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Creation of a European financial area

No 36 May 1988

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Liberalization of capital movements and financial integration in the Community

Abbreviations and symbols used

Countries

B	Belgium
DK	Denmark
D	Federal Republic of Germany
GR	Greece
E	Spain
F	France
IRL	Ireland
I	Italy
L	Luxembourg
NL	The Netherlands
P	Portugal
UK	United Kingdom
EUR 9	European Community excluding Greece, Spain and Portugal
EUR 10	European Community excluding Spain and Portugal
EUR 12	European Community, 12 Member States

Currencies

BFR	Belgian franc
DKR	Danish krone
DM	Deutschmark
DR	Greek drachma
ESC	Portuguese escudo
FF	French franc
HFL	Dutch guilder
IRL	Irish pound (punt)
LFR	Luxembourg franc
LIT	Italian lira
PTA	Spanish peseta
UKL	Pound sterling
ECU	European currency unit
USD	US dollar
SFR	Swiss franc
YEN	Japanese yen
CAD	Canadian dollar
ÖS	Austrian schilling

Other abbreviations

ACP	African, Caribbean and Pacific countries having signed the Lomé Convention
ECSC	European Coal and Steel Community
EDF	European Development Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMS	European Monetary System
ERDF	European Regional Development Fund
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
LDCs	Less-developed countries
Mio	Million
NCI	New Community Instrument
OCTs	Overseas countries and territories
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
SMEs	Small and medium-sized enterprises
SOEC	Statistical Office of the European Communities
toe	Tonne of oil equivalent
:	Not available

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General introduction

Alongside the free movement of goods, persons and services, the free movement of capital within the Community is one of the basic freedoms laid down by the Treaty establishing the EEC.

However, lifting the restrictions in this field was over a long period considered a secondary objective of European integration. Indeed, there was relatively little capital mobility between the various Member States at the start of the 1980s compared to the considerable progress which had been made on intra-Community trade and the spectacular development of international financial relations through the Euromarkets.

In just a few years, the target of fully liberalizing capital movements has become a key element in the drive for economic and monetary union in the Community. At the Commission's proposal, the Council is currently examining a set of texts aimed at completing the process of liberalizing capital movements in the Community.

The purpose of this publication is to set out the main stages in the thinking which has led the Commission to present its proposals, and to describe both the reasons behind the proposals and their scope.

This general introduction aims to put the new impetus to the liberalization of capital movements within the Community into perspective. It will show why, after the strides made in the early 1960s, the process remained blocked for so long. It will explain the reasons behind the new initiatives taken by the Community in recent years. Finally, it will indicate what full liberalization of capital movements is mainly about, and how the Commission plans to achieve this goal.

I — The new impetus to liberalization of capital movements

1. Liberalization of capital, a process held up for years

Reference is habitually made to the relative caution of the EEC Treaty's provisions dealing with capital. Obstacles to the movement of capital are to be abolished 'progressively' and only 'to the extent necessary to ensure the proper functioning of the common market'. Unlike the provisions on the customs union, those on capital do not lay down a timetable specifying the successive stages for dismantling restrictions: they leave it to the Council to implement liberalization by issuing directives adopted on the basis of proposals from the Commission. This is still the only course open today.

Up to the end of 1986, the main achievements in liberalizing intra-Community capital movements dated back to the early 1960s. By virtue of two directives adopted in 1960 and 1962,[1] capital transactions most directly linked to the exercise of the other basic freedoms established by the Treaty (direct investments, commercial credits and guarantees, personal capital movements) were unconditionally liberalized, as were transactions of a more strictly financial nature (acquisition of foreign securities quoted on a stock exchange).

Following the adoption of these instruments, attention focused on the harmonization or approximation of the national rules and regulations governing financial activities; the matter was discussed in particular by a group of experts appointed by the Commission and chaired by Mr Segré.[2] On that basis, it was possible to adopt a number of directives concerning the activities of financial intermediaries and stock exchanges. However, further attempts to continue the step-by-step liberalization of capital movements were blocked. In 1964, the Commission had presented to the Council a new proposal for a directive along those lines. The proposal aimed to abolish, subject to certain ceilings, restrictions on the issue and placing on the national market of the securities of companies from other Member States. This proposal was not taken up. In the 1970s, some of the ground gained in the previous decade was actually lost, since several Member States made extensive use of the safeguard clauses provided in the Treaty to introduce and maintain restrictions on capital transactions which, in principle, had been liberalized.

Thus, at the start of 1983, of the 10 Member States only the Federal Republic of Germany, the United Kingdom, Belgium and Luxembourg (the latter two countries operating a two-tier foreign exchange market) had abolished exchange controls on all capital transactions. The Netherlands complied with its Community obligations and adopted a liberal attitude towards transactions not subject to the liberalization requirement. In contrast, France, Italy, Ireland, Denmark and Greece remained short of their Community obligations and applied exceptional arrangements in respect of capital transactions which had, in principle, been liberalized.

This reverse was probably due to the instability of international monetary relations, the worsening economic environment following the collapse of the Bretton Woods fixed exchange-rate system, and the energy crisis. Another reason,

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[1] First Directive for the implementation of Article 67 of the Treaty, OJ 43, 12.7.1960, p. 921/60, and Directive 63/21/EEC, OJ 9, 22.1.1963, p. 62/63.

[2] This group's report was published by the Commission in November 1966 under the title 'The development of a European capital market'.

however, was the difficulty, in the absence of sufficiently close coordination of economic policies within the Community, of reconciling the four goals of free trade, exchange-rate stability, freedom for capital movements, and monetary policy autonomy.

Thus, France and Italy, faced with conflicts between internal and external objectives, opted for membership of the EMS exchange-rate mechanism, but chose to recover some room for manoeuvre by partially ridding themselves of the discipline which was considered the least essential to the proper functioning of the common market, i.e. the free movement of capital.

In contrast, the United Kingdom, which fully liberalized capital movements at the end of 1979, chose not to accept exchange-rate discipline as it was anxious to preserve its monetary autonomy.

Finally, Germany, the country which managed best to reconcile the free movement of capital, membership of the EMS exchange-rate mechanism and the pursuit of a relatively independent monetary policy, was only able to do so by virtue of the international status of its currency and the pivotal role which the latter played within the EMS.

2. The revival of the liberalization process

The Communication on financial integration presented by the Commission to the Council in 1983 (COM(83) 207 final) reopened Community discussion on the liberalization of capital movements. It described the deadlock mentioned above, assessed possibilities for progress and identified practical initiatives capable of reviving the interrupted process of financial integration.

One year later, the Commission introduced a system of tighter management of exceptional arrangements applied to capital movements. By substantially revising its decisions authorizing a number of Member States to maintain restrictions on capital transactions liberalized under Community law, it strictly limited their scope and period of validity. The decision in favour of Denmark was therefore repealed, and the decisions concerning France, Italy and Ireland had their scope reduced to the strict minimum and their period of validity limited to two or three years. The same approach was followed in 1985 when, at the end of the transitional period laid down in the Act of Accession, Greece was authorized to maintain certain restrictions on capital movements.

The new Community initiatives on the liberalization of capital movements were not only the expression of a political will, but were also dictated by international financial developments, by the increased convergence—in particular within the EMS—of the key economic aggregates, and by the new awareness on the part of national authorities of the relative ineffectiveness of exchange restrictions and the limitations of an autonomous economic policy in an increasingly integrated area such as the Community.

The early 1980s were marked by a speeding-up of the globalization of financial markets and by the spectacular development of financial innovations to meet the needs of businesses faced with increased instability of interest and exchange rates in the world economy. In this context, several Member States considered it necessary to open up and modernize their financial structures in order to keep up with these developments, and believed that the European dimension was vital to national financial institutions as a means of achieving the necessary competitiveness.

Moreover, with trade between the Member States' economies increasingly integrated, exchange-rate discipline acted as a constraint on the conduct of domestic economic policies, even if restrictions were imposed on capital movements. The practical working of the EMS gradually led the participating Member States to acknowledge that exchange-rate stability must be based on cooperation and convergence of economic policies, and not on control of capital movements.

3. The requirements of completing the large internal market

Adopted in February 1986, the Single European Act, amending the Treaties establishing the European Communities (OJ L 169, 29.6.1987), set a target date of 31 December 1992 for the Community to create an area without internal frontiers in which the free movement of goods, persons, services and capital would be guaranteed.

The Single Act, which gave formal recognition to the objectives of the Commission's White Paper on the internal market (COM(85) 310 final) in this field, therefore added a new dimension to the aim of complete liberalization of capital movements. This is now seen as necessary for the proper functioning of the common market, and must be considered part and parcel of the drive for economic and monetary union. Not only does it mean that those restrictions on capital movements still in force must be lifted, without undermining exchange-rate stability, but also that, in parallel, all forms of discrimination affecting the free movement of financial services within the Community must be abolished, without damaging the protection afforded to savers, fair competition or the stability of financial systems.

4. The Commission's programme and implementation of its initial phase

In May 1986 the Commission decided to make complete liberalization of capital movements one of the Community's top priorities, and it presented a programme in the form of a Communication to the Council,[1] followed by an initial proposal for a Directive (COM(86) 326 final).

The Commission's programme laid down two phases for completing the liberalization of capital movements. The aim in the first phase was to achieve effective liberalization throughout the Community of the capital transactions most directly necessary for the proper functioning of the common market and for the linkage of financial markets.

In practice, this meant first and foremost continuing the gradual dismantling of the derogations from Community obligations then in force. Consequently, the decision authorizing France to take protective measures was repealed in June 1986, and that applicable to Italy was first limited in scope and then repealed in July 1987.[2]

The next step was to produce a directive extending Community liberalization requirements to include all transactions involving the acquisition and issue of shares or bonds, whether or not dealt in on a stock exchange. The new directive[3] was adopted by the Council in November 1986, only five months after the Commission's proposal had been presented, thereby setting an example for cooperation between Community institutions.

The second phase laid down by the Commission is aimed at achieving complete liberalization of all capital movements, including all short-term or long-term banking and financial transactions, even those of a purely monetary or quasi-monetary nature not linked to commercial transactions.

Implementation of this final phase has major implications and therefore merited detailed forward analysis. Apart from the regular exchanges of views between the Commission and the trade organizations concerned, this analysis has been organized at two levels:

(i) within Community institutions, i.e. the Commission staff in liaison with specialized committees (the Monetary Committee and the Committee of Governors of the Central Banks);[4]

(ii) within a group of independent consultants drawn from the academic world and charged by the Commission with reporting on the various implications of complete liberalization of capital movements for the various Member States and the EMS.[5]

The main conclusions from the analyses made are summarized below.

II — Implications of complete liberalization of capital movements

1. Quite generally, complete liberalization of capital movements is necessary for the proper functioning of the large internal market and represents an important step towards monetary unification in the Community.

The opening up of national financial markets produced by liberalization will make the process of channelling savings into investment more efficient and generally less costly to business, if only because of the economies of scale associated with a large integrated market. Savers will be offered a means of managing their investments more efficiently and will have a choice of better profitability/risk mixes. The enlargement and proliferation of secondary markets will enable claims to be mobilized on better terms. Borrowers will have access to more diverse, cheaper and better-suited financing methods.

2. However, complete liberalization of capital movements inevitably carries risks and will not bring financial integration all by itself:

(i) It necessitates modernization and adaptation of national financing systems, including methods of managing the public debt, the cost of which will be easier to see.

(ii) It will occur in a changing international environment, therefore imposing increasing constraints on the conduct of monetary policies, with risks for exchange-rate stability; the imperatives of the internal market and the EMS demand that the objectives of liberalization and stabilization of exchange-rate relationships be pursued jointly; in order to achieve this, it is therefore vital that

[1] See Part One of this publication.
[2] At present, four out of the 12 Member States are authorized to maintain restrictions on capital movements liberalized under Community law: Greece and Ireland, by virtue of authorizations (safeguard clauses) granted by the Commission; Spain and Portugal, by virtue of transitional arrangements based on the Act of Accession.
[3] Directive 86/566/EEC, OJ L 332, 26.11.1986.
[4] See Part One of this publication.
[5] See Part Two of this publication.

convergence and monetary cooperation are stepped up and EMS mechanisms strengthened; if temporary difficulties should arise, recourse must be had to safeguard arrangements rather than to relaxing exchange-rate discipline.

(iii) It has major implications for taxation (distortions and discrimination under internal rules and regulations, greater risk of evasion) which must be dealt with pragmatically.

(iv) It is only one component in the creation of a European financial area; it must therefore fit in with other measures to harmonize national rules and regulations to enable freedom of establishment and freedom to supply financial services to be exercised in full, whilst guaranteeing security for savers and healthy competition for intermediaries.

Without parallel efforts in these fields, three types of negative reaction would ensue:

(i) a loss of ground on what has already been achieved, owing to systematic application of safeguard clauses;

(ii) the maintenance of protectionist measures in the area of financial services, based on considerations of national interest or on attempts to protect national savings;

(iii) major distortions in capital flows rather than the improved allocation of resources aimed at, and an artificial shift in financial activities.

3. As the degree of financial development is not the same in all Member States, the Community should be given appropriate means and procedures to ensure that complete liberalization of capital movements does not aggravate regional and structural imbalances within the Community.

