such contingencies.

From the viewpoint of those countries to which large net speculative and flight movements of capital have occurred, their overall balance-of-payments surpluses have been magnified, resulting in larger acquisitions of reserves and/or the need for extending greater foreign credits and grants than would have otherwise been made available. It is evident, for example, that a significant part of the foreign aid of the United States government has in effect gone to finance hot money movements from the recipient countries to the United States and elsewhere.⁸⁷ Credit extensions under the European Payments Union have likewise reflected in part the financing of intra-European hot money movements. Since most of the countries which have been large net importers of speculative and flight capital, e.g., the United States, Switzerland, and Belgium, have been free of, or have had only relatively limited, payments and direct trade controls, the acquisition of reserves from these capital movements has not resulted in any significant reduction of such controls where they have existed. Thus, from the viewpoint of the world as a whole, the levels of trade and payments restrictions have been higher than they would have been in the absence of hot money movements.

Drains on hard-currency reserves have resulted even when the capital movements have taken place entirely within a given monetary area where payments are settled in the currency of the metropolitan country. The outstanding case in point has been the massive net movement of private capital from Great Britain to other sterling area countries, amounting to about 1,075 million pounds in 1946-1952, inclusive.⁸⁸ As we have already seen, the bulk of this

⁸⁷ The able and authoritative correspondent of the *New York Times*, Michael L. Hoffman, in a dispatch to that paper published on July 25, 1953, estimated that the volume of "capital flight" from Western Europe in the postwar period had actually much exceeded United States government foreign aid to that area during the same period. But for my part I cannot believe that the export of flight and speculative capital from Western Europe, however large, was anywhere near the massive net total of 25 billion dollars of economic aid that we extended to that area up to March 31, 1953.

⁸⁸ This figure, obtained from official British balance-of-payments statistics,

capital moved to South Africa and Australia, and the larger part of it was probably of the flight and speculative variety. Although payment for these movements was initially taken in the form of additions to the sterling balances in London of the sterling area countries concerned, the result, nevertheless, has been to add greatly to the drain on the gold and dollar reserves of the sterling area as a whole and to necessitate tighter import and payments restrictions against the nonsterling world than would have been the case in the absence of these capital movements.

This result has followed, for one thing, from the fact that, by constantly replenishing the sterling balances of the rest of the sterling area, these capital movements have enabled these countries to maintain throughout the postwar period a much larger current-account deficit with Great Britain than would have otherwise been the case.⁸⁹ The greatly added strain of unrequited exports on the British economy has absorbed British resources which might otherwise have been applied, at least in part, to the production of goods for export to more difficult markets from which dollars could have been received in payment, or for replacing imports for which dollars had to be paid.⁹⁰ To the extent, moreover, that the added availability of sterling (and the higher level of internal demand) associated with these capital movements encouraged outer sterling area countries on balance to expand their imports from the dollar

is a residual balancing item probably consisting predominantly of private capital movements. There has also been a substantial net movement of capital from France to the overseas franc area of the equivalent of several hundred million dollars a year (including some flight capital to North Africa), but consisting chiefly of public investment carried out in French territories under the Monnet Plan. On the other hand, there has been a smaller reverse movement of private capital from Indochina to France of the flight and speculative variety.

⁸⁹ In the years 1946-1952, inclusive, Great Britain's current-account surplus with the rest of the sterling area amounted to about 1,500 million pounds. Yet the sterling balances of the rest of the sterling area actually rose by 205 million pounds because of the capital movement from Britain to these countries and to a much lesser degree because of their current-account surplus with the rest of the world and their gold sales to Britain. How much smaller Britain's current-account surplus with the rest of the sterling area would have been in the absence of these capital movements cannot of course be estimated.

⁹⁰ It might also be noted that the large movement of capital from Great Britain to South Africa in 1947-1948, by adding to the sterling acquisitions of the latter country, likewise deprived Britain of some South African gold that she would otherwise have obtained in payment for her exports to that country.

world and from countries to which at least partial dollar payment was required, there was an additional, and direct, drain on the central gold and dollar reserves of the sterling area. Finally, some of the capital movements to the outer sterling area absorbed dollars to the extent that these movements were motivated by a desire to obtain that currency by taking advantage of laxer exchange-control administration in some of the peripheral members of the area.⁹¹ Despite the admitted advantages of freedom of capital movements within the sterling area as a force holding the area together, some doubt may be cast, therefore, upon the wisdom of Britain's decision, in the face of such massive private capital outflows, to permit continued unrestricted freedom of movement. During the past year or two, however, the outflow admittedly has declined very considerably.

The hot money movements of the postwar period have also had the effect, in many cases, of accentuating inflationary pressures in capital-receiving countries at times when those pressures originating in other sources were already strong and the authorities were having difficulty in controlling them. The monetary and fiscal problems of such countries as Switzerland, Canada, Australia, South Africa, and Belgium, for example, have at times been rendered much more troublesome by these movements.⁹² To be sure, although hot money inflows have consisted, in the main, of the acquisition by foreigners of deposits and other short-term claims which did not involve direct income-generating expenditures in the countries concerned, they nevertheless have added to the loan potential of the commercial banking system and exerted downward pressure on interest rates. To the extent, moreover, that the hot money went to the purchase of outstanding securities, the money supply in the hands of residents of the capital-importing countries was directly increased, thereby swelling the funds at their disposal for possible income-generating expenditures.

⁹¹ For the relation between Britain's capital exports to other sterling area countries and its dollar problem, see, e.g., the 1949, 1951, and 1952 *Economic Survey of Europe* of the Economic Commission for Europe; R. F. Kahn, "The Balance of Payments and the Sterling Area," *District Bank Review*, December 1951, pp. 16-17; and L. Robbins, "The Sterling Problem," *Lloyds Bank Review*, October 1949, pp. 5-7.

⁹² For discussions of this matter, see the annual reports of the central banks of the countries in question.

Admittedly, from the viewpoint of the capital-losing countries, there may have been, symmetrically, some deflationary (or rather anti-inflationary) pressure exerted by hot money outflows, at least to the extent that the funds exported were diverted from domestic consumption or investment (which would be more probable in the case of capital flight than in that of speculative movements), or to the extent that the resulting drain on monetary reserves put restraint on the lending capacities of the commercial banking system. But the effects are much more difficult to trace in these cases.⁹³

Hot money movements, especially of the flight capital variety, have yielded no benefits to compensate for the disturbances which they have caused. Unlike "normal" foreign investments, they have not significantly added to productive capacity or the level of output in the receiving countries; they have not provided a reserve of overseas assets that could be mobilized in case of need by the authorities of the capital-exporting countries (since most commonly the capital is outside the reach and/or the knowledge of the authorities); and for the most part they have yielded no foreign exchange to the authorities of the capital-exporting countries in the form of investment income.

