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Speculative and Flight Movements of Capital in Postwar International Finance

Arthur I. Bloomfield

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Gardner Patterson, *Director*
International Finance Section

Princeton University
October 1953

TO

JULIUS LEMPERT, M.D.

IN APPRECIATION

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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 postwar 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 anticipated 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

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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.