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International Finance Section

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

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

The Minority View

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

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

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

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

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

Domestic and International Financial Intermediation

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

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

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

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

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

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

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

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

The Bank Example

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

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

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

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

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

Behind the Monetary Veil

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

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

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

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

The Volatility of Short-Term Funds

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

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

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

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

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

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

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

Exchange-Rate Speculation

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

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

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

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

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

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

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