VIII. INDUCING THE REPATRIATION OF DOMESTIC CAPITAL

Before turning to the problem of what further measures are needed to check hot money outflows, we may briefly examine the related problem of how to induce the repatriation of capital already held abroad clandestinely in violation of exchange regulations and in some cases of tax legislation. This is a problem with which many countries have grappled in the postwar period in an effort to put to good use, in the interests of the national economy, the concealed foreign exchange and assets in question.⁹⁴ It is also

⁹³ One writer has called attention to the fact that the flight of capital from Western Europe has absorbed a significant fraction of the individual savings that might otherwise have found their way into the European capital markets, thereby limiting the rate of private investment. But he concludes, somewhat curiously, that inflationary pressures in Western Europe have thereby been *reinforced*; this might be true, however, from a longer-run point of view. See R. M. Bissell, "European Recovery and the Problems Ahead," *American Economic Review*, Papers and Proceedings, May 1952, pp. 323-324.

⁹⁴ A parallel problem, which will not concern us here, has been that of inducing residents to dishoard stocks of gold privately held.

a problem in which the United States government has had an obvious interest in view of the large-scale aid which it has been giving to Western European and other countries and in view of the fact that much of the foreign capital concerned has been lodged in this country.

Unilateral Attempts

In attempting to deal with this problem, a number of countries have declared amnesties with respect to repatriators of assets illegally held abroad in that they have been promised freedom from penalties for their fraudulent status, or in some cases only nominal penalties in the form of a specified tax.⁹⁵ More positive inducements to repatriation have also been given in various cases. Thus, for example, the French in January 1948 authorized residents to repatriate capital illegally held abroad at the favorable rates prevailing on the free foreign exchange market in Paris established at that time. A desire to stimulate the repatriation of domestic capital illegally held abroad also appears to have been one of the factors leading to the establishment of a free foreign exchange market in Brazil in February 1953. More ambitious were the attempts by Italy and France, in March 1946 and February 1948, respectively, to encourage the repatriation of domestic capital through the mechanism of the so-called *franco valuta* or "imports without exchange payments" systems.⁹⁶ Briefly, these schemes involved arrangements whereby undeclared assets abroad could legally be used by their holders to finance the importation into the two countries of specified goods, usually commanding high prices on local markets, or legally be sold at favorable rates to other importers of such goods. Approximately 250 million dollars of capital was repatriated to Italy through this channel in 1946-1948, and perhaps about 60 million dollars to France in 1948.

A different type of measure used in a few cases to encourage capital repatriation has been the adoption of internal financial policies designed to create shortages of liquid funds and thereby

⁹⁵ E.g., the French government early in 1948 granted an amnesty to capital repatriators but provided for the payment of a 25 per cent "legitimation tax" which could be made anonymously to any tax collector.

⁹⁶ A similar scheme was introduced in Colombia early in 1947, and a few other countries, including Israel, have experimented with it.

to bring pressure to bear on the owners to bring their funds home to meet needed local expenditures which cannot otherwise be financed. Both Italy and France, for example, have at times introduced measures of monetary restraint with this as one of the objectives in mind.

In general, however, these various measures, where introduced, have yielded only modest results. The reasons are not difficult to determine. So long as the considerations which prompted the original exports of the capital, e.g., internal political instability, inflation, expectations of exchange depreciation, etc., have persisted—as they often have—most of the owners have logically preferred to keep their holdings abroad, despite the inducements offered or the pressures brought to bear. Besides, there is sometimes a distrust of promised amnesties and a fear of subsequent reprisals, even when official measures are taken to “ensure” the anonymity of capital repatriators. On the other hand, in those cases where there has been a restoration of confidence in the country’s currency and/or of reasonable internal political stability, domestic capital illegally held abroad has tended to be repatriated in large amounts more or less automatically.⁹⁷ These are of course the same conditions which would discourage hot money outflows, as we shall elaborate upon in a later section of this study.

Cooperative Measures

In some cases countries have been able to get control of their nationals’ assets illegally held abroad as a result of assistance rendered by the countries in which such assets are lodged. Thus, for example, the Anglo-French Financial Agreement of March 1945 provided that the two governments would make available to each other any information that they might possess regarding existing assets held by nationals of the one country in the territory of the other. Partly as a result of such cooperation, the French government is reported to have been able to locate and eventually to repatriate the bulk of the assets illegally held by its nationals in Britain at that time.

The most outstanding example of such cooperation in the post-

⁹⁷ An example which has recently attracted wide attention is provided by Austria. See, e.g., *New York Times*, July 4, 1953, pp. 25-26.

war period, however, is provided by the United States, although the cooperation was applied only with regard to foreign assets in this country outstanding at the end of 1945. By General License No. 95 issued in December 1945 by the United States Foreign Funds Control, a procedure was established whereby foreign private dollar assets that had been blocked up to that time by the Control could be unblocked upon certification, by the authorities of the foreign countries of which the owners involved were nationals, that no enemy had an interest in such assets. Although the primary objective of this ruling was to find concealed enemy property, it had the additional effect of putting pressure upon the owners of such assets to declare their holdings to their authorities, since otherwise the holdings would remain blocked. Of the private assets that were certified and unblocked under this procedure, some were formally requisitioned by foreign monetary authorities (against payment in local currencies to the owners) and disposed of in financing deficits with the United States; in other cases, the owners were allowed to retain their holdings but had to turn over to their governments any dividends or interest that accrued thereon. In 1946-1948, for example, France and the Netherlands liquidated several hundred million dollars' worth of the unblocked dollar securities of their nationals.

However, many foreign nationals, fearful of penalties (even where amnesties were promised), or for other reasons, did not declare these holdings to their authorities under the certification procedure. Anxious to assist Western European countries to recover the dollar assets of their nationals so as to relieve the strain on the American taxpayer, the National Advisory Council of the United States decided late in 1947 that this country should give all reasonable assistance to prospective recipients of aid under the European Recovery Program in helping them to obtain control of these undeclared assets. The position was taken, however, that the *liquidation* of such assets, when brought under official control, should not be made a condition precedent to American aid.⁹⁸ The

⁹⁸ Under the Foreign Assistance Act of April 3, 1948, each recipient country was obligated, among other things, to take measures "to locate and identify and put into appropriate use" assets (and earnings therefrom) belonging to citizens of that country and situated in the United States. This same commitment was

Council believed, moreover, that assistance should be given with regard only to assets still blocked, and not with regard to "free" private dollar assets: i.e., dollar assets of Britain, Turkey, and Eire (which had never been blocked); previously blocked assets that had been unblocked but had not yet been repatriated; and assets accruing to foreign nationals after December 1945.⁹⁹

The program of assistance, announced early in 1948, comprised the following main elements: all assets remaining blocked on June 1, 1948 were to be transferred to the jurisdiction of the Office of Alien Property;¹⁰⁰ a new census was to be taken of blocked assets as of that date and the resulting information as to individual accounts was to be made available to the foreign governments concerned;¹⁰¹ and blocked assets held through intermediaries in third countries (e.g., Swiss banks) and not certified by that date would be vested as enemy property.