This should be achieved primarily through specific measures to strengthen economic and social cohesion within the Community, and notably through financial engineering, i.e. by linking budgetary measures to the provision of loan finance and by developing national financial structures by means of integrated programmes.

Special transitional arrangements should also be introduced to help the new Member States, or those with a less developed financial system, to adapt to the requirements of financial integration in the Community.

Finally, by adjusting the purpose and resources of the Community instruments for medium-term balance-of-payments support, it should be made possible, where necessary, to back up the efforts to liberalize capital movements undertaken by Member States suffering from a vulnerable external position.

4. Any integration process automaticaliy strengthens the Community's identity *vis-à-vis* the outside world. Three principles must be adopted here:

(i) For reasons of economic efficiency, the Community must opt for a high degree of openness to the outside world; it must therefore achieve maximum liberalization of capital movements between itself and third countries.

(ii) With capital movements completely liberalized, the Community's identity in relation to third countries must be based on closer monetary cooperation—in particular through a coordinated exchange-rate policy against non-Community currencies—and work towards greater alignment of national rules and regulations; the exchange-rate arrangements and policies of the Community and its Member States *vis-à-vis* third countries must be managed applying Community procedures that become increasingly strict as progress is made towards economic and monetary union.

(iii) During the transitional phase, the Community must still be free to take concerted action to regulate destabilizing capital movements to or from third countries, so as to be able temporarily to strengthen the Community's exchange-rate policy and cohesion within the EMS.

III — The Commission's proposals for the final phase of liberalization of capital movements

The lessons drawn by the Community institutions from the January 1987 realignment have confirmed the need to establish a link between further liberalization of capital movements and strengthening EMS mechanisms. The agreements on the EMS reached in Basle and Nyborg in September 1987 opened the way for the implementation of the final phase of liberalization.

To this end, the Commission presented a Communication and three proposals[1] to the Council in November 1987.

The Communication introduces the Commission's proposals and draws attention to a number of complementary questions: harmonization of supervisory and prudential rules, taxation aspects, and the link with participation of the Community currencies in the EMS exchange-rate mechanism. The Commission considers that solutions to these questions must not be regarded as preconditions for implementing the programme for the liberalization of capital move-

[1] See Part Three of this publication.

ments. But they constitute important elements in the creation of a truly integrated financial market, the implications of which need to be fully appreciated.

In its proposals, the Commission aims to:

(i) extend liberalization to all capital movements; a specific safeguard clause is included to enable controls to be reintroduced for short periods on short-term capital movements in cases where a Member State's monetary or exchange-rate policy is seriously disrupted; Spain, Ireland, Portugal and Greece are granted longer timetables for implementation of the new liberalization obligations;

(ii) amend an existing directive on regulating international capital flows in order to introduce the principle of extensive liberalization of capital movements to and from third countries, whilst providing for the possibility of concerted use of a range of instruments for regulating short-term capital flows in the event of an external monetary shock;

(iii) establish an instrument to provide medium-term financial support for Member States' balances of payments by combining existing mechanisms (the medium-term financial assistance and Community loan mechanisms); this instrument could be used not only to assist a Member State experiencing balance-of-payments difficulties but also, in an appropriate form, to back up an effort to liberalize capital movements.

The Commission's proposals and the complementary questions raised are currently being discussed within the Community institutions. Formal opinions are expected from the specialized committees, the European Parliament and the Economic and Social Committee. The Commission hopes that its proposals, amended if necessary in the light of the opinions expressed, will be adopted by the Council before the end of this year.

Part One — The approach proposed by the Commission

The three documents presented in this first part are from the Commission. They describe the general background to its efforts to achieve complete freedom of movement for capital in the Community in the near future.

In its Communication to the Council of May 1986, the Commission recalls the reasons why the process of liberalization should be completed; it puts forward a programme for achieving this objective and identifies the main conditions for and implications of its implementation.

The Commission staff paper prepared in December 1986 for the Monetary Committee and the Committee of Governors of the Central Banks examines this last point in greater detail. Its aim is to initiate analysis of the consequences of complete liberalization of capital movements and of how to take due account of them in working for genuine financial integration. The focus is on the additional constraints imposed on Member States' monetary policies and the need for increased cooperation in this field; the impact on the organization and functioning of national financial systems and the aims to be pursued in harmonizing national rules and regulations; the situation of the Member States which have made less progress on the road towards financial integration; relations between the European financial area and the rest of the world.

In a memorandum sent to the President of the Council on the occasion of the informal meeting of Ministers for Economic and Financial Affairs held at Knokke in April 1987, the President of the Commission draws provisional conclusions from this analysis and describes the basic approach adopted by the Commission at that stage for implementing the final phase of the programme announced.

Programme for the liberalization of capital movements in the Community

Communication from the Commission to the Council — May 1986[1]

Introduction

The communication on financial integration which the Commission presented to the Council in April 1983[2] gave new impetus to Community discussions on the liberalization of capital movements. Today there are two essential reasons for placing this question among the Community's top priorities.

First, the Luxembourg Act makes new demands on the process of financial integration which has already begun. The Act clearly affirms the need for the large internal market to assume its full financial dimension, since the objective of free movement by 1992 also applies to capital and financial services.

Already, a considerable effort is in progress to remove the technical, administrative and legal obstacles to trade: the effort covers the harmonization of standards, the opening-up of public procurement contracts, the ending of excessive controls at frontiers and the approximation of indirect taxation. It would be difficult to imagine that it should not extend to exchanges of capital.

The result will be the closer coordination of economic and monetary policies, which is important for the Community's integration. This will have to be accompanied by appropriate measures to bring levels of development as close together as possible and to reduce the structural differences between the Member States. Article 130(b) of the Single Act provides that the implementation of common policies and of the internal market shall take into account the objectives of cohesion. The proposals set out in this communication, while ultimately beneficial for all, may create difficulties for some Member States. In such cases, it may be necessary to take additional measures, outside the scope of this communication, in order to help those Member States to participate fully in the creation of a genuine common market in financial services with full freedom of capital movement.

Second, there is a close link between the development of the EMS and the free movement of capital: this link was established by the Commission in its communication to the Council of November 1984 on developing the European Monetary System.[3] The EMS experience has played a decisive role in the evolving attitude of the Member States. The opinion which has prevailed is that the stability of exchange rate relationships must reflect and be nurtured by a genuine convergence of monetary policies and economic performances.

The purpose of this communication is:

(i) to trace the logic behind the Commission's proposed approach and the major phases in that approach, so as to arrive at as liberal as possible a Community system of capital movements;

(ii) to set out the resultant implications for the effective integration of the financial markets and for the coordination of the monetary and financial policies of the Member States.

[1] COM(86) 292 final.
[2] COM(83) 207 final.
[3] COM(84) 678 final.

The proposed approach for the liberalization of capital movements

1. The logic behind the liberalization of capital movements

1.1. Analysis and experience show that there are three degrees in the progressive liberalization of capital movements which, in simple terms, correspond to three categories of operations:

(i) capital operations — such as commercial credits, direct investments or various personal capital movements — which are directly linked to the effective exercise of the other fundamental freedoms of the common market (the freedom of trade in goods and services, the free movement of persons, the freedom of establishment);

(ii) operations in financial market securities (bonds, shares and other securities of a participating nature), the liberalization of which determines the existence of a single European financial market; liberalization in this area has to cover the operations carried out by investors as well as those carried out by issuers;

(iii) operations involving financial credits and operations relating to money market instruments, the liberalization of which is necessary for the establishment of a unified financial system in the Community.

1.2. As each threshold is crossed, growing constraints are imposed on the Member States in the conduct of their monetary policy.

The first group of operations requires merely that the inevitable consequences, in terms of balance of payments, be drawn from a system of freedom of establishment and the free movement of goods, services and persons. The liberalization of operations in securities also opens the possibility of choosing between the financial markets of the Member States and therefore places them in direct competition. The extension of liberalization to monetary transactions imposes not only a greater constraint in terms of the balance of payments, it also affects the organization and functioning of national banking and financial systems and the methods of controlling the external indebtedness of financial institutions and the external circulation of the national currency.

1.3. In the face of these constraints, the Member States are not in identical positions. Three factors determine their room for manoeuvre in settling potential conflicts between the internal and external objectives of their monetary policy:

(i) their level of development and the structural characteristics of their balance of payments, which determine the speed and ease with which the requisite adjustments can be made;

(ii) the international status of their currency (its importance as a vehicle of trade and a reserve instrument) and of their exchange regulations (whether or not they participate in the EMS exchange rate mechanism);

(iii) the level of development of their domestic financial system (size, liquidity, diversification of techniques, methods of regulation).

2. The main phases in the liberalization of capital movements

In this context, two phases could be involved in the process of continuing to liberalize capital movements.

2.1. In the first phase, the objective would be to achieve the unconditional and effective liberalization throughout the Community of the capital operations most directly necessary for the proper functioning of the common market and for the linkage of national markets in financial securities.

Two types of measure are required for the attainment of this objective:

2.1.1. *The ending of exceptional arrangements*

(a) Certain of these exceptional arrangements derive from the application of the safeguard clause provided for in Article 108(3) of the EEC Treaty and is within the Commission's field of competence. The Decisions relating to France, Ireland and Italy were revised, and made stricter, in December 1984. A target date was fixed for the expiry of the Decisions (the end of 1986 for France, the end of 1987 for Ireland and Italy). Similarly, in November 1985 Greece was authorized to maintain certain restrictions on capital movements normally liberalized under Community law, but only for a period of three years.

Also, the revised Decisions referred to the need for restrictions to be gradually relaxed before the expiry date, in line with the results achieved in the recovery of the balance of payments. This partial progress is to be consolidated at regular intervals by the modification of the original authorizations.

(b) Other exceptional arrangements were introduced on a temporary basis by the Treaty of Accession of Spain (until the end of 1990) and Portugal (until the end of 1992). Here too, and chiefly in order to avoid the difficulty of bringing all the authorized restrictions to an end at once, on the expiry date, the Commission will ensure that every opportunity for partial liberalization is taken.

2.1.2. *An extension of Community obligations as regards liberalization*

As a result of the discussions held on this question in the Monetary Committee, two main guidelines have been identified.

First, the legislative progress in view, which will not assume its full significance unless it is applied by all the Member States, must not make it more difficult to dismantle the existing exceptional arrangements. It is logical for these exceptional arrangements to apply, initially, to the new liberalization obligations, in so far as they relate to the same type of operations or present an equivalent risk to the balance of payments. (For example, could a Member State be compelled to liberalize transactions in securities not dealt in on a stock exchange if restrictions on operations in listed securities were still authorized?).

Secondly, the extension of Community obligations must mean that all the capital operations involved in the free movement of goods, services and persons or which are the very basis of a financial market can be reclassified within the rules of unconditional liberalization. On the basis of these criteria, the Commission is preparing a proposal for a Directive, which it intends to present shortly to the Council, and which would make the following additions to the Community's liberalization rules of 1960-62:

(i) The obligation of unconditional liberalization applying to the operations in Lists A and B of the present Directives would be extended to:

(a) long-term commercial credits;

(b) the acquisition of financial market securities, whether or not they are dealt in on a stock exchange;

(c) the admission of securities to the capital market (introduction on a stock exchange, issue or placing). On this point, the Commission had first envisaged that, in the initial stage, the liberalization obligation would be restricted to the admission of certain categories of securities only: shares, units of undertakings for collective investment subject to Community coordination rules, and bonds issued by Community institutions. But it felt that liberalization which immediately covered the admission of all bonds (except the public securities referred to in Article 68(3) of the Treaty) would be closer to the objective of achieving the close linkage of national financial markets, and would avoid giving preferential treatment to certain categories of issuers, as recommended by the Monetary Committee.

(ii) It would also be proposed that, for all liberalized capital movements (Lists A and B), uniform conditions would be laid down for the functioning of any dual exchange market which might exist, by aligning these conditions on the most binding provisions of Article 1 (List A operations) of the present Directive. As a result, Lists A and B of this Directive could be merged.[1]

2.2. In a second phase, the realization of a large internal market, in full possession of its financial dimension, means that a decisive step must be taken towards the total freedom of capital movements.

2.2.1. In the White Paper 'Completing the internal market', the Commission stressed the need to achieve the liberalization of financial services in the Community by 1992 at the latest. The attainment of this objective, and more generally the logic of a European financial system without internal frontiers, inevitably leads to the ending of all restrictions on capital movements. The free movement of capital will therefore have to extend to operations which, under Community law, would still remain excluded, i.e. financial loans in both domestic and foreign currencies, money market operations, deposits and balances on current account. Such liberalization is necessary if the financial intermediaries are

[1] Lists A and B cover direct investments, personal capital movements, short and medium-term credits related to commercial transactions or to provision of services in which a resident is participating, transfers in performance of insurance contracts, and the acquisition of securities dealt in on a stock exchange. Liberalization of these operations is unconditional and may be suspended only by the implementation of the safeguard clauses provided for in Articles 73, 108 and 109 of the Treaty.

The capital movements contained in List C (in particular the issue of securities, the acquisition of securities not dealt in on a stock exchange and financial credits) are subject only to conditional liberalization, in that a Member State may maintain or reintroduce restrictions on these operations provided that they were operative on the date of entry into force of the Directive or on the date of accession, when such free movement of capital might form an obstacle to the achievement of the economic policy objectives of that Member State.

For the other operations — chiefly short-term capital movements (securities dealt in on the money market, the opening and placing of funds on current or deposit accounts, etc.) — the Member States can choose whether or not to impose restrictions.

to compete fully on the European market and derive full advantage from the freedom to provide services which they will be offered. Complete exchange liberalization will make it possible to do away with control procedures for the purposes of verification which have to be maintained, even on liberalized operations, so long as restrictions continue to exist.

2.2.2. The question which arises is whether all the Member States are capable of moving towards this objective of the complete freedom of capital movements at the same speed. This question is especially relevant since, as indicated above, a link has been established between the liberalization of capital movements and the development of the EMS in which not all the Member States fully participate. Moreover, the Luxembourg Act provides for the possibility of special arrangements for the most vulnerable Member States in the realization of a large internal market.

In any event, any differentiation to be made between the Member States in the liberalization process should not be introduced below a uniform level of Community obligations as previously defined (point 2.1. above). Also, through its instruments for supporting balances of payments, the Community must be able to offer Member States which are faced with special constraints the means of overcoming these difficulties so as to enable them to take part in the full process of the liberalization of capital.

2.2.3. Consequently, the approach required for completing the process of liberalization without doubt differs from the one followed up to this stage and based on the progressive transfer of certain categories of operations to a system of unconditional liberation (save where recourse is had to the safeguard clauses of Articles 108, 109 or 73 of the Treaty):

(i) For operations involving financial loans and credits, monetary operations or deposits, the liberalization rules should be more flexible and better suited to their nature. One possibility would be to provide, for this category of transactions, a specific safeguard clause which is less binding than the one in Article 108 of the Treaty.[1] A safeguard clause of this kind, incorporated in the basic Directive, could be activated by the Commission, after consulting the Monetary Committee, if the corresponding movements of capital lead to disturbances in the conduct of the monetary policy of a Member State and are liable to harm the stability of exchange rates in the Community. The derogations authorized would be the subject of a periodic examination within the Monetary Committee.

Consequently, the instruments provided for by the 1972 Directive on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity could be put into operation between the Member States only pursuant to this safeguard clause.

(ii) This important step towards the full liberalization of capital movements should logically be accompanied by:

(a) ending the possibility of resorting to a dual market, save by invoking a safeguard clause;

(b) a tighter formulation of the obligations applying to unconditionally liberalized operations: such obligations would have to cover not only the lifting of exchange restrictions and measures having equivalent effect which do not directly derive from the exchange control regulations, but also all other types of discrimination, taken for reasons of domestic control (in particular tax treatment or placement rules imposed on institutional investors).

(iii) In the light of experience and of the development of financial techniques, the revision of the rules governing the liberalization of capital movements should be seized as an occasion for clarifying and bringing up to date certain definitions and provisions which are over 25 years old. This would mean taking account of the new techniques which have emerged, for example, in the field of transactions in securities or with regard to lending instruments or clarifying the content of certain headings, e.g. those relating to blocked funds or to transfers of assets by migrants.

On the basis of these guidelines, the Commission intends to prepare a new Directive which could be presented to the Council in the first half of 1987.

The other implications of financial integration

A high degree of liberalization of capital movements is a necessary but not sufficient condition for the Community's genuine financial integration. It is therefore important for liberalization to be paralleled by provisions designed to

[1] Article 108 applies to situations in which a Member State is in difficulties or seriously threatened with difficulties as regards its balance of payments. Under this Article, the Commission may grant protective measures only on completion of a prior procedure consisting of: (i) examination by the Commission of the position of the Member State and the sending of a recommendation; (ii) the adoption of a position by the Council on the possible granting of mutual assistance. The scope of the protective measures is not confined solely to capital movements, but may concern any other Community obligation.

ensure the cohesion and identity of this financial area. Also, a truly integrated financial market is bound to have consequences for the conduct by the Member States of their monetary policies.

The Commission intends to embark immediately on a forward-looking analysis of these questions. Only the broad lines of this analysis are presented here.

1. The cohesion of the European financial area

1.1. The objective goes beyond the establishment of a financial free trade area in Europe; it is the establishment of a Community-wide integrated financial system. The intensification of intra-Community financial relations, favoured by the lifting of restrictions, will naturally derive support from the progress already made and to be continued in commercial integration and the convergence of economic and monetary policies. It will have to be accompanied by parallel progress towards the creation of a common market in financial services. The objective is to establish fair conditions of competition which will favour the development of a diversified range of high quality financial instruments and to enable users to exercise their activities throughout the territory of the Community without having to fragment their financial relationships.

1.2. The integration of the European financial area must therefore be preceded by some standardization in the Community of the laws or administrative provisions governing access to financial activities and the exercise thereof.

The main guidelines adopted in this area were described in the White Paper 'Completing the internal market'.[1] The Luxembourg Act offers additional legal means of advancing along this road.

Harmonization must as a priority concentrate on the establishment of a minimal basis of common rules for the protection of the users of financial services and the supervision, by the country of origin, of the suppliers of these services. This harmonized system of prudential rules would guarantee the quality of the financial services offered in the Community.

It would also be necessary to establish rules for the mutual recognition of financial techniques rather than to carry out standardization of an administrative nature, which would damage this sector's innovative capacity.

Lastly, the liberalization of financial services within the Community implies the establishment of common rules applying to third country suppliers.

Also, as the Monetary Committee has noted, the development of the use of the ECU as a vehicle for trade could play a useful role in unifying this market.

The forward-looking analysis which the Commission intends to make would *inter alia* have as its object to identify the obstacles to the creation of a homogeneous network of financial services, and in particular the structural difficulties characteristic of certain countries; it would define its links with the liberalization of capital movements and evaluate its economic significance.

1.3. Apart from its function of mobilizing and allocating savings in the Community, an integrated financial system must permit the establishment of an effective network of payments between the residents of the various Member States for the performance of all current transactions.

The complete liberalization of capital movements will do away with the indirect barriers which may result from national provisions relating to exchange control (e.g. rules governing forward cover for import and export operations), the organization of the foreign exchange market (e.g. the use of multiple exchange rates) or rules on methods of payment (restrictions on the free choice of method of settlement).

In the communication of November 1984 on developing the EMS, the Commission indicated a need for enhanced surveillance, by the Community, of the external payments systems of the Member States. The achievement of an integrated market by 1992 reinforces this need so long as the process of liberalizing capital movements has not reached completion. This would mean, for example, defining at Community level, in a legal form to be agreed, certain rules of conduct with the aim of prohibiting certain practices of a restrictive nature, unless a derogation were granted by common accord.

2. The conduct of monetary policies

2.1. Substantial progress towards the full convertibility of the European currencies, while respecting the exchange rate

[1] COM(85) 310 final of 14 June 1985.

disciplines of the EMS, will inevitably create new conditions for the management of the system.

At the present time, there are two classes of participant in the EMS exchange rate mechanism. Five Member States operate a liberal system, or one which at least complies with existing Community obligations in respect of movements of capital. In this first group of countries one currency performs a guiding role on the monetary policy of the other Member States, which are smaller in economic dimension and, for the most part, are extremely open to the outside world. By contrast, the other three participating Member States maintain a relatively strict system of exchange controls and one of them benefits from a wider margin of fluctuation for its currency. In this mixed situation, the system has been managed satisfactorily in terms of the objectives pursued of stability and convergence, and the progress made in these areas opens the way to the greater liberalization of financial flows.

A system broadened to include other participants and in which the principle of the free movement of capital would become the rule would inevitably be far more sensitive, from the point of view of the variability of interest and/or exchange rates, to cyclical lags and to the expectations of economic groups. It would therefore require a substantial reinforcement of convergence but also of the effective coordination of the monetary policies of the Member States. In its turn, this closer coordination will increase the dynamism of economic policies and increase confidence and investment throughout the Community.

2.2. The pace at which coordination can be reinforced and the procedures for achieving it will have to be determined in the light of experience and it would be largely artificial to wish to specify all the details in advance. Especially since the chief requirement, as the Commission stressed in its communication to the Council of November 1984, would be to make full use of the coordination system which exists, by a more explicit affirmation of the objectives pursued and a stricter application of existing procedures. In other words, coordination should be brought in at a fairly early stage in the definition of the monetary policies of the Member States, in order to prevent divergences rather than to aim for a correction, however rapid, of the imbalances.

As for the management of monetary policy instruments, account will have to be taken of the fact that a higher degree of liberalization of capital will make management by interest rates and the removal of barriers between domestic sources of financing inevitable in the long run, and this will lead to greater uniformity within the Community of the techniques of monetary control.

2.3. The reinforcement of coordination will raise similar questions with regard to the Community's external monetary relations.

In the first place, closer coordination of the monetary policies of the Member States will contribute, at international level, to the stabilization of exchange rates between the major currencies.

Also, Article 70 of the Treaty gives the Community the legal means for the progressive coordination of the exchange policies of Member States in respect of the movement of capital between those States and third countries. Clearly there can be no question of establishing a Community system of exchange control between it and other countries. The principle, adopted by the Monetary Committee, must remain that of liberalization *erga omnes*. However, it would be appropriate to update in good time the 1972 Directive on regulating international capital flows, notably in order to limit the use of the instruments provided for therein solely to relations with third countries and to coordinate their implementation.

Timetable for the Commission's forthcoming initiatives

(i) In view of the easing of exchange controls which has taken place in France and Italy, the Commission will without delay repeal the Decision taken pursuant to Article 108(3) of the Treaty relating to France — this Decision being no longer applicable — and will revise the Decision relating to Italy, so as to reduce its scope solely to the protective measures which remain in force; the period for which the Decision is valid will not be changed.

(ii) Taking account of the discussions which will have taken place within the specialized committees, the Commission will present, early in the summer of 1986, a proposal for a Directive extending Community obligations as regards unconditional liberalization to long-term commercial credits, transactions in securities not dealt in on a stock exchange and operations for the admission of securities to the capital markets, and introducing uniform conditions for the functioning of a dual market.

(iii) In close collaboration with the Committee of Governors and the Monetary Committee, the Commission will initiate a forward study on the implications of financial integration for monetary cooperation and on the liberalization of financial services, and more generally on

the inter-relationships necessary between the different aspects of the internal market (including the approximation of tax systems). The results of this study will as soon as possible be the subject of a communication to the Council.

(iv) On the basis of this study and the guidelines which will be adopted by the Council and the specialized committees consulted for this purpose, the Commission will prepare a new proposal for a Directive establishing the principle of extending the liberalization obligation to all movements of capital. The text of this proposal could be presented to the Council in the first half of 1987.

Implications of the full liberalization of capital movements within the Community

Note from the Commission's departments — December 1986 — for the attention of the Monetary Committee and the Committee of Governors of the Central Banks

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Introduction

In its programme for the full liberalization of capital movements in the Community, which has been endorsed by the Council, the Commission stated that:

(i) the logic of financial integration inevitably leads to the ending of all restrictions on capital movements and to the lifting of all types of discriminatory treatment;

(ii) with this in view it would initiate, in collaboration with the Monetary Committee and the Committee of Governors, a forward study on the implications of liberalization for the conduct of monetary policies, for developing the internal market in the field of financial services, for the machinery for financing economies, for Community cohesion and, lastly, for monetary and financial relations with third countries.

The legislative progress required to complete the liberalization of capital movements in the Community comprises two phases.[1] The first phase is to complete the liberalization, under Community law, of the capital operations most directly necessary for the proper functioning of the common market and for the linkage of financial markets within the Community. The Council adopted the relevant Directive on 17 November and it will be applied in February 1987.

The second phase will extend the liberalization obligations to financial loans and to operations of a monetary or quasi-monetary nature (operations relating to short-term securities, current or deposit accounts),[1] but will also end the possibility of resorting to a dual exchange market as well as the maintenance, in the domestic regulations of the Member States, of discriminatory forms of treatment relating to capital operations and based on the nationality or on the place of residence of the parties or on the place where the capital is invested.[2]

The purpose of this paper is to present a preliminary analysis and assessment of the economic implications of attaining the final stage of the liberalization of capital movements and the conditions in which this can be done, in order to aid the Committees' deliberations.

[1] See Communication from the Commission to the Council of 23 May 1986 — Doc. COM(86) 292 final.

[2] Article 67(1) of the Treaty states: During the transitional period and to the extent necessary to ensure the proper functioning of the common market, Member States shall progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in Member States and any discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested.

The full liberalization of capital movements and the conduct of monetary policies

1. The full liberalization of capital movements involves risks and places constraints on national monetary policies

1.1. In comparison with a situation in which only medium and long-term capital movements are liberalized, the lifting of all restrictions on short-term capital flows will mean that the conduct of monetary and exchange rate policies is more exposed to the effects of differences which may occur between domestic monetary and financial situations and the international monetary environment at the time, whether or not the country concerned participates in the EMS exchange rate mechanism. The greater mobility of capital could lead to more sensitive interest and exchange rates.