The announcement of this program was sufficient to induce many foreign nationals, who had not previously done so, to declare their blocked assets to their authorities in view of the fact that the data on their holdings would soon be revealed or the holdings themselves vested by the United States government. The census of blocked assets as of June 1, 1948, however, revealed that a total of some 500 million dollars of such assets (largely in the form of dollar securities) were still held on that date in the names of citizens of ERP countries; and the information regard-

incorporated in the various bilateral agreements which the United States signed with the recipient countries.

⁹⁹ The Council believed, on the one hand, that most of these "free" private assets were already known to, and were being held at the disposition of, the foreign governments concerned. On the other hand, it recognized that there would be "serious practical difficulties" in attempting to help foreign countries to locate and get control of those "free" private assets not known to them.

¹⁰⁰ Small accounts, not exceeding 5,000 dollars, were, however, to be unblocked without certification, except when a known former enemy interest existed.

¹⁰¹ It was recognized of course that such a step would violate the principle of banking secrecy. But as former Secretary of the Treasury Snyder pointed out: ". . . these are not ordinary times. Some European countries are in dire need of dollars to permit their survival as free nations. American taxpayers are being called upon to make substantial contributions to European recovery. Moreover, most of the foreign governments have repeatedly asked our assistance in obtaining control of the holdings of their citizens, who have concealed them." See *Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1948*, Washington, D.C., 1949, p. 291.

ing the ownership of these assets was made available to the governments concerned. Once the latter, after investigation, certified that no enemy interests were involved, the assets in question were unblocked. By June 1953 an aggregate of only about 50 million dollars of blocked assets still remained outstanding, and all of these belonged to residents of Eastern European countries; a certain amount of assets, the ownership of which could not be determined, had also been vested as enemy property. No information is available regarding the ultimate disposition of the assets that have been unblocked, but it was United States cooperation that made it possible for these assets to be brought under the effective control of the governments concerned.

IX. POSSIBLE SOLUTIONS

In 1943-1944, when the international plans for the postwar world economy were being developed, it was generally believed that the problem of hot money would not be a particularly troublesome one in the future because of the existence of exchange controls over these movements. In retrospect, this has proved to be only one of the several major miscalculations made by international planners.¹⁰² Experience since 1945 has amply demonstrated that exchange controls have been no guarantee against large-scale speculative and flight movements of capital when the underlying factors motivating them are, as they have been, sufficiently strong.¹⁰³ Although these movements have been considerably reduced in magnitude during the past year, there is no assurance against their recurrence on a large and disturbing scale in the not too distant future. A reexamination of the problem of how best to bring such movements under firmer control and/or to minimize their impact seems, therefore, very much in order.

¹⁰² This writer himself took a rather optimistic view with respect to the potential effectiveness of exchange controls in curbing hot money movements. See A. I. Bloomfield, "Postwar Control of International Capital Movements," *American Economic Review*, Papers and Proceedings, May 1946, pp. 687-709.

¹⁰³ It is of course obvious, however, that in the absence of exchange controls the problem would have been infinitely worse. The international planners also appear to have underestimated the magnitude of hot money movements that would take place between countries that did not place restrictions on these movements, e.g., the flow of capital from Great Britain to Australia and South Africa.

Tightening Controls

One possible solution to the problem would be to tighten existing controls over hot money movements and to attempt to close the loopholes through which these movements have occurred. Most countries that have, despite the existence of controls, been subjected to sweeping outflows of capital have in fact done precisely this on various occasions when these outflows were making heavy drains on their reserves.¹⁰⁴

Thus, for example, various countries have on different occasions: reduced the amount of domestic bank notes that individual resident or non-resident travelers could legally take out or bring in with them; reduced exchange allocations to resident tourists when it was believed that they were using their exchange to build up balances abroad illegally; tightened border and customs controls; introduced a closer inspection of invoice values and of applications for exchange; "cracked down" on black market exchange transactions; ruled that payments for imports could not be made until the goods themselves had actually been imported; reduced the maximum amounts of working balances that domestic commercial concerns could legally hold abroad; reduced the permissible maturities of forward exchange contracts; increased the margins to be deposited against domestic purchases of forward exchange; and imposed more severe penalties for violations of exchange transactions.

There can be no doubt that technical measures such as these have in varying degrees been effective in reducing the magnitude of hot money movements below the levels that they would otherwise have attained. There can also be no doubt that in the case of many countries there is room for a further tightening of controls over private capital outflows and that such steps would further curtail the magnitude of such outflows in the future. Nevertheless, there are definite limitations to this particular approach to handling the problem of hot money. Short perhaps of totalitarian-type systems of exchange control, which it is obviously not desirable to foster, there will always be unavoidable loopholes through which

¹⁰⁴ Moreover, as mentioned earlier, in a few cases, e.g., the Philippines in 1949, controls over private outflows of capital had to be imposed where none had existed previously.

a substantial amount of capital can escape when the underlying motives are compelling enough. The efficient management of exchange-control systems, moreover, even at present levels of restrictiveness, presupposes a degree of technical competence (and morality) on the part of the administrators that many countries of the world, especially underdeveloped ones, simply do not possess. Finally, a further tightening of restrictions over private capital outflows would inevitably interfere with current-account transactions, which it is not desirable further to burden.¹⁰⁵ In general, then, this line of approach does not seem very promising or attractive.¹⁰⁶

Cooperative Measures

Another possible approach to the problem of controlling hot money movements would be through international, or at least bilateral, cooperation. A considerable amount of official lip service has in fact been given to this approach.¹⁰⁷ Many of the postwar bilateral monetary and payments agreements between various countries have included a clause calling for mutual cooperation in controlling undesirable capital movements. Thus, for example, a standard clause in postwar British monetary agreements with individual Western European countries provides that: "The two Contracting Governments shall cooperate with a view to assisting each other in keeping capital transactions within the scope of their respective policies, and in particular with a view to preventing

¹⁰⁵ To take but a few examples: To restrict or eliminate the leads and lags effect associated with shifts in the average time before exporters repatriate their export proceeds, the legal time limits on repatriation would have to be reduced or all exports would have to be put on a cash basis. But clearly either step would seriously affect the volume of a country's exports. Likewise, a country's tourist trade would be adversely affected if all foreign visitors were subjected to the onerous regulations that would be necessary to prevent their resort to local black exchange markets.

¹⁰⁶ On the other hand, such considerations would scarcely justify a continued *absence* of restrictions on the movement of private capital from Great Britain to other sterling area countries should that movement again reach disturbing magnitudes. If continued freedom is deemed advisable under such conditions, it might perhaps be appropriate to block the sterling balances received by sterling area countries as a result of the private capital imports from Britain. This is exactly what was provided for in British agreements with Pakistan, India, Ceylon, and Iraq in the early postwar years.