At present the amount of liquidity available on the Euromarkets and the sophistication in managing the treasuries of multinational companies can generate short-term financial flows which are already capable of disturbing foreign exchange markets and domestic money markets. To this will be added the effect of a broad measure of substitutability between the liquid assets of the residents of all the Member States.

The liberalization of operations of a monetary character will facilitate speculative transfers of funds which will obey without constraints the exchange rate expectations of economic agents, and the liberalization of financial loans in national currency will make it easier for non-residents to speculate against that currency.

1.2. The full and effective liberalization of short-term capital movements will therefore mean, in particular within the EMS, a relative loss of national autonomy as far as monetary policy is concerned.

Since the substitutability between domestic and external financing will become almost perfect, lasting recourse to direct instruments of monetary control, or even the use of monetary targets limited to the 'resident' money supply will become less relevant. Monetary regulation will have to be based chiefly on indirect management techniques through the manipulation of short-term interest rates and 'open-market' operations. A movement in this direction is already underway. Full liberalization of capital movements will render it irreversible.

Because of this substitutability and the impossibility of isolating Euromarket interest rates from those prevailing on the domestic money market, the monetary authorities will hardly be able any longer to use the short-term rates to pursue, as a priority, autonomous domestic objectives concerning the volume of financing in the economy and the conditions governing it.

Policies to sterilize the monetary effect of foreign exchange intervention will also lose their efficiency in temporarily reducing possible conflicts between internal and external objectives of monetary policy. Indeed, in the complete absence of exchange controls, compensating movements of capital will more easily be able to cancel out the effects of sterilization.

Although to a lesser extent, these constraints will also affect the member countries with flexible exchange rates in so far as they apply some kind of exchange rate target.

The general lifting of exchange controls in the Community will also have its effect on the conduct of monetary policy in the member countries which have already liberalized capital movements in full. It will be more difficult for them to limit the effects of capital inflows on internal liquidity in that their residents will have free access to foreign currency financing which until then had not been readily available.

2. To a great extent these constraints are already having an effect

2.1. Experience has shown that the control of capital movements does not give countries with open economies more than a relative and, in any case, only temporary monetary autonomy in relation to their main partners. In a situation of external imbalance and in the absence of a credible domestic adjustment policy, exchange rate expectations will deteriorate and undesirable autonomous capital movements can occur, despite the application of exchange controls.[1] In this situation, a country can prolong the period for the requisite domestic monetary adjustments only at the price of an organized external indebtedness which in the long run merely

[1] It has been shown that the variability of capital movements is virtually as high in the countries with exchange controls as in the countries which do not maintain restrictions. This can be explained by the fact that exchange control regulations do not generally apply to non-residents' operations and they are not very effective in the face of powerful speculative behaviour such as taking advantage of 'leads and lags'.

accentuates the external constraint. The full liberalization of capital movements would indeed make the need for these adjustments more immediate, but this would act to strengthen and maintain convergence within the Community.

2.2. Most Member States have already attained a high level of liberalization of capital movements. So experience already exists in this area and the assimilation of the chief constraints resulting from the mobility of capital has largely begun.

Banking disintermediation, the 'globalization' of financial markets and international financial innovation have strongly stimulated the adaptation at national level of monetary and financial structures and regulatory methods (on the monetary side, more recourse to indirect monetary policy instruments and predominance of market mechanisms and on the financial side, decompartmentalization and opening up of financial markets). Several Member States are concerned, even among those which have not yet entirely liberalized capital movements (Spain, Italy, France, Denmark and the Netherlands).

3. Liberalizing capital movements in full while respecting the disciplines of the EMS implies that economic policy coordination and monetary and financial cooperation will be reinforced and renewed

3.1. The objective of the full liberalization of capital movements clearly raises the question of its compatibility with the objective of exchange rate stability within the EMS.

By putting the EMS into practice, the Community has clearly opted for exchange rate management determined chiefly by striving for the convergence of nominal trends at the lowest inflation rate possible and conforming, in the medium term, to developments in the economic fundamentals of the participating countries.

Experience has shown that frequent exchange rate variations destabilize expectations and are liable to give rise to perverse dynamic processes (overshooting of exchange rates, imported inflation, undesirable movements of capital) without having predictable, significant and lasting effects on the trade balance (substantial lags in the beneficial effects expected and short-term predominance of J-curve phenomena).

In contrast, the acceptance of EMS obligations, apart from its beneficial effects on convergence, also produces a powerful signalling effect. The economic agents are generally convinced that the participants in the mechanism are prepared to accept the constraints of a strong exchange rate policy and, as uncertainty surrounds the dates of realignments, exchange rate expectations are usually stabilized for long periods within the EMS. Added to this, in so far as they limit potential speculation by residents, exchange controls may appear to add to the ability to resist of the central banks.

For several years, convergence towards monetary stability has been growing more apparent within the EMS (greater downward convergence of inflation rates, wage costs and interest rates). There is also appreciable convergence towards a sustainable configuration of the external balances of the various countries participating in the mechanism. Of course much progress remains to be accomplished, especially in the area of public finance, but one may consider that the present situation allows, under certain conditions, the continued movement along the path towards full capital liberalization. During the last few years, certain Member States have been able to organize or assure a large measure of capital liberalization while respecting the disciplines of the EMS and the mechanism has stood up well to the savage turn-round of the dollar which started in 1985. If in the future the nominal divergences within the EMS are reduced further and stay limited, and if, in addition, concertation and coordination procedures associated with the mechanism assure in a lasting way the stability of economic agents' exchange rate expectations, then the increased mobility of capital will not be destabilizing in character, but will serve to compensate the unavoidable asymmetries on current accounts by permitting sound financing for member countries having to undertake a more sustained investment effort.

3.2. However, the full liberalization of capital movements may in the short term make the cost of exchange rate discipline higher in terms of the level of money market interest rates, the volume of interventions on the foreign exchange market, and the organized external indebtedness required to withstand inopportune short-term outflows of capital.

So, without increased economic convergence, closer monetary cooperation and the better coordination of budgetary policies, there are grounds for fearing that the greater weight of external constraint will produce either a lasting deflationary bias in the European economy or a looser operation of the EMS. The EMS might be seen as no more than a method of avoiding the overshooting of exchange rates, and as a result a widening of the margins of fluctuation and more frequent realignments could be envisaged. Such a situation would take the Community further away from its final objective, economic and monetary union.

At present it is one central bank, whose credibility is based on its institutional autonomy and on the proven stability of its currency, which establishes the common reference for the conduct of monetary policies in the Community and the definition of the parity grid within the exchange rate system, and which effectively takes on the essential responsibility of managing relations between the system and major third currencies. This situation has its merits and the procedures of the Monetary Committee and the Committee of Governors make it possible to increasingly clarify and share in the choices of this central bank. Nevertheless, the full liberalization of capital movements, by reducing even further the residual autonomous room for manoeuvre of the other national monetary authorities, will create a situation in which the basic monetary choices, domestic as well as external, will have to be as collective as possible. With this in mind it will be appropriate to put in place a set of 'rules of the game' in order to strengthen the efficiency of coordination procedures. In this context the concept of Community money supply could start to take on some reality and it will be necessary to study the implications for the rules governing intra-marginal interventions — which in principle would have to be more symmetrical and non-sterilized — and for extending the international role of all the Community currencies, including the ECU.

3.3. In parallel with the adjustment of the objectives for the safeguard clauses and for the Community instruments of medium-term financial support proposed in the Section 'The full liberalization of capital movements and taking account of the diversity in the situations of the Member States' below, it would also be important to reinforce the machinery for monetary solidarity between the Member States participating in the EMS so that they could if necessary cope with more substantial intervention and external financing requirements. As yet, the short-term monetary support mechanism (STMS) has hardly been used. Yet it can be activated independently of needs to intervene at the margins and therefore not necessarily to consolidate a very short-term financing operation. Perhaps its use should be made dependent solely upon the application of the procedures for coordinating monetary policies managed by the Committee of Governors of the Central Banks. The Monetary Committee would be kept informed of this.

The full liberalization of capital movements and the development of the internal market in the field of financial services

1. The requirements of financial integration

Looking ahead to the financial integration of the Community, the full liberalization of capital movements is a necessary condition for the realization of an economic area in which there is complete freedom to establish financial institutions, freedom for these institutions to supply financial services and an integrated securities market manifested especially in close operation between stock exchanges.

In these areas, the regulations necessary at Community level to a large extent already exist and any gaps should be filled by execution of the programme contained in the White Paper 'Completing the internal market'.[1] Also, the level of capital liberalization already reached is favourable to the free provision of a wide range of services and the integration of the financial markets.

However, in several Member States, the national rules still contain a body of discriminatory practices and administrative or regulatory obstacles which impede or disrupt the free movement of capital and the free provision of financial services. With a view to financial integration, it is important to organize the removal of such discrimination and obstacles so that the present segmentation of the European financial markets does not survive the full liberalization of capital.

2. Approaches to the more systematic implementation of the principle of the free provision of financial services

2.1. The financial services sector is of major economic importance today, and it is appropriate to create at Community level the necessary conditions in which it can benefit from the economies of scale associated with the integrated market. The important point is to find the right mix between the pre-eminence of common rules (principle of harmonization) and that of national rules (principle of mutual recognition). In accordance with the approach outlined by the Commission in the White Paper and since adopted by the Council, priority should be given to harmonizing the supervisory rules governing the provision of financial services, in preference to a standardization of the service offered. This supervision should be carried out by the country of origin.

Already a common approach to banking supervision at Community level is in operation adoption of the First Directive on banking coordination and the Directive on consolidated banking control, proposals relating to mortgage credit, to harmonizing the concept of own funds and solvency ratios, to the surveillance of large risks, to the liquidation

[1] COM(85) 310 final of 14 June 1985.

of credit establishments and to deposit insurance, or to harmonizing the annual and consolidated accounts of banks and the periodic information which they must provide for the supervisory authorities. The Commission considers that the measures which have been taken or which are now planned — notably in the White Paper — to implement the principle of 'home country' control with a view to freedom of establishment and freedom to provide services are sufficient to guarantee an adequate level of protection to savers in all the Member States, to preserve satisfactory conditions for competition between suppliers of financial services and to assure the stability of the financial systems (in particular by the application of solvency and liquidity ratios). Consequently, achieving the free provision of financial services will not in principle require entirely new work on coordination.

2.2. With regard to the securities markets, the Commission considers that it is necessary to improve their transparency and to reduce the costs and delays involved in transactions between residents of different Member States. For these reasons, it attaches great importance to the following work:

(i) realization of the IDIS project (Interbourse Data Information System) of the Committee of Stock Exchanges in the European Community, intended to create a real time information exchange system between Community stock exchanges which should eventually lead to the establishment of a genuine European securities market;

(ii) improving the settlement of cross-frontier transactions in securities by means of agreements between the central securities depositaries in the Member States;

(iii) adoption of the amended proposal for a Council Directive on the prospectus to be published when public offers are made for securities; this would facilitate simultaneous issue on several markets as a result of the prospectus published in the country of origin being recognized by the authorities of other Member States.

3. The elimination of discriminatory treatment and other obstacles affecting the free movement of capital and of financial services appears necessary

3.1. In the national regulations of the Member States, it is possible to identify several types of discrimination or indirect obstacles to capital movements and to the provision of financial services.

3.1.1. *Taxation:*

in several member countries national securities receive privileged treatment with regard to personal taxation or indirect taxes imposed on securities transactions.[1]

3.1.2. *Placement rules imposed on institutional investors:*

several member countries restrict the volume of acquisitions of foreign securities.

3.1.3. *Concerning the freedom to provide financial services:*

(i) several member countries prohibit or limit the participation of non-resident financial institutions in issuing operations on the national market or in national currency;

(ii) several member countries prohibit or make difficult the access by foreigners to the occupation of broker or exchange broker; also foreign brokers or financial institutions often cannot canvass national investors or are obliged to go through an approved intermediary to effect transactions;

(iii) lastly, in several member countries, the guarantees given by foreign banks are not recognized by the public authorities, national export guarantee systems do not extend to the financing granted by foreign banks, etc.

3.2. The ending of discriminatory treatment relating to the movement of capital is in fact formally written into Article 67(1) of the Treaty but the Commission has up to now accepted that the scope of Community obligations in respect of capital movements was limited to that laid down in the provisions of Directives adopted pursuant to Article 69 of the Treaty,[2] i.e. to the ending of restrictions on the conclusion and performance of liberalized capital operations

[1] Irrespective of these problems of discrimination, the taxation of financial transactions is far from being harmonized within the Community: this introduces distortions and increases the risks of tax avoidance under a system of fully liberalized capital movements.

[2] Article 69 provides for the adoption of directives for progressively putting into effect Article 67.

and to related transfers.[1] The discriminatory treatment (essentially by taxation) of a liberalized capital operation is not explicitly covered by the directives in force.

However, in a recent judgment[2] the Court of Justice seems to favour a wider interpretation on this point, namely that all the provisions of Article 67(1) should apply to capital operations liberalized by the directives adopted putting it into effect. Consequently, the question of discriminatory treatment should be clarified during the second phase of the programme for the liberalization of capital movements.

3.3. It should be said that the principle of dismantling discriminatory treatment and other obstacles affecting the free provision of financial services is already established in Community law by the direct applicability of Article 59 of the Treaty which refers to the general abolition of restrictions on freedom to provide services within the Community. From the end of the transitional period, the coordinating directives adopted in this area cannot, therefore, have as their object the granting of a right which is already established, but solely the facilitating of the exercise of this right. The adoption of these directives cannot thus be considered by the Member States as a precondition for the removal from their domestic regulations of provisions which may impede the freedom to provide services.

These questions, as well as the scope of the notion of public interest sometimes advanced to justify the maintenance of discriminatory regimes, should be clarified following a judgment in principle which the Court will shortly hand down on the subject of the supply of non-life insurance services. But, irrespective of any legal argument, it is clear that the maintenance of segmentation with regard to the provision of financial services would make the realization of the Community's financial integration illusory.

Lastly, with regard to the dangers of tax evasion which may arise pending harmonization of the taxation of financial transactions, it should be recalled that Article 5 of the present Directive on capital movements permits the Member States to take all requisite measures to prevent infringements of their laws and regulations. However, cooperation between Member States, especially concerning their control procedures, could prove necessary in this area.

The full liberalization of capital movements and financing channels in the Community

1. The impact of liberalization on financial intermediation

1.1. At the Community level, there is a probably unnecessary diversion of savings towards the intermediation channels of non-Community currencies. Two main reasons can be put forward for this situation:

(i) an area for the international circulation of Community currencies which does not measure up to European commercial integration (restrictions on capital movements are generally accompanied by restrictions on current payments procedures) nor to the Community's economic importance internationally;

(ii) national finance markets which are segmented and poorly linked with one another at European level (flawed adjustment of supply of capital to demand).

Experience shows that the freedom of capital movements in a country encourages the invoicing and financing of international transactions and the financial placements of non-residents in that country's currency. It can therefore be expected that the currencies of the member countries — particularly of those which occupy an important position in world trade — will naturally see their international role develop, as and when the restrictions on the free movement of these currencies are removed.

In this context, greater use of the ECU could make a useful contribution to the integration of the European financial market:

(i) the development of the ECU as a currency for invoicing international transactions, particularly transactions within the Community, would contribute to the more equal sharing of the exchange risk between importers and exporters and to greater transparency in the conditions of competition;

(ii) similarly, the development of the ECU as a currency for denominating issues on the Community's stock markets would facilitate simultaneous access of issuers to several European financial centres and would favour the cre-

[1] Such liberalization is clearly intended to end all restrictions on capital movements, whether or not the restrictions derive strictly speaking from the exchange control regulations. Thus, any law, regulation or administrative provision which has as its direct objective the influencing of liberalized capital movements is incompatible with the provisions of the directives (measure having equivalent effect to an exchange restriction). Further, Article 68(2) of the Treaty requires Member States to apply to movements of capital so liberalized the domestic rules governing the capital market and the credit system, in a non-discriminatory manner (for example this covers the conditions for operating a calendar of issues).

[2] See Judgment of 24 June 1986 in Case 157/85 *Brugnoni-Ruffinengo*.

ation within the Euromarkets of a large homogeneous compartment offering a relatively small exchange risk for European operators.

1.2. The full liberalization of capital movements accompanied by an absence of barriers to the free provision of financial services will expose all the national finance systems to a very competitive international environment to which they will have to adapt. The experience of several countries and recent developments on international finance markets suggest, in fact, that the opening up of national financial systems to other countries often goes together with mergers and the establishment of 'universal' financial institutions. But this type of development is not incompatible with the viability, nationally, of financial institutions which are smaller in size and which can handle the 'distribution' of sophisticated financial products devised by the financial institutions operating internationally, and which can adapt to local needs — notably those of SMEs — the new financial services which are developing.[1]

More generally, though it is no doubt true that the full liberalization of capital movements requires that market mechanisms predominate in the methods of regulating national financial systems, this does not necessarily imply a standardization of financial structures in the short term. In the longer term, one may suppose that competition will promote homogeneity of the structures but it is difficult to establish *a priori* which form will predominate.

Keener international competition will stimulate innovation, produce large productivity gains and encourage national financial institutions to extend their activities into other member countries (e.g. in sectors as important as the financing of large-scale projects of Community interest, mortgage credit or consumer credit). If certain member countries, whose financial systems have long been protected from international competition, were to be authorized to liberalize their exchange controls more gradually than other countries, they would nevertheless have to make a rapid choice either to develop a competitive financial system themselves, or to accept in their country the predominance of the financial institutions of the partner countries.

The size of the predictable effects of full capital liberalization on certain national financial structures and on the conditions of international competition underlines the need, for the central banks, for a change in legislation on prudential control and for closer cooperation in this field. Certain provisions of the White Paper concern this objective.

2. The impact of liberalization on the non-financial sector

In general, the removal of barriers between national financial markets resulting from the liberalization of capital movements would make the process of allocating savings to investments more efficient and generally less costly for economic agents, if only because of the economies of scale associated with a large integrated market.

Savers would be enabled to manage their liquid assets more rationally, but would also be offered a wider range of financial assets permitting more diversified placements and better risk-return combinations. The enlargement and increased number of secondary markets would create better conditions for mobilizing claims. Borrowers could have access to more diversified financing methods, less costly and better suited to their needs. In particular, access to international financing in Community currencies would be easier, even for operations involving smaller amounts than those normally dealt in on the Euromarkets, and this could be particularly useful for SMEs.

However, the existing channels for financing the private sector would not necessarily be upset. Already, the large international enterprises have access to the international markets, and these will remain the 'wholesale' financial markets. For these enterprises, the liberalization of capital movements should above all result in a greater preference for financing operations, in Community currencies. As for the financing of SMEs, even if it is diversified among several Community currencies, in most cases it will probably go on being provided by the local bank network in so far as it will be able to give SMEs access to modern and competitive financing techniques.

In several member countries the public sector now benefits from preferential financing channels (direct tapping of savings, system of Treasury correspondents, obligations on banks and institutional investors to place money in public securities). Even if these preferential financing channels are retained once the liberalization of capital movements is complete, the Member States will no longer have direct means of tapping residents' savings and will have to accept financial conditions as regards cost and financing the public debt which are competitive with those of the private sector.

[1] See the conclusions of the recent work of the OECD Committee on Financial Markets.

3. The impact of liberalization on the conditions for settling intra-Community transactions

The full liberalization of capital movements, and more particularly the liberalization of lending operations and financial deposits, would considerably facilitate the settlement of all intra-Community transactions (current and capital). All controls on cross-frontier movements of funds (basic travel allowances, restrictions on the transfer of banknotes, etc.) would have to be ended and all rules governing payments for international operations (choice of invoicing currencies, the requirement that the proceeds of exports or incomes originating abroad must be repatriated etc.) would be unnecessary. Also, the settlement of all cross-frontier supplies of financial services would be easier and the costs incurred in such operations reduced.

Against this background, it will moreover be appropriate to promote, within the Community, an 'interchangeability' as wide as possible among the new methods of payment which will become current as a result of technological developments. This approach would serve not only financial integration but also the objective of the people's Europe. In this area, the Commission is preparing a specific measure concerning systems of payments cards.

The full liberalization of capital movements and taking account of the diversity in the situations of Member States

1. The question of coherence and Community cohesion

It is probable that when the final phase in the liberalization of capital movements within the Community comes into operation, the Member States will not be able to attain the objective of full liberalization at the same pace and in the same circumstances.

Nor can it be ruled out that in future, after the full liberalization of capital movements, some Member States have to cope with disturbances of their balance of payments equilibrium, in the functioning of their financial markets or of the conduct of their monetary or exchange rate policies.

It is therefore important to ensure that appropriate Community procedures exist which will enable Member States in difficulties to withdraw temporarily from some of their obligations or which will guarantee if necessary that Community solidarity is appropriately expressed. This approach conforms to the provisions of the Single Act on economic and social cohesion within the Community. Moreover it is the only way to avoid an accumulation of preconditions for a full liberalization of capital movements.

2. The management of the exceptional arrangements for newly acceding Member States

The 1985 Act of Accession provides a transitional period for Spain and Portugal enabling them to defer the liberalization of certain capital movements liberalized under Community law until 1990 and 1992 respectively. It is appropriate for these two Member States to be able to defer, for similar periods and for the same economic reasons, the implementation of new liberalization obligations in this area. But, in accordance with the provisions of the Act of Accession, if circumstances permit, the Member States concerned will liberalize capital movements in full before the end of the transitional period. For the conditions in which such advance liberalization could be implemented, the Commission, in agreement with the Member State concerned, could consult the Monetary Committee and if necessary submit any appropriate proposal to the Council.[1]

3. The application of the Treaty's safeguard clauses

3.1. The procedures of Articles 108 and 109 are permanent provisions of the Treaty which permit any Member State in difficulties or seriously threatened with difficulties as regards its balance of payments to adopt, under Community control, the necessary safeguard measures. In practice these measures comprise severe restrictions on outflows of capital.

Three Member States (Greece, Ireland and Italy) are now authorized, under Article 108(3), to maintain restrictions on normally liberalized capital operations. These exceptional arrangements are from now on strictly limited in scope and destined to disappear in the relatively near future (the end of 1987 for Ireland and Italy, the end of 1988 for Greece).

[1] See Articles 65, 66, 224 and 225 of the Act of Accession of Spain and Portugal.

3.2. The provisions of Article 73 of the Treaty also form a body of Community procedures enabling a Member State to adopt or maintain protective measures in the field of capital movements. The Article 73 procedures are simpler than those required to activate Article 108. However, the scope of this clause is strictly defined since Article 73 cannot be invoked unless:

(i) disturbances occur in the functioning of the capital market in a Member State;

(ii) these disturbances are clearly the result of movements of capital;

(iii) there is no threat, however, to the balance of payments. [1]

In practice, Article 73 therefore authorizes the adoption, under Community control, of protective measures, chiefly when inopportune inflows of capital (acquisitions of domestic securities by non-residents) or an excessive drain on a country's savings (issues on the domestic market by non-residents) endanger the balanced functioning of the capital market of a Member State.

No Member State is now authorized to maintain restrictions on capital movements pursuant to Article 73.[2]

3.3. The safeguard clauses of Articles 108, 109 and 73 are permanent provisions of the Treaty and can obviously be invoked by any Member State when circumstances justify this. But these clauses cannot be used as a way of postponing indefinitely the effort of economic convergence and structural adjustment necessary if all the Member States are to participate fully in the process of the Community's financial integration. The Commission for its part is determined to ensure a strict management of exceptional arrangements.

4. The establishment of a safeguard procedure specifically for situations leading to disturbances in the monetary or exchange rate policy of a Member State

4.1. The strengthening of the convergence of monetary and financial policies and the deepening of monetary cooperation described above will have to be brought into operation according to a certain timetable, and the dates may on occasions not be met.

Therefore, if need be, and temporarily, a Member State should be allowed to take measures permitting the regulation of short-term monetary and financial flows, from or to other countries, if they were such as to seriously disturb the conduct of the Member State's monetary policy or the stability of its exchange rate.

To this end a specific safeguard clause could be incorporated into the directive liberalizing financial loans and operations of a monetary nature. The capital movements concerned would undoubtedly have to be identified with precision in order to prevent the Article 108 and 109 procedures from being circumvented. The capital operations referred to in this specific clause should form a coherent whole so that their possible control can be applied with a degree of temporary effectiveness. They could cover:

(i) credits and financial loans granted by non-residents, in national or foreign currency, and by residents in national currency;

(ii) operations in short-term securities (normally handled on the money market) by non-residents on domestic markets and residents on foreign markets;

(iii) placing of funds on non-residents' current or deposit accounts in national currency and on those of residents in foreign currencies;

(iv) forward foreign exchange operations whether or not related to the cover of operations involving the import or export of goods and services.[3]

The implementation of such rules would be authorized for short periods only and in a situation in which the economic fundamentals of the Member State concerned did not diverge significantly from those of the other Community countries. If such a situation existed, the Member State concerned would have to adopt an economic recovery programme, request the adjustment of the exchange rate and possibly have recourse to the procedures of Articles 108 and 109.

[1] If there was a threat to the balance of payments, the provisions of Articles 108 and 109 would apply and not those of Article 73.

[2] From 1979 to 1983 Denmark was permitted to maintain restrictions on non-residents' acquisitions of Government securities denominated in Danish kroner, in accordance with the provisions of Article 73.

[3] These operations are not at present included in the lists for the liberalization of capital movements. The Commission has nevertheless on several occasions indicated that the rules relating to operations for the forward cover of imports or exports formed part of a 'grey area' which should be placed under Community surveillance, so long as capital movements remain subject to restrictions.

4.2. With regard to procedure, the mechanism of this safeguard clause could be modelled on the clause contained in Article 73 of the Treaty. However, its implementation should be considered as an integral part of the procedures for coordinating the monetary and exchange rate policies of the Member States. Therefore, not only the Monetary Committee but also the Committee of Governors ought to be associated in the activation of this safeguard clause. Thus the Commission, after consulting the Committees, may authorize the Member State in difficulties to take protective measures, the conditions and details of which it would determine. The Council, acting by a qualified majority, could revoke or amend this authorization. On grounds of urgency, the Member State may take the measures on its own initiative, after informing the Commission and the Member States. In this event, the Commission would have to decide, after consulting the Committees, whether these measures should be maintained, amended or dismantled.