¹⁰⁷ Notably during the early discussions on the White and Keynes plans.

transfers between their areas which do not serve direct and useful economic or commercial purposes."¹⁰⁸ Despite these official sentiments, however, there is little evidence of any significant amount of cooperation in this field in the postwar period.

International cooperation in controlling unwanted capital movements could take two major forms. One would consist of the exchange of information regarding assets held by residents of one country in the territory of another. Postwar experience, as we have seen, provides a few examples of this type of cooperation, although it was limited only to assets that had been accumulated before and during World War II and were being held thereafter in violation of exchange regulations. It is highly improbable, however, that countries would be willing to cooperate in this way in the future on any systematic scale with regard to assets being currently acquired illegally, in view of the widespread disinclination to breach the traditional rule of banking secrecy. Besides, the existence of many assets illegally held abroad is not even known to the authorities of the countries in which the assets are located in view of the fact that they are commonly cloaked under the names of residents of these countries or in forms exceedingly difficult to detect; to obtain detailed information on such holdings would be virtually impossible. Even if a system of exchange of information were instituted, therefore, its effect would probably be, not to discourage illegal capital movements, but merely to induce clandestine capital exporters to cloak *all* of their current acquisitions of foreign assets under dummy accounts or in forms not easily detectable.

The other major form of international cooperation in this field would consist of action on the part of capital-importing countries to restrict undesirable capital inflows in order to reinforce the controls of the capital-exporting countries over capital outflows. During the postwar period a number of countries have in fact

¹⁰⁸ A variation of this clause was included in the Financial Agreement of October 9, 1947 between Great Britain and South Africa, which provided that the two governments "shall consult together on the extent to which measures may be necessary to control or prevent movements of capital from the United Kingdom which are not required for any useful economic purpose in the Union, and the Union Government undertakes to give all such reasonable assistance as may be necessary to make such measures effective in the interests of both countries." This clause was prompted by the heavy movement of capital at that time from Britain to South Africa.

placed restrictions on speculative and flight imports of capital, although predominantly for the purpose of serving their own particular interests rather than as a means of assisting the countries in which these movements originated. Thus, for example, Belgium in late 1951 placed restrictions, within the framework of its exchange-control system, on hot money imports from other European Payments Union countries in order to keep down its extreme creditor position in, and the need for credit extensions to, that organization.¹⁰⁹ All payments from other EPU countries were subjected to careful scrutiny so as to ensure that they were the counterpart of bona fide transactions; payments not related to such transactions were not approved. For similar reasons, Switzerland imposed certain restrictions in December 1950 on imports of capital (including the repatriation of Swiss capital) from countries with which payments were controlled, and further such restrictions were imposed late in 1951. Italy provides another example of a country which, in order to keep down its European Payments Union surplus, tightened its exchange controls in 1951 so as to check capital imports for speculative purposes. A few other examples of action along these lines could also be cited.

Theoretically, it is quite possible to conceive of an international system involving controls over hot money imports as well as exports, the one set of controls serving to reinforce the other. But as a practical possibility such a system will probably have to be ruled out. Among other reasons, the main countries which are characteristically net importers of hot money tend to have only relatively mild systems of exchange control or none at all; and they would hardly be willing to impose the tight restrictions that would be needed to yield really significant results. The United States, for example, could scarcely be expected to agree to the introduction of exchange control as a means of reducing flight and speculative inflows of capital, no matter how undesirable these inflows might be. This is not to deny of course that there is some room for international cooperation in the form of direct restrictions on undesirable capital imports by the recipient countries—as the examples in the preceding paragraph indicate—but the

¹⁰⁹ At about the same time Belgium freed all private capital exports to other European Payments Union countries.

conclusion must be that this is not a very hopeful or in fact desirable approach to the problem.¹¹⁰

Reducing Liquidity

It was noted in an earlier section that the wherewithal for the large postwar hot money movements has been provided by the abnormal liquidity and monetary ease prevailing in the majority of countries in the postwar period. Another possible approach to the hot money problem, therefore, would consist of measures of fiscal and monetary restraint designed to reduce the supply and availability of money and thus to put a squeeze on potential exporters of capital.¹¹¹ While it is clear that measures of restraint could, if carried far enough, reduce capital outflows (of all kinds) appreciably, it is not clear how far restraint would have to be applied in any given case to yield really significant results in this way, especially if the outflows are of the sweeping capital flight variety,¹¹² or how far the authorities in the capital-losing countries would be willing, at the cost of possible unemployment, to push restrictive measures as a means of accomplishing this particular objective.¹¹³

¹¹⁰ There is also room for *indirect* restrictions on capital imports, but these would not be very effective. One postwar example of such indirect restrictions is provided by Switzerland. In 1950 the Swiss commercial banks concluded a gentleman's agreement with the central bank whereby they stopped interest payments on foreign deposits (old and new) and required a one month's notice on withdrawals of new foreign deposits that had not been withdrawn within a specified period after entry.

¹¹¹ Policies of monetary restraint also make it more difficult for foreigners to speculate against the currency. In December 1951, for example, Britain, as part of its new monetary policy, imposed stringent restrictions on the credit facilities previously made available to overseas customers of British banks; and such restrictions have proved quite effective in reducing the short position in sterling that had been associated with foreign borrowing in the London market.

¹¹² In this connection one recalls Machlup's famous deflationary prescription for capital flight in his article, "Die Theorie der Kapitalflucht," *Weltwirtschaftliches Archiv*, Vol. XXXVI (1932, II), pp. 512-529.

¹¹³ For an optimistic view on the potential effectiveness of fiscal-monetary measures in checking hot money via the liquidity effect, see *Annual Report on Exchange Restrictions* for 1950, International Monetary Fund, p. 29: "To a large extent, of course, it is within the power of their responsible authorities to limit capital flight through appropriate budget and internal credit policies. If governments as well as central and commercial banking authorities acted with more restraint, the monetary liquidity would be lacking which is necessary for international capital transfers on a large scale."

The experience of Western European and other countries in the past year or two has, however, admittedly demonstrated that restrictionist financial policies can contribute to reducing the volume of private capital outflows considerably, as well as encouraging the repatriation of domestic capital held abroad. But it is not clear whether these results have followed primarily because of the reduction in liquidity as such, i.e., because of the "liquidity effect," or because of the effect of monetary restraint in checking inflationary developments, in improving the current-account balances of the countries concerned, and thus in strengthening general confidence in their currencies. Both effects were undoubtedly at work, but I suspect that the latter was the more important. I also suspect that the relative smallness of capital flight from Western Europe during the past year or two was much more the result of the eased international political situation than of the influence of policies of monetary restraint on liquidity positions. This brings us to a discussion of the problem of removing the incentives for speculative and flight capital movements as another method of handling the hot money problem.