5. A more appropriate implementation of the Community instruments of financial support

The full liberalization of capital movements, while respecting the disciplines of the EMS, is a difficult challenge for Member States in a precarious balance of payments situation or whose financial structures are ill-adapted. In accordance with the guidelines of the Single Act, the Community should strengthen its cohesion by implementing common policies and policies of the internal market, through the financial instruments which it possesses.

With this view, the Community, through its structural instruments and integrated schemes, notably under the IMPs, could support moves to adapt the financial structures (infrastructure projects, telecommunications etc.) of the Member States engaged in the process of the full liberalization of capital movements.

Above all it would be necessary to broaden the objective of the Community instruments providing medium-term balance of payments financial support, so that they were not only instruments of stabilization but also instruments backing and supporting the full liberalization of capital movements. It would thus be conceivable for the Community loans mechanism to take the form of a medium-term credit line opened for a specific period, for a Member State which, although in a precarious balance of payments situation, intended to embark on the process of fully liberalizing capital movements or to maintain a system of full liberalization. The conditionality attaching to this way of activating the mechanism would thus concern specifically the commitment to ensure the free movement of capital. However, this conditionality should also be directed at the general macroeconomic framework making such capital mobility possible.

The full liberalization of capital movements and financial services and relations *vis-à-vis* third countries

1. The liberalization of capital movements should extend to third countries but a system of safeguards should remain possible

1.1. The Community must affirm its identity as a coherent economic area, wide open to the outside world. It must therefore endeavour to attain the highest possible degree of liberalization of movements of capital to and from third countries.

In these circumstances, the chief instrument for regulating capital flows out of or into third currencies or countries would be the Community's exchange rate policy combined with a coherent interest rate policy. The provisions of Article 107 of the Treaty should thus result, in particular for Member States participating in the EMS exchange rate mechanism, in the establishment of a genuine common exchange rate policy (including an intervention policy) *vis-à-vis* the major third currencies. This approach has since 1978 been written into the Brussels Resolution and the Bremen Annex and progress has already been made. It will probably be necessary to go farther along this road in parallel with the abovementioned closer coordination of monetary policies.

1.2. Although it is true that in restricting or liberalizing capital movements, the Member States, for practical reasons and in order to respect their international commitments (OECD) do not discriminate between Community and non-Community residents, it is no less true that the principle of liberalization *erga omnes*, adopted by the Commission and the Monetary Committee, is not written into Community law. Admittedly, Article 70(1) of the Treaty, which forms the legal basis for the coordination of the policies of Member States in respect of the movement of capital between those States and third countries, clearly states that the Community shall endeavour to attain in this area the highest possible degree of liberalization. However, for it to be really binding this principle should be incorporated into a Community Directive.

1.3. To date, only one Directive has been adopted on the basis of Article 70(1).[1] The principle behind this Directive, adopted in 1972 with a view to economic and monetary union, is that it is in the interests of the Community for Member States to be able, in case of need, to decide to adopt concerted monetary protection *vis-à-vis* third countries. However, this Directive does not establish the procedures for organizing this protection where necessary, but confines itself to defining a set of exchange control or monetary policy instruments which the authorities of the Member States should have available in order to regulate undesirable international financial flows. In addition, these instruments chiefly relate to inflows of capital and make no distinction between operations involving Community residents or currencies and operations involving third-country residents or currencies.

The full liberalization of capital movements is bound to have an effect on this machinery for 'monetary' protection *vis-à-vis* third countries. It will be necessary to consider whether to amend this directive, in particular:

(i) so that the range of instruments which it mentions relates to both inflows and outflows of capital and applies, at least, to the same operations as those referred to in the clause for 'monetary' protection to be incorporated in the new rules for the liberalization of capital movements;

(ii) so that implementation of this directive forms part of the procedure for the close coordination of monetary and exchange rate policies within the EMS;

(iii) so that the procedures for activating these instruments are defined and so that the Council can decide, in case of need, on their implementation by the EMS countries — or by all the Member States with a view to ensuring the cohesion of the EMS or in providing temporary assistance for the Community's exchange rate policy in the face of possibly destabilizing short-term international financial flows.[2]

Apart from the hypothesis of coordinated action described above, a Member State would always be able to impose unilateral limits on capital movements from or to third countries only.

2. The benefit of the integrated financial market should be extended to non-Community suppliers of financial services in conditions which preserve the cohesion and interests of the Community

2.1. The Community's integrated financial market will be characterized:

(i) by the freedom of establishment and the freedom to provide services within the Community;

(ii) by coordinated rules relating to the access to or exercise of the profession of financial intermediaries, which are intended to ensure that all users of financial services enjoy the same protection;

(iii) by coordinated systems of surveillance and control, designed to ensure the stability of the financial system.

This market should on the whole remain wide open to suppliers of financial services originating in third countries, if only to assure and strengthen the Community's role as an international financial centre.[3] Foreign competition, often crucial in this area, should thus be able to operate on equal terms within the different member countries. However, this implies a greater effort towards the coordination, if not the standardization, of the national systems which apply to suppliers of services of non-Community origin. For, if different external systems were retained, the result would in fact be that, without concertation at Community level, the most accommodating Member State's system would become the rule, and this would be used to justify the re-emergence of barriers within the Community.

2.2. In parallel with the process of completing the internal market the Member States should therefore examine the possibility of establishing common external systems relating to the various financial services sectors.

Companies based in a third country do not benefit from the full right to provide financial services, whether they are carried out directly (without an establishment in the Community) or through their European branches. To the extent that a Member State gives them this right, the system from

[1] See Directive 72/156/EEC of 21 March 1972 on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity.

[2] The protective measures taken under this Directive would be compatible with the provisions of the OECD Code of liberalization of capital movements. Article 10 of the Code in fact provides that the Community may adopt internally a more liberal system than that which it grants to the other OECD countries.

[3] This justifies the choice of the broad liberalization of capital movements *vis-à-vis* the third countries mentioned above. However, it could prove necessary to make the complete liberalization of certain capital operations originating from third countries dependent upon the prudential rules of those countries first being harmonized with those of the Community. The operations referred to are, in particular, the admission of foreign securities or units of foreign Ucits to Community markets and the insurance or guarantee contracts concluded by Community residents with foreign companies.

which they benefit cannot be more favourable than that under which Community companies operate in the framework of the coordination directives concerning the access to the different financial service activities. Where it proved useful for these common systems, which may in the future govern the activity of these companies in the Community, to be granted solely on a basis of reciprocity (e.g., within the framework of GATT negotiations), or to differ from the corresponding intra-Community systems, the Community could envisage negotiating agreements with third States. These accords should also aim at strengthening cooperation between supervisory authorities of third countries and those of the Community. The Community has the legal capacity to conclude such international agreements and even enjoys exclusive competence in this matter according to the Court of Justice.[1]

The question of conditions on the activities of European subsidiaries of foreign financial companies arises in different terms. Any company established within the Community and set up in line with the conditions provided for in Article 58 of the Treaty[2] has in effect the right to the free provision of services throughout the Community. If it were to appear useful to make the right to establish subsidiaries dependent on reciprocal conditions, it would be necessary to agree on the arrangements for effective coordination of investment conditions in the Community for non-Community financial companies.

[1] See Judgment 22/70 of 21 March 1971 (AETR). In this case the Court states that 'whenever, in order to implement a common policy laid down in the Treaty, the Community has taken measures establishing in whatever form, common rules, the Member States are no longer entitled, whether acting individually or collectively, to contract with third States obligations which affect these rules'.

[2] i.e. in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community.

Note from the President of the Commission to the President of the Council

Informal meeting of the Ministers for Economy and Finance at Knokke — April 1987

In May 1986 the Commission presented the Council with a programme for the full liberalization of capital movements. Since then a first stage in applying this programme has been accomplished. Certain safeguard regimes have been withdrawn or made more restrictive (France, Italy). A directive liberalizing the last operations necessary for the genuine inter-linkage of the financial markets has been adopted and entered into force on 28 February 1987.

The Commission has undertaken to promote a study of the various implications of the full liberalization of capital movements before proposing the corresponding directive to the Council. This study is under way, notably within the Committee of Governors and the Monetary Committee. The Commission's provisional conclusion is that liberalization could be accomplished, at least in a majority of Member States, even before the deadline of 31 December 1992 set by the Single Act for completing the internal market. The purpose of this paper is to identify the conditions for the venture to succeed.

1. The liberalization of capital movements in the Community concerns all the Member States and is part of a general process

1.1. The objectives which underlie the liberalization programme concern all the Member States. The realization of an internal market having its full financial dimension is now an objective which the Community has set itself. The liberalization of capital movements will help improve the allocation of savings resources and can be expected to produce additional growth in the Community, from which all the member countries will benefit. In short, it aims to reinforce and consolidate the convergence of economic policies, which, though remarkable, could still now be seen to be reversible.

The interdependence of the economies means that no Member State can remain indifferent to the process which is taking shape. The countries primarily involved are undoubtedly those participating in the EMS exchange rate mechanism which consider that they still have a significant margin of autonomy in the conduct of their monetary policies. But the liberal countries will have to reckon with the opportunity given to their residents of access to currencies which have so far been unavailable. The countries which still have strict exchange controls will have to define, in terms of a timetable, their relative priorities with regard to the liberalization of their exchange rules and their participation in the EMS.

1.2. It will be necessary to carry through a development which is already well under way. Exchange controls have on the whole become appreciably more liberal in the last two years. The decisions taken by Spain, notwithstanding the provisions of the Treaty of Accession, are very encouraging.

The distance which still remains to be covered should not be overestimated: the operations in question are financial loans in domestic currency, transactions in money market securities and the opening of accounts in foreign currencies. Financial innovation is known to be blurring the traditional distinction between the short-term and long-term sections of the financial markets. For some countries the issue of the repeal of the safeguard clauses from which they benefit — and which is already written into the timetable — comes on top of the implications of the second stage of liberalization and obstructs their calm consideration of it.

2. The completion of the liberalization of capital movements will open a new phase in the development of the EMS and monetary cooperation

2.1. The first period of the EMS has been one of painful and successful convergence towards a model of monetary stability consistently provided by Germany. One of its instruments has been exchange rate discipline, relaxed from time to time by moderate realignments and somewhat facilitated by the existence of exchange controls.

This first phase is coming to an end and the realignment of 12 January 1987 probably marks its completion. The new level of exchange liberalization reached in the Community, together with the increasingly general use of indirect methods of monetary control, have made the foreign exchanges more volatile and more sensitive to the relative financial data, in particular interest rate differentials. Convergence is becoming more demanding; since it must now aim to ensure the coherent management of public finances and the pursuit of monetary stability; it is also becoming less straightforward since the exemplary behaviour of the principal partner is becoming more general. It follows that when there are strains within the EMS, the methods of adjustment are proving less simple and that it will no longer be possible to evade the difficult question of sharing the burden of adjustment.

2.2. The EMS is going to have to face a challenge when capital movements are liberalized of the same nature as the one it would have faced as a result of sterling's accession: how to manage the triangle of incompatibilities which results from the coexistence of exchange rate stability and the free movement of capital, with the relative autonomy of monetary policies of certain member countries.

There are two rival schools of thought as to how to resolve this overdetermination in the long term. Either reliance is placed on common adherence to the same objective of monetary stability and on the formation of a 'stable block' within the EMS to generate a process of spontaneous coordination of monetary policies (subject to a degree of flexibility in the management of the system to react to unexpected shocks); or the choice of a more institutional solution is recommended, with a collectivization of the fundamental monetary choices in the Community (preferably accompanied by more scope for resorting to the mechanisms of financial solidarity in order to defend the stability of exchange rates in the event of transitory strains).

Whatever the respective merits of these two approaches, the issue at stake in the new phase of the EMS is more immediate. It is to define a method of managing a transitional stage characterized by the greater freedom of capital movements, the juxtaposition of convergent and coherent monetary policies whose credibility is however still widely dissimilar, and strict application of the EMS. It would be unrealistic to think that realignments will not be necessary from time to time. But the completion of the internal market implies, and this is how it differs from a free trade area, a rational stability of exchange rates — and for all the Member States.

The cost and the constraints of this transitional period — notably in terms of growth rates, of volatility and level of interest rates, and of volume and financing of interventions — are liable to prove excessive for some Member States if behaviour in terms of adjustment, coordination and EMS solidarity is not cooperative. In particular there must be agreement: in seeking at Community level a rate of economic growth which makes the best use of the growth potential while respecting the priority of monetary stability; in attaining the highest degree of liberalization of capital movements, while revising a rigorous system of safeguard clauses; in reinforcing and widening the purposes of the Community's monetary and financial instruments.

It will be essential to strengthen the methods of coordinating monetary policies. For example, coordination must cover the definition of an objective of monetary stability acceptable to all; the use of the existing elements of flexibility in the EMS designed to frustrate speculation; the management of interest rate levels and differentials which is consistent with the defence of the EMS parity grid and the desired exchange rate relationships with third currencies.