Attacking the Motives of Hot Money

The most attractive method of controlling hot money movements would be to remove, or at least greatly reduce in importance, the underlying causes of these movements. In this connection the distinction which we have drawn between speculative and flight movements becomes of great importance. For while, as we shall see, it is within our reach to attack the motives behind speculative movements with some success, there is relatively little that can be done at any one time, especially by individual countries, to remove the major causes of capital flight, namely, war scares and internal political instability. In this section, then, we shall focus on the problem of controlling the causes of speculative movements alone. We shall work here on the assumption of the International Monetary Fund system of fixed but adjustable exchange rates. This assumption will be removed in the following section.

How best might one attack the motives for speculative capital movements of the disequilibrating sort? Such movements, as we have seen, have been associated with expectations of adjustments

in exchange rates; and these expectations, which have been so common in the postwar period, have at bottom reflected the widespread disequilibrium in international payments, and especially the periodic swings in payments balances, coupled with the general inadequacy of monetary reserves at the disposal of the great majority of foreign authorities.¹¹⁴ Whenever a country begins to lose monetary reserves on any significant scale, speculative pressures quickly begin to build up against the currency concerned, thereby accentuating the existing balance-of-payments pressures and the loss of reserves. This in turn gives added impetus to speculative outflows of capital. Under the IMF system of exchange rates, such speculation involves a relatively "safe" gamble in view of the virtual certainty that, if the rate is adjusted at all, the movement will be only in a downward direction. The general inadequacy of reserves tends to strengthen the market's conviction, moreover, that official action to stop the reserve drain, whether in the form of an exchange adjustment or a tightening of import controls, cannot be long delayed. Similarly, when a country is consistently gaining reserves, it is virtually certain that any exchange adjustment that might be made would be an upward one.

It follows that the problem of checking speculative capital movements of the disequilibrating sort merges into the larger and more important problem of achieving reasonable international payments balance in general.¹¹⁵ So much has been written about the causes and cure of international imbalance, especially that between the dollar and nondollar worlds, that it would be superfluous and in any case outside the scope of this study to examine this fundamental problem here. Suffice it to say that it is now generally agreed that the most important single requirement for external balance is the adoption by countries of financial policies

¹¹⁴ See *Measures for International Economic Stability*, Report by a Group of Experts, United Nations, 1951, especially pp. 32-41. For a detailed analysis of the concept of "adequacy" of reserves, with statistical materials, see the study *Adequacy of Monetary Reserves*, submitted by the International Monetary Fund to the Economic and Social Council of the United Nations in June 1953.

¹¹⁵ It is obvious that official denials of intentions to adjust exchange rates are an almost completely worthless way of attempting to attack the motives behind speculative movements. With monotonous regularity, monetary authorities have denied any intentions of adjusting exchange rates at times of speculative pressures (even when such adjustments were in fact contemplated), but in all cases with little or no deterring effect on the flow of capital.

designed to achieve and maintain reasonable internal stability, i.e., to keep aggregate demand within the limits of available real resources. The experience of the past few years has shown that the effective pursuit of such policies can in fact contribute powerfully to the achievement by the countries concerned of more balanced over-all payments positions, a reduction or elimination of their deficits with the dollar area, and—of special interest here—a diminution or termination of disequilibrating speculative pressures. While appropriate financial policies are of prime importance for individual countries, it is of course evident that a satisfactory and durable solution to the problem of international payments imbalance (especially that between the dollar and nondollar worlds) must also comprise other requirements, including the maintenance of high levels of economic activity and the avoidance of deflationary pressures in surplus countries, especially the United States; the liberalization by these countries of their commercial policies; the adjustment of palpably overvalued exchange rates; an increase in long-term private foreign investment; and certain structural changes in world production and trade, including an increase in the production of food and raw materials in nondollar areas and an increase in European exports to “third” markets in displacement of United States exports. It is of course much easier to list these requirements (including inflation control) than to get them put into effect.

Even if, as a result of measures such as these, countries are able to balance their international accounts over a normal economic cycle, they will still inevitably be subject to temporary and perhaps even sharp setbacks in their payments positions from time to time. Unless the monetary reserves of individual countries are adequate to handle these setbacks and also to maintain general confidence in their currencies—as they do not appear to be for the great majority of countries today—speculative pressures against these currencies via leads and lags, etc., and a consequent magnification of the deficits on current and normal long-term capital account will be inevitable at such times. For, given inadequate reserves, these setbacks will create expectations of exchange adjustments, and the countries concerned will be forced to resort to such adjustments or, what is much more likely, to tighten their

import restrictions at such times. The general shortage of monetary reserves also points up sharply the difficulties and risks for most foreign countries inherent in any sudden "dash" for currency convertibility at the present time.

It is evident, then, that monetary reserves (including access to the International Monetary Fund and other sources of compensatory finance) will have to be enlarged if most foreign countries are to be ensured against speculative attacks at times of temporary setbacks in their payments positions (even if these positions are in balance over the course of the cycle), and if they are to move progressively towards payments and trade decontrol. Whether or not additional reserves should be made available in the form of a further liberalization of the Fund's loan policies, an enlargement of its resources, a rise in the world price of gold, special stabilization credits, or other measures cannot be discussed here.¹¹⁶

Although the provision of adequate reserves should enable countries to ride out temporary setbacks in their balances of payments without being subjected to strong disequilibrating speculative pressures and without having to resort to tightened payments restrictions (or exchange depreciation), there will, from time to time, inevitably emerge situations of "fundamental disequilibria," despite appropriate monetary policies, adequate reserves, etc. Under the IMF system of exchange rates, such disequilibria will call for and make desirable an adjustment of exchange rates. Once the market becomes aware of this possibility, speculative attacks against the currencies concerned will become inevitable, regardless of how adequate reserves might be, and result in additional balance-of-payments pressures. How seriously such attacks should be regarded, especially since a large part of the capital is likely to return following the exchange adjustment, is a matter for differences of opinion, but it must be admitted that they are from time to time unavoidable under the IMF exchange rate system,

¹¹⁶ In its pure sense, a stabilization credit should be regarded, not as a means of enabling a country to finance temporary deficits on current and long-term capital account, but as a means of supplementing the existing reserves available for that purpose in an amount necessary to maintain confidence in a country's currency and thus to discourage speculative attacks. A "pure" stabilization credit, then, is one that, because of its very availability, should minimize the possibility of its being drawn upon.

even with continued direct controls over capital movements and ample exchange reserves.

Fluctuating Exchange Rates

During the past year or two there has been a considerable revival of interest in fluctuating exchange rates, especially in connection with the discussions of the possibility and desirability of an early restoration of currency convertibility. Some steps have in fact already been taken in this direction. The most outstanding example is provided by Canada, which, as we have seen, unpegged its currency on September 30, 1950 (and removed all exchange controls on December 14, 1951); its currency has since been permitted to fluctuate freely, except for occasional official intervention designed to smooth out excessive short-run rate fluctuations. A much more modest step was taken by Great Britain on December 17, 1951 when, within the framework of its exchange-control system, it widened its spot exchange rates to 2.78 dollars on the selling side and 2.82 dollars on the buying side—a spread which, however, remains within the 1 per cent on each side of parity permitted under the International Monetary Fund Agreement. Within these limits the authorized banks have been free to conduct exchange dealings and to determine their own rates of exchange. A similar flexibility in exchange rates and freedom in exchange operations have also recently been introduced by a number of other Western European countries.

While the case for fluctuating rates is usually presented in terms of their alleged ability effectively to discourage speculative pressures of the disequilibrating sort and to encourage equilibrating short-term capital movements,¹¹⁷ there is a divergence of views

¹¹⁷ A relatively small number of economists also favor fluctuating exchange rates over fixed (but flexible) rates as a mechanism for maintaining over-all balance, as such, in a country's international payments. See, e.g., L. W. Mints, *Monetary Policy for a Competitive Society*, New York, 1950, chap. 5; and Milton Friedman, letter to *The Economist*, January 3, 1953, p. 16. For the more conventional view on this matter, see, e.g., S. Laursen and L. A. Metzler, "Flexible Exchange Rates and the Theory of Employment," *Review of Economics and Statistics*, November 1950, p. 283: "... short-run movements in exchange rates are likely to be unstable even apart from speculative capital movements. It is probable that the short-run demand for imports and exports is quite inelastic, and for this reason day-to-day or month-to-month fluctuations in currency values would not be an appropriate method of eliminating short-run discrepancies between international

regarding the type of fluctuating rate system that is called for. Some, moreover, favor fluctuating rates as only a transitional device to cushion the shock of a sudden restoration of currency convertibility and/or to enable a country more effectively to determine the "correct" level at which its currency should be pegged; others favor them, however, as a more or less permanent arrangement.

A large number of possible types of fluctuating exchange rate systems can be distinguished, depending upon (1) the degree of freedom permitted to rate fluctuations and (2) the degree of freedom permitted to exchange transactions. Under (1), one might distinguish: (a) completely uncontrolled rate fluctuations; (b) fluctuations with no formally fixed limits but subject to control through occasional official intervention in the market; and (c) fluctuations within limits fixed by widened gold points outside (or within) the range permitted under the Fund Agreement, such fluctuations being either uncontrolled or officially controlled within these limits. Under (2), there is a wide variety of possibilities, including: (a) complete absence of all exchange controls on current and capital account (and of direct trade controls); (b) maintenance of approximately the existing levels of exchange (and direct trade) controls; and (c) any intermediate situation between these two.¹¹⁸

It is evident from the foregoing that there are a large number of possible combinations of fluctuating rate systems. Canada, for example, provides an example of the bold combination 1b-2a. But in most of the current discussions a much more modest combination is usually envisaged which would embrace continued external controls (although coupled perhaps with full convertibility of

payments and receipts. Quite the contrary, such movements in exchange rates might easily aggravate the discrepancies they were intended to correct. In the long run, on the other hand, the presumption seems to be the other way. . . . If correct, this view suggests that the appropriate foreign-exchange market is not a completely uncontrolled market, but a market in which foreign-exchange rates are kept at fixed prices, with occasional changes made in these prices in response to persistent deficits or surpluses."

¹¹⁸ In addition, one might distinguish freely fluctuating markets within the framework of multiple rate systems, certain transactions, chiefly of the capital variety, being permitted to pass through such markets, and others having to pass through official markets. We have already noted a number of examples of such free markets in the postwar period. On this, see below.

currently earned *foreign* balances in the currencies concerned) and gold points widened so that they lie somewhat outside the narrow limits permitted by the Fund Agreement. It is, of course, hoped and expected that with the passage of time there would be a progressive relaxation of exchange and direct trade controls, but there are few who would advocate in the near future a *general* dismantling of controls, even over current-account transactions alone, to accompany the introduction of fluctuating rates.

Regardless of the exact type of system contemplated, the argument for fluctuating rates is usually advanced in terms which run somewhat as follows: So long as exchange rates are pegged (with very narrow spreads between buying and selling prices), speculative pressures of a disequilibrating sort build up rapidly when an adjustment of the peg (downwards or upwards) is expected in view of the essentially riskless character of such speculation; that is, in view of the virtual certainty that if the rate moves it will move in only one direction. These pressures, under exchange-control regimes, result largely from a retardation or acceleration of commercial payments and receipts as well as of commercial transactions themselves. What is needed, contend the floating-rate advocates, is the introduction of a system which would permit the possibility of substantial *two-way* movements in the exchange rate. To make such a system fully effective, it is further argued, the authorities must be prepared to intervene in the market from time to time so as to manipulate the rate if need be and to execute occasional squeezes designed to punish those engaged in noxious speculation.¹¹⁹

A system of fluctuating rates would, so it is argued, have a tendency, with every significant swing in a country's balance of payments, to discourage speculative pressures of the disequilibrating sort and to encourage speculative activities of the equilibrating sort. Thus, if the exchange rate declined under the impact of ad-

¹¹⁹ The "classical" statement of the case for a floating-rate policy as a means of curbing noxious exchange speculation, written over a decade ago, is the brilliant article of the late F. D. Graham, "Achilles' Heels in Monetary Standards," *American Economic Review*, March 1940, pp. 16-32. For more recent statements, with special emphasis on the role of official "counter-speculation," see J. E. Meade, *The Balance of Payments*, London, 1951, pp. 218-232 and 290-303; and A. P. Lerner, *Economics of Employment*, New York, 1951, especially pp. 360-368. Graham, Meade, and Lerner work on the assumption of no exchange controls.

verse balance-of-payments pressures (whether or not associated with a move towards payments and trade decontrol), there would tend, after a point, to be increasing expectations of the reversal in the rate movement. As a result, traders and professional speculators, in view of the risk of losses that would result from such a reversal, would tend to be increasingly reluctant to take bearish positions against the currency; similarly, the decline in the rate would tend to induce bullish speculation by those hopeful of profiting from an upward movement. These reactions would thereby tend to cushion the original balance-of-payments pressure against the country, to protect its reserves, and to limit the extent of decline in its exchange rate. Likewise, an upward movement in a country's exchange rate following upon favorable balance-of-payments developments would tend to set up the converse sequence of events. Recent Canadian experience, as we have seen, provides an excellent example of the working of such an equilibrating mechanism in actual practice.

It must be emphasized, however, that the realization of such potential benefits must presuppose certain conditions. Of most importance, the country concerned must, as a result of appropriate internal policies and other circumstances, be in a relatively balanced or "strong" payments position, with or without exchange and direct trade controls. Otherwise, a decline in its exchange rate will not be likely to provoke the desired responses and might, on the contrary, accentuate bearish pressures in a self-inflammatory way by creating anticipations of further declines. As a result, the exchange rate will simply settle at the lower gold point, where the authorities will have to support it, or, where no formal gold points exist, official intervention will be necessary at some other support level unless the rate is to drop to an unduly low position, with adverse effects on the terms of trade and sharp inflationary pressures on the internal economy. In either case, a tightening (or imposition) of trade and payments restrictions will probably be necessary, just as might be the case if the exchange rate were not allowed to fluctuate. In short, floating rates, with or without gold points, would not be of value in the case of a fundamental imbalance in a country's international accounts, except perhaps to the degree that the *de facto* devaluation stimulated exports and

reduced imports. But clearly a simple devaluation of the same amount would have been equally effective in this respect.