3. The full liberalization of capital movements will reveal the variety of obstacles which will also have to be removed in order to attain a high degree of financial integration

3.1. The liberalization of capital movements is clearly a necessary but not a sufficient condition for financial integration. Financial integration presupposes: the effective freedom to provide financial services, for which the movement of capital is often only the support; no discriminatory treatment connected with the location of placements; conditions of competition between suppliers of services unbiased by non-economic considerations (tax evasion). This means that financial integration will not necessarily keep pace with the liberalization of capital movements, even if liberalization only fully makes sense in the perspective of financial integration.

3.2. Although it is in principle directly applicable, the exercise of the freedom to provide financial services presupposes a degree of harmonization in national legislation in the fields of banking, insurance and the organization of financial markets. It is sufficient to recall here the approach of the White Paper, adopted by the European Council in 1985. The White Paper forgoes — in the interests of realism — the harmonization of financial products, and instead advocates seeking a sufficient degree of harmonization — sometimes a little awkwardly termed 'minimal' — of the supervisory rules, so that, in accordance with the principle of mutual recognition, the country in which the service is supplied must be satisfied with the supervision of the authorities in the supplier's country of origin. The harmonization sought does not at all mean alignment on the most flexible supervisory rules. What is desired is, on the contrary, to use the most relevant rules notably in the face of renewed banking risks. A recent judgment by the Court of Justice recognized that the wish to protect savings and the users of financial services may result in the freedom to provide services being legitimately subordinated to authorization procedures where harmonization is insufficient.

It remains that, in the field of banking at least, the Commission considers that the directives which have already been adopted, those which it has presented to the Council and those which it has announced, form a body of texts sufficient to ensure the effective freedom to provide services.

3.3. The Commission intends to propose a redrafting of the scope of liberalization obligations in relation to financial

operations; in addition to the foreign exchange authorization, liberalization should cover everything which could impede the conclusion and execution of transactions. In a recent judgment, the Court of Justice even seemed, in the name of the principle of the freedom of capital movements, to condemn certain forms of administrative and possibly tax treatment which discriminated between national and Community placements.

3.4. The dangers should not be underestimated of placements and financial activities being moved to other locations as a result of differences in the tax system of the Member States, although these differences affect just as much the location of the production of goods and services. They could exacerbate the effects of the normal diversification of portfolios and even in some cases take the form of 'inverse transfers', hardly consistent with the optimum allocation of financial resources. These problems can be solved by harmonizing tax systems. In the meantime, the Member States are authorized under Community law 'to take all requisite measures to prevent infringements of their laws and regulations' but provided that these controls do not render illusory the right to engage in liberalized capital movements.

4. The liberalization of capital movements must not run counter to the cohesion of the Community

This gives rise to three essential questions:

4.1. Because Member States do not start from the same situations, is there a need for supporting and transitional measures?

In the majority of the Member States the liberalization of capital movements will be complete before the 1992 deadline. Does it have to be complete by the same date in the new Member States? This is not definite, especially if it is remembered that for them the implications are particularly significant. In particular they will have to modernize their financial systems — this could be helped by the Community's structural instruments — rearrange their systems of financing the public sector, reconsider the return on and the taxation of savings, etc.

The Commission has already announced its plan to broaden the scope of the instruments providing medium-term balance of payments assistance. In the past they have always been activated to assist member countries which, at a time of balance of payments crisis, have introduced or tightened exchange controls. Their use could be envisaged to support a State which, although its external situation was precarious, undertook to proceed along the path of liberalization. An appropriate form of conditionality would have to be worked out.

4.2. Because of the greater fluidity of the monetary environment of each of the Member States, should the system of safeguard clauses be amended?

Discussions in the committees have shown the advantage there would be in a Member State being able temporarily to prevent short-term capital movements from entering or leaving the country in a situation in which they seriously disrupted the regulation of bank liquidity, but without there being any significant divergence in economic fundamentals.

It has been argued that this need could be met by the safeguard clause of Article 73 of the Treaty, authorized by the Commission, after consulting the Monetary Committee. But this clause does not really meet the same need, because it refers to disturbances in the functioning of the capital markets. A broad interpretation could give grounds for the accusation that a procedure was being circumvented. The Commission would therefore prefer to incorporate a specific safeguard clause, relating to monetary operations, in the future Directive.

4.3. In a financial market that is becoming global, is the financial identity of the Community an illusion?

There is broad agreement on the idea of liberalization *erga omnes*. Nevertheless, it will be necessary to update the 1972 Directive on regulating international capital flows since it will no longer be possible to activate the instruments of control to which it refers within the Community except by virtue of a safeguard clause, whereas today their use is discretionary. When updating the Directive, the Commission would also suggest examining the advisability of providing for the possible concerted application of this Directive in the event of exceptionally large capital movements to or from third countries; this would moreover be in line with the explanatory memorandum to the Directive, which was drafted before the EMS existed.

The financial identity of the Community will be based on the juxtaposition of the liberalization of capital movements and the free provision of services, the exercise of which is subject to legislative harmonization which will apply only to the States of the Community. Third countries will have to negotiate with the Community a regime for supplying financial services, for which it will be able to determine the

conditions of reciprocity and the degree of liberality. The Commission considers however that the lack of coordination demonstrated in Member States' negotiations on the establishment of the branches of foreign financial institutions may lead to unbalanced concessions to the advantage of third countries.

Conclusion

1. Notwithstanding the additional comments which may be made by the Ministers, the Monetary Committee and the Committee of Governors envisage finalizing their reports for the informal economic and financial Council meeting of September. Between now and then the Commission envisages, independently from work on strengthening the EMS, continuing its examination of the following points in particular: advisability of subdividing the second phase, recommended by certain Member States for reasons of taxation; exact scope of the liberalization obligations; safeguard clauses; modifications to financial instruments. After the economic and financial Council meeting of September the Commission intends to present the Council with the corresponding proposed Directives or Decisions, having made a progress report to Parliament at its request.

2. At this stage of the discussions the Commission is in a position to make three observations:

(i) The implications of full liberalization are multiple and major; but none of them represents an insurmountable obstacle;

(ii) full liberalization now corresponds to an obligation of the Treaty. It means carrying through an irreversible process, even if its pace differs from one member country to another. It will be a challenge to the stability of the EMS, but also an opportunity to strengthen it;

(iii) lastly, and perhaps most importantly, there is no precondition for the liberalization of capital movements. On the other hand, it will have a powerful stimulatory effect on the adoption of the accompanying measures necessary for it to lead to the completion of the internal financial market.

Part Two — Reports prepared by a group of independent experts consulted by the Commission

To help with the thinking on the implications of complete liberalization of capital movements, the Commission considered that a detailed analysis was needed and decided to seek the opinions of several independent experts.

In general terms, each consultant was asked to analyse the economic, financial and monetary implications of a complete lifting of restrictions on capital movements, as set out in the Commission's Communication to the Council of May 1986.[1]

Within this overall analysis, each expert was expected to deal with one specific aspect.[2]

The contribution by Professor de Boissieu therefore attempts to outline the consequences of complete liberalization of capital movements for the European Monetary System.

Each of the other contributions focuses on the particular case of one Member State or of a group of Member States:

(i) Italy (Professor Basevi);

(ii) France (Professor Wyplosz);

(iii) Spain (Mr Cuervo-Arango Martínez[3]);

(iv) the small open economies —Belgium, Denmark and the Netherlands (Mr Steinherr and Mr De Schrevel);

(v) the Member States less advanced in the integration process because of their more recent accession: Greece, Spain and Portugal (Professor Braga de Macedo[3]);

(vi) the United Kingdom (Professor Artis).

The contributions reproduced in this part are preceded by an introductory note setting out the main issues investigated in the analyses and presenting the Commission's point of view. The opinions expressed in this commentary are those of the Commission's departments alone and do not necessarily reflect the positions of the experts consulted.

[1] See Part One of this publication.

[2] The contributions were prepared in English.

[3] These consultants, having been contacted by the Commission at a later date, had only a relatively short time to complete their studies.

Summary and comments by Commission departments

For the purposes of this summary, the main points of the consultants' analyses have been grouped around four principal subjects:

(i) the impact of the liberalization of capital movements on resource allocation;

(ii) the consequences for the determination and evolution of exchange rates;

(iii) the effect on monetary and budgetary policies;

(iv) the envisaged solutions to the problems.

On each of these subjects, the viewpoint of Commission departments is also presented.

This arrangement, adopted for the sake of clarity, should not conceal the fact that these problems are heavily interdependent, as is clearly brought out by the experts' analyses.

For example, the distinction made between the impact of the liberalization of capital movements on resource allocation and its consequences for exchange rates is, in certain respects, arbitrary. As *Basevi* in particular stresses, exchange rates may overreact by reference to changes in the economic fundamentals and this may have a substantial effect on resource allocation.

More generally, examination of the interdependence of the problems inevitably leads to the fundamental question of the incompatibility between fixed exchange rates, free movement of goods, services and capital and the independence of economic and monetary policies. In other words, it poses the problem of the degree of coordination necessary to ensure both the freedom of financial and monetary relations and the stability of exchange rates, both of which are indispensable for the realization of an internal market in line with the objective which the Community has set itself for 1992.

From the Commission's point of view, the solutions to this problem must take account of the fact that, by reference to traditional theoretical analyses, the Community finds itself in a transitional phase with regard to the liberalization of capital movements, the coordination and convergence of economic policies and the system of exchange rate relationships, added to which situations differ from one Member State to another.

1. The effects of liberalization on resource allocation, saving, investment and employment

Summary

1.1. On the basis of a two-country model, *Steinherr* provides the theoretical demonstration that free capital movements encourage the optimum allocation of resources at world level and that they are therefore globally welfare improving. Assuming that the productivity of capital is higher in country A than in country B, liberalization will be reflected in an export of capital from B to A. The two countries will gain, but the benefits will not be the same for all sections of the community. In country B, the outflow of capital will reduce the productivity of labour; wage and salary earners will therefore suffer a loss of income, but this will be more than offset by the rise in the revenue of capital holders deriving from the investment made in country A. Conversely, in country A wage and salary income will rise and the revenue of the capital holders will fall. In other words, in country B, GNP will increase more in absolute value than GDP will fall in absolute value:

$$|\triangle^{+} \text{PNB}| \quad > \quad |\triangle^{-} \text{PIB}|$$

while in country A the two aggregates will increase but the increase in GDP will be larger than the increase in GNP:

$$\triangle^{+} \text{PIB} \quad > \quad \triangle^{+} \text{PNB}$$

This process assumes that country B's wage earners are prepared to accept a reduction in their real remuneration; if this is not the case, because of imperfections on the labour market, the export of capital will cause a reduction of employment in that country. Global income will not increase so much, and it may even decrease. *Artis* observes that by reducing capital productivity, the imperfections of the labour market may be the root cause of outflows of capital, but that this should lead the authorities to correct these imperfections, and not to prevent outflows of capital. *Steinherr* recalls that the situation of the Belgian franc was critical until 1982, the date when a radical reform of the wage indexation system was adopted. *Basevi*, referring to the Italian experience, is far more sceptical as to whether it is possible (or even advisable) to correct the imperfections of the labour market in the short term, and even in the medium term. In these circumstances, the theory of the 'second best' justifies measures, such as the dual exchange market, which, without preventing capital movements, 'throw sand' in the works. *Cuervo-Arango* feels that adjustments in the labour market are necessary to enable Spain to achieve real integration (abolition of tariff barriers) in satisfactory conditions. Nevertheless, he sees no major problems in direct and portfolio investment being liberalized during this transitional period, which will have to enable the sustainable exchange rate for the peseta's entry into the EMS to be established. *De Macedo* emphasizes the need for the newly-integrating countries first to liberalize the markets in goods, if the 'welfare effect' of the integration of the financial markets is to be maximized.

1.2. Another advantage of liberalization is that it offers the possibility of being better able to satisfy savers' and investors' preferences, which differ according to country, with respect to the degree of liquidity of placements and the time horizon; whence a globally positive effect on the level of saving and investment *(Steinherr)*.

1.3. According to *Steinherr*, in the present European situation, liberalization will be reflected above all in increased competition between financial intermediaries and therefore in a reduction of their profit margins, to the benefit of savers and borrowers. Empirical estimates suggest that the interest elasticity of investment is stronger than the interest elasticity of savings; the reduction of intermediation margins could therefore be reflected in a transfer from banks to savers rather than in an increase of investment.[1] However, *de Boissieu* quotes other studies which show that the global saving of households is chiefly a function of income but that interest rates play an important role in the distribution of households' saving between financial assets and real assets. Consequently, the increase in the yield would give rise to an increase in financial saving.

1.4. According to the consultants, competition will have a positive effect on the quality, the diversification and the prices of financial services. *Cuervo-Arango* stresses the importance of the contribution made by foreign banks' subsidiaries to the modernization of financial structures in Spain. *Wyplosz* considers that the possibility of failure for some intermediaries is a price worth paying for the advantages of liberalization. *De Boissieu, Artis* and *Basevi* mention the possibility that liberalization may increase the concentration of operations on certain financial centres (notably London) but do not consider that this should give rise to serious concern.

1.5. Exchange controls are imposed in some countries in order to contain the cost of the public debt. *Wyplosz* observes that the reduction in the cost of the debt obtained in this way represents a tax on savers. By doing away with this disguised taxation, liberalization implies the use of other, more explicit forms of tax. *Wyplosz* considers this process to be positive from the point of view of tax transparency. Liberalization will give rise to a redistribution of income as a result of this new distribution of the effective tax burden.

1.6. Another redistributive effect may result from the abolition of privileged financial channels and administered rates *(Wyplosz, de Boissieu)*; liberalization implies that interest rates, rather than a compartmentalization of the market, should be used for monetary and financial management.

De Boissieu mentions the possibility that some Member States will seek to maintain a selective interest rate policy by protecting certain sectors from outside influence, through forms of 're-regulation'. *Wyplosz* observes that after liberalization, the only way of favouring certain categories will be to grant them loans at reduced rates of interest charged to the budget. The advantage of this system is transparency, since in the end the subsidy is always paid by someone (under the system of administered rates by savers or by categories of borrowers who are obliged to obtain finance at a higher market rate).

According to *de Macedo*, the abolition of privileged financing channels and the increase in interest rates which may result could lead to a riskier selection of investments, and consequently a greater risk for the whole financial system.

1.7. For *Steinherr* and *Wyplosz*, differences in regulatory conditions, e.g. with regard to compulsory reserves and taxation, could continue to restrict competition despite liberalization.

Steinherr stresses the advisability of adopting systems which eliminate both double taxation and tax evasion. According to him, the solution would be a uniform tax at source for the Community. It would be even better to set the uniform rate at zero, so that capital income would be tax-exempt. However, he adds that the harmonization of regulations (even tax rules) will emerge as a by-product of liberalization, and should not be a precondition for it. *Basevi* cautions against the danger that liberalization may lead to unrestrained deregulation.

Comments

1.1. Commission departments consider that evaluation of the effect of the full liberalization of capital movements on resource allocation must take account of the degree of financial openness already achieved. In almost all the Member States, both incoming and outgoing direct investment is already almost entirely liberalized. With the exception of a few of the small, newly acceding countries, it seems difficult to maintain that direct investment in the member countries provides widely differing rates of return.

It is true that interest rates are another factor in determining where direct investment is made. If a country seeks to keep its real interest rates at a low level to stimulate domestic

[1] Otherwise the increase in investment will give rise to a deterioration in the current account balance, because of an excess of investment over domestic saving.

investment, but leaves residents free to make direct investment abroad, it is probable that they will borrow on the domestic market to invest abroad (and so, even recently, in several Member States residents were obliged to finance direct investment abroad in foreign currencies). However, in most of the countries real interest rates have become much the same in the 1980s. In these circumstances, France in 1986 and Italy in 1987 were able, with no major problems, to lift the restrictions on portfolio investment, so that these operations are now unrestricted in the large majority of Member States.

On this point it is interesting to refer to the distinction made by *de Macedo* between capital movements based on differences in endowments and capital movements based on arbitrage opportunities which enforce capital market efficiency. The former type of movement tends to enforce the equality of returns on real (direct) investments; the latter type tends to enforce the equality of returns on portfolio investments. This equalization has already taken place in most of the Member States so that full liberalization, while further promoting optimum resource allocation, will not cause massive shifts. Greece and Portugal, where these conditions do not yet fully obtain, have justly been granted a longer period, under the terms of a safeguard clause and of the Act of Accession, within which to liberalize direct and portfolio investment. Since Spain is closer to the other member countries in terms of economic and financial homogeneity, the exceptions which apply are narrower and the Spanish authorities have already been able to abolish some of the restrictions authorized by the Act of Accession.

1.2. In addition, the possibility exists of improving structures and making them more similar. Much progress has been made in several countries in recent years with regard to labour market flexibility. In this area, as in others, the liberalization of capital movements is likely to accelerate structural changes, for example by making the consolidation of public finances and better management of the public debt even more essential.

1.3. The liberalization of capital movements must also be seen in the context of the completion of the internal market, of which it forms an essential component. The lifting of exchange controls will, for example, make it possible to abolish a good many formalities which today impede everyday trade. It will also unlock the full potential of action taken to facilitate the freedom to provide financial services.

1.4. Liberalization will entail a modernization of financial structures. Modernization will probably stem from increased competition between national intermediaries, following the deregulation resulting from the liberalization of capital movements, as much as from competition between domestic and international intermediaries.

When assessing the reduction in intermediation margins entailed by liberalization, it is necessary to take account of the different factors in each country, which may influence their size. The constraints on bank assets differ according to country. The consultants mention some of them but it must not be forgotten that debtor rates may include a risk premium which may vary from country to country and that some services are provided free of charge by the banks which recover their cost on creditor or debtor rates. The size of intermediation margins and therefore the possibility of reducing them must be assessed with some caution. It is, however, certain that in the medium term liberalization will give rise to the harmonization, in itself desirable, of the *modus operandi* of monetary policies, so that competition between intermediaries is not distorted by the use of different supervisory instruments, and to bank management which is increasingly inspired by criteria of efficiency.

2. The impact of liberalization on exchange rates

Summary

2.1. All the consultants stress that in the absence of corrective measures (examined in point 4) the full liberalization of short-term capital and financial credits may have a destabilizing effect on exchange rates and the EMS. This judgment is based on experience of crisis periods during which the market expects an early realignment. Observation shows that during such periods, the differential between Eurofranc and Eurolira interest rates and interest rates on the domestic market or the gap between the Belgian franc official and free markets may become very large. This implies that exchange controls have been effective during crisis periods and that without controls the countries concerned would have had difficulty in complying with the EMS exchange rate discipline. Of course, the exchange rate can always be defended by raising short-term interest rates; but in crisis periods the rise could reach untenable proportions. *Wyplosz* observes, for example, that if the market expects a 10 % depreciation one week ahead, the interest rate increase required to counter speculation in the currency concerned would have to be of the order of 520 percentage points.

2.2. Outside crisis periods, the impact of liberalization on exchange rates will chiefly depend on the degree of substitutability between financial assets. *De Boissieu* makes an initial distinction between capital mobility which is essentially a

legal concept and the substitutability between financial assets, which depends on the wealth and behaviour of operators and in particular on their attitude to risk. In theory, perfect substitutability between financial assets denominated in different currencies deprives monetary policy of all autonomy while imperfect substitutability leaves the authorities some margin of autonomy. However, when the markets expect a realignment, the holding of weak currencies becomes more risky (i.e. the degree of substitutability between weak currencies and strong currencies diminishes). If the authorities of weak currency countries wish to avoid or defer the realignment they will be obliged to raise domestic interest rates which will then incorporate a risk premium. In this case a lower degree of substitutability reflects a loss of monetary autonomy since the external constraint becomes more severe.

De Boissieu points out that if liberalization causes speculative movements which give rise to more frequent realignments, this would mean a lower degree of substitutability between European currencies; in this case, it would therefore be movements of capital which determine the degree of substitutability, and not the reverse.

2.3. *De Boissieu* observes that the impact on exchange rates will differ according to whether liberalization leads to a concentration of portfolios in one currency or on the contrary to a process of diversification between the different currencies. The former will generally have a destabilizing and the latter a stabilizing effect. Admittedly, distinctions must be made according to cases, since a shift into the German mark may be considered as diversification (out of the domestic currency) or concentration (in the German mark).

In principle, liberalization will be *erga omnes* so that diversification and concentration will also concern third currencies.

2.4. According to *Steinherr* and *Basevi*, liberalization could cause effects of over-adjustment of exchange rates in relation to third currencies. This process between currencies belonging to the EMS could, however, occur only as a result of the system being abandoned or if realignments were no longer to respect the principle of purchasing power parity.

Comments

2.1. In crisis periods, the wide variations observed on the Eurocurrency markets are also the result of the thinness of these markets, and can give no precise indications as to the scale of the rise in domestic rates should capital movements be liberalized. The figures given as an example by *Wyplosz* assume that operators have very precise expectations as to the date and scale of realignments. Uncertainties make speculators far more cautious and reduce the scale of the interest rate increase required to defend the exchange rate.

2.2. Furthermore, it is difficult to extrapolate from past experience, since convergence is now far greater; it must be considered as an established achievement and a starting point for more ambitious objectives. When inflation rate differentials are of the order of 2 or 3 %, operators can no longer expect substantial realignments. In addition, recent experience shows that certain economic policy measures (including a significant but moderate change in interest rates) may curb speculative attacks through their announcement effect. This effect, more than the monetary measures themselves, discontinued after a few months, halted speculation against the lira at the beginning of 1986. Admittedly, for the countries which are more divergent, liberalization and acceptance of EMS obligations can only be gradual, as *de Macedo* and *Cuervo-Arango* stress.

2.3. 'Diversification' and 'concentration' have implications not only for how the EMS but also for how the international monetary system as a whole functions. It can be assumed that liberalization, by increasing the credibility of economic policy, will make the currencies concerned more attractive. The result will be a diversification, from which all the European currencies will benefit, in the portfolio of international investors, including third-country residents, and this will strengthen the cohesion of the EMS. The fact that the greater presence of the European currencies would have a direct positive effect on the stability of the international monetary system considered as a whole may be disputed, but greater stability will be possible because Europe's negotiating capacity will be strengthened.

3. The impact of liberalization on interest rates and on monetary and budgetary policy

Summary

3.1. All the experts observe that according to the Mundell-Fleming model, in a system of fixed exchange rates, monetary policy has very little independence (*de Macedo*'s analysis is less definite on this point). Consequently, for the countries concerned, participation in the EMS exchange rate agreements involves a restriction on the management of their

monetary policy, which varies in severity according to the country's economic power and size.

All the experts consider experience of the EMS to be positive, and stress the need to preserve its achievements. However, opinions are somewhat divided on the degree of monetary policy independence allowed by the EMS and on the advisability of retaining or even enlarging it by means of adjustments to the system.

3.2. *Wyplosz* maintains that the existence of a margin of fluctuation and the possibility of realignments have not deprived the EMS of its fundamental character of a fixed exchange rate system. In accordance with the Mundell-Fleming model, the member countries have lost the possibility of conducting an independent interest rate policy, because the interest rate completely incorporates the expected rate of fluctuation within the band and the eventual rate of change at the time of realignment. However, *de Boissieu* considers that in normal times, the coexistence of the EMS and of the liberalization of capital movements should mean a tendency for nominal interest rates to equalize. *Artis* considers it possible that a change in interest rates in the leading country might not require so much of a parallel change in the interest rates of the other countries but be accepted in a change in the exchange rate, if this is permitted by the band width and the position of the currency within the band. Consequently, increasing the band width is likely to increase monetary autonomy. According to *Basevi*, the dual exchange market would enable the country which adopted it to maintain its monetary independence (better control of its money supply) even if it belonged to the EMS because capital movements would pass through the free market and would have no effect on domestic liquidity. *Steinherr* refers to empirical results which are said to confirm that membership of the EMS involves an almost total loss of monetary policy autonomy in the smaller countries.

3.3. According to *Wyplosz*, the sole monetary independence allowed to EMS participants is to be able to maintain a long-run inflation rate which differs from that of the partner countries. The liberalization of short-term capital movements is liable to do away with this last area of limited but important independence in so far as it makes it possible to avoid the social costs of a policy aimed at the rapid reduction of inflation differentials. *Wyplosz* considers that there are still major structural differences in the member countries which make periodic realignments inevitable; these realignments trigger speculative attacks which are liable to make the system unworkable, if short-term movements are unrestricted. Although ineffective in the medium term, exchange controls on capital movements play an important role in the short term and their existence has contributed to the stability of the EMS. In this light, it seems difficult, for *Cuervo-Arango*, to abolish exchange controls on short-term operations. According to *de Macedo*, in the new member countries, liberalization should initially be confined solely to long-term inflows of capital.

3.4. The coordination of policies is a way of both coping with the dangers of liberalization and of compensating for the loss of monetary autonomy resulting from liberalization. However, the consultants are sceptical as to whether progress can be made along this road in the current situation. *De Boissieu* mentions the obstacles represented by differences in structure (which imply a different reaction to external shocks) and by the differences in the models used to interpret the functioning of national and international economies; the dominant position occupied by Germany in the EMS is also an obstacle to coordination, in so far as the other States are not prepared to accept this position.

According to *Wyplosz* it could be argued that the countries belonging to the EMS implicitly agree to align themselves on Germany's monetary policy and 'buy' the credibility of the Bundesbank. It remains to be proved whether this approach is always the best solution since in some circumstances the EMS countries might wish the Bundesbank to change its policy. *Artis* observes that there is no certainty that one of the factors which in the recent past has favoured convergence, namely the priority given to fighting inflation, will persist in the future.

The sterilization policy which aims to offset the impact of capital movements on domestic liquidity is an important element of coordination. This policy could be negotiated in advance. *Artis* quotes empirical studies on Germany which show that the effectiveness of sterilized interventions is limited, and observes that in theory the liberalization of capital movements is likely to reduce such effectiveness. However, as can also be seen from other studies quoted by *de Macedo*, the results of empirical work vary according to country and period so that it is difficult to draw any definite conclusions.

De Boissieu states that in order to make progress towards liberalization, it would be necessary to move from the present level of coordination, based on an agreement concerning certain fundamental economic policy objectives, to a higher level covering certain instruments of economic policy, e.g. interest rates. However, *de Boissieu* goes