If the above-claimed benefits are to be realized at all, therefore, one must presuppose situations of essentially short-run strains on the balances of payments of countries in a fundamentally balanced or "strong" external position. When such short-run strains emerge, the resulting decline in the exchange rate might, via the mechanism noted above, relieve the pressure on the monetary reserves of the country concerned and thereby enable it to ride out these temporary setbacks without having to tighten its trade and payments controls. But even here it must be emphasized that a floating-rate experiment would yield such potential benefits only if the country's monetary reserves were not so low as to raise doubts in the minds of the market as to the ability of the authorities to prevent the rate from going beyond the lower gold point or some other support level. If monetary reserves were too low, short-run strains on a country's balance of payments might well lead to a cumulative growth of disequilibrating speculative pressures and eventually necessitate the same type of defensive action (tightened restrictions) as would have been the case had there been no floating-rate system.

The effectiveness of a floating-rate policy as a means of influencing speculative pressures in the desired direction is therefore by no means assured under all conditions. It all depends upon the particular expectation-and-response pattern on the part of traders and speculative interests with respect to exchange rate movements; this in turn will depend in large part upon the underlying and prospective balance-of-payments position of the country concerned and upon the "adequacy" of its reserves. When a country has approximate balance in its external accounts and reserves adequate to meet temporary setbacks and to maintain confidence in its currency, a floating-rate scheme would seem to be unnecessary. When a country has approximate external balance but rather low reserves the scheme might admittedly be of value in sheltering these reserves against temporary balance-of-payments setbacks, although when reserves are *too* low this benefit would not likely be realized. Finally, when a country is in a fundamentally weak balance-of-payments position and also has low reserves, the scheme

would be virtually useless. It is evident from all this that it is difficult to generalize with regard to the possible efficacy of a floating-rate experiment in any individual case. Much will depend on the magnitude of the country's periodic balance-of-payments pressures relative to its existing reserves and on the psychology of the market, neither of which can safely be predicted in advance.¹²⁰

In any case, it is evident that an appraisal of the relative merits of fluctuating versus fixed exchange rates would have to go far beyond the question of the relative effectiveness of the two systems in curbing undesirable speculative pressures. For example, would forward market facilities be adequate to remove (at moderate cost) the inconveniences and risks to traders that floating rates would create? Would the broken cross-rate problem, in a world of incompletely convertible currencies, be rendered more or less troublesome? Would fluctuating rates have any real advantages over periodically adjusted rates as a means of correcting deep-rooted current-account imbalances? Would floating rates create any special difficulties for the effective operation of the International Monetary Fund and the European Payments Union? What are the implications of a floating-rate policy from the viewpoint of its internal financial and economic repercussions? These important issues are, however, outside the scope of this study.

Although it is evident that the writer has doubts as to the necessity or desirability of any widespread "freeing" of exchange rates, he hastens to add that he would not be opposed to fluctuating rates

¹²⁰ The "success" of the Canadian experiment in floating rates since 1950 has depended in large part on a combination of circumstances not likely to be widely duplicated at the present time: namely, the favorable balance-of-payments prospects of Canada; the large volume of reserves at its disposal which can be thrown into the market at any time; the confidence inspired by Canada's general economic policies; and the notion that there is a "natural" tendency for the Canadian dollar to gravitate towards parity with the United States dollar and that the authorities will not in fact permit too large a deviation from this parity. The modest benefits yielded by Britain's limited experiment with slightly widened gold points since December 1951 must likewise be attributed to the basic "strength" in the sterling area's external accounts during most of this period. The narrower the spread in the gold points, of course, the smaller are the potential benefits to be derived. Where the spread is fixed by the narrow maximum limits permissible under the Fund Agreement, for example, the risk of loss from a reversal of the rate movement is relatively negligible compared with the possible profits from a devaluation beyond the lower limit, and such risk is thus not likely to deter bearish speculation when such devaluation is expected.

as a *transitional* device to cushion the shock of a sudden restoration of currency convertibility (when and if the conditions for such are ripe) or to enable a country which has stabilized its internal financial position to seek a new parity at which to peg its exchange rate more realistically. Nor would he necessarily oppose, even as a more permanent arrangement, a spread between gold points moderately wider than that now permitted under the Fund Agreement. But he would be skeptical of the wisdom of establishing, for the great majority of countries, a *substantial* spread between the gold points, as is proposed in various quarters, or of removing gold points altogether and permitting free rate movements within a wide range. As a device for curbing hot money movements, moreover, fluctuating rates would in any case operate primarily on speculative capital movements, since flight capital movements are relatively insensitive to exchange rate fluctuations.

One of the major objections raised against systems of floating rates is that the wide fluctuations in exchange rates which they might involve would have disturbing effects on foreign trade and other current-account transactions, on the terms of trade, and on internal economies. This particular objection could be met by an alternative system, which has been recommended for certain countries by various economists¹²¹ and has, as we have already seen, been adopted by a number of countries during the postwar period.¹²² Such a system would route undesirable private capital movements (and perhaps certain other balance-of-payments transactions) through a fluctuating free market, while channeling current-account transactions (and "normal" long-term capital movements) through official markets where rates are fixed (but periodically adjustable). Such a system would admittedly have certain advantages. The country's foreign trade, its monetary reserves, its price system, and its internal economy would tend to be insulated from large and sudden shifts in the flow of hot money, since the effect of such shifts would be largely confined to pushing

¹²¹ See, e.g., R. Prebisch, "El Patrón Oro y la Vulnerabilidad Económica de Nuestros Países," *Jornadas*, No. 11 (Mexico, 1944), pp. 20-22; and Hoffman, *op.cit.*, pp. 263-265 (who recommends this arrangement for intra-European capital movements).

¹²² During the thirties Argentina had also experimented with this system. See, e.g., M. S. Gordon, *Barriers to World Trade*, New York, 1941, especially pp. 109-110.

up or down the exchange rate in the free market. Since capital would now be free to move openly and legitimately, the system would have the additional advantage of discouraging illegal exchange operations, which cannot in any case be effectively controlled in most instances.

On the other hand, such a system would have a number of limitations which would seem to preclude the feasibility or desirability of its widespread adoption. Of most importance in this connection is the fact that by definition it involves a multiple exchange rate structure. Whatever solid merits may be claimed for multiple rate systems under certain conditions and for certain purposes,¹²⁸ it is, I believe, obvious that it would be unwise to encourage the introduction or perpetuation of such systems in any large number of countries as a means of minimizing the impact of undesirable private capital flows, especially when more attractive alternatives exist. Not all unwanted capital flows could in any case be channeled through the fluctuating free exchange market; the troublesome movements associated with leads and lags are an outstanding case in point. Besides, difficult control problems would still remain if the free rate got too far out of line with the official rate, since under these conditions (assuming the free rate for the local currency is at a discount below the official rate) there would be a strong tendency for sales of foreign exchange (from merchandise exports, etc.) to be illegally diverted to the free market and for purchases of foreign exchange (for capital exports, etc.) to be illegally diverted to the official market. Moreover, unduly wide spreads, as well as excessively large swings in the free rate, are bound to have psychological repercussions of a sort tending to jeopardize the stability of the official rate unless controls over transactions in the official market are tightened. To the extent of course that the authorities periodically intervene in the free market to prevent such wide spreads and swings from developing, the flow of capital would have a direct impact on that country's monetary reserves and some repercussions on its internal economy.

¹²⁸ For an excellent study in this field, see E. R. Schlesinger, *Multiple Exchange Rates and Economic Development*, Princeton Studies in International Finance, No. 2, Princeton, 1952.

X. CONCLUSION

The foregoing survey of the large and disturbing hot money movements of the postwar period, and of the various possible mechanisms for handling them, leads to no startling or especially novel conclusions, nor does it seem to call for any detailed summing up. These abnormal capital movements have at bottom reflected the highly disordered economic and political conditions of our time. As long as such conditions prevail, the problem will continue to be a troublesome one, regardless of the use of exchange-control devices or of the resort to special gimmicks designed to meet it. Such measures will in themselves relieve, but not adequately solve, the problem. The roots of the problem lie deep; and the only sound solution is to attack it at its roots.

With regard to eliminating or easing the political and social tensions which have been the major cause of capital flight, nothing can of course be said here. But it is at least within our reach to launch a frontal attack on the international financial disequilibrium which, in addition to its more objectionable consequences, has been so potent a cause of speculative movements of capital of the disequilibrating sort. The experience of the past few years, for example, has indicated that monetary-fiscal policies designed to achieve and maintain reasonable internal financial stability can contribute powerfully to achieving closer balance in international accounts, to paving the way for payments and trade liberalization, and to reducing hot money movements, especially of the speculative sort. Further action towards achieving these objectives would comprise the liberalization of trade policies by countries with a chronic surplus; the avoidance of sharp deflationary pressures in these countries; the stimulation of long-term private foreign investment; the adjustment of overvalued exchange rates; certain structural changes in world production and trade mentioned earlier; and an enlargement of the monetary reserves at the disposal of the majority of foreign countries. With approximately balanced international accounts, and with reserves adequate to meet temporary setbacks in the balance of payments and to maintain general confidence in currencies, countries would undoubtedly find the

problem of disequilibrating speculative movements of capital in their balances of payments greatly reduced in magnitude.

An approach to the broader problem of international disequilibrium along these lines would not of course exclude the possible necessity or desirability for some countries of, at least temporarily, tightening their controls over capital movements, moderately widening the spread between their gold points, or adopting other special measures in an attempt to discourage undesirable capital movements. Each country is of course likely to meet the problem in ways best suited to its own needs and capabilities. But the more successful the fundamental approach proves to be, the less the need for special expedients of this sort.

Even if, as a result of a progressive improvement in international payments positions, it should eventually prove possible to free current-account transactions from the restrictive application of exchange (and direct trade) controls and to restore convertibility on current account over a large part of the world, it is highly probable that a majority of countries would still need or want to maintain some measure of exchange control over private capital movements. The threat of disequilibrating speculative movements of capital will, to be sure, have been greatly attenuated, but such controls will probably be deemed desirable, among other reasons, to protect reserves against the threat of capital flights so long as international and internal political and social tensions persist.

Nevertheless, it is at least pleasant to look even further ahead to the possibility some day of a world sufficiently stable and balanced, politically and economically, for exchange controls to be eliminated altogether for the great majority of countries. For clearly, exchange control, even over capital movements alone, cannot be regarded with anything other than deep misgivings in view of its heavy administrative burdens and costs, the extensive bureaucratic apparatus which it necessitates, its tendency to undermine business ethics, the inconveniences to all parties concerned which it involves, and the many abuses to which it is readily subject. Besides, it may legitimately be questioned whether it will indeed be technically feasible to maintain and operate an exchange-control system which applies restrictively to capital movements but permits complete freedom with regard to the making of payments

and transfers on current account, i.e., a system which, while involving the licensing of all exchange transactions to make effective the control of capital movements, permits current-account payments to take place freely. Apart from certain technical difficulties in achieving this objective (e.g., distinguishing "current" and "capital" transactions, preventing the inconveniences to traders and in some cases the actual obstacles to trade that the mere act of exchange licensing and supervision involves, etc.), the very existence of an exchange-control apparatus will, if history is any guide, tend to create strong temptations on the part of its administrators to curtail current-account transactions as well, and indeed to use the controls for other objectionable ends.¹²⁴

While it must be readily admitted that the primary objective should be to free current-account transactions as far as possible from the restrictive application of exchange (and direct trade) controls, it is to be hoped, therefore, that, with a continued improvement in international payments positions, consideration would also be given to the feasibility and desirability of a gradual relaxation of at least some of the more restrictive controls over private capital movements. Few countries, to be sure, will be likely to develop "strength" so rapidly as to be enabled, like Canada, safely to remove all exchange controls within a relatively short period of time (whether or not on the basis of floating exchange rates). Such progress as is made in this direction will in most cases inevitably be gradual, with top priority being given, as it properly should, to the relaxation or removal of controls over current-account transactions. With regard to controls over capital movements, however, an appropriate start in the direction of liberalization would seem to be to permit increased freedom of repatriation of long-term foreign capital (and perhaps even of "old" private foreign blocked balances), while maintaining, for the time being at least, the restrictions on the outflow of domestic capital. In the past few years there has in fact been a tendency

¹²⁴ As Viner wrote a decade ago: "... the instrument is so powerful, so flexible, so versatile, that, once introduced, its operators tend to succumb to the itch to experiment broadly with its possibilities." See J. Viner, "Two Plans for International Monetary Stabilization," *Yale Review*, autumn 1943, p. 103. Viner develops this point further in his *Trade Relations between Free-Market and Controlled Economies*, Princeton, League of Nations, 1943, pp. 28-30.

for many countries to move in this direction in the hope of attracting new private foreign investments.¹²⁵ At some more distant date, if the underlying conditions are ripe, consideration could then be given to the feasibility of increasingly removing controls over domestic capital exports as well. In such a relatively peaceful and economically balanced world, private capital movements, freed from controls, should tend predominantly to be of the equilibrating variety, subject to the influence of more "normal" motivations and forces.

¹²⁵ This is not to imply, of course, that exchange restrictions on the repatriation of foreign capital are the only barrier to private foreign investment. For a recent discussion of other such barriers, see Sir Arthur Salter, *Foreign Investment*, Princeton Essays in International Finance, No. 12, Princeton, 1951, pp. 35-37.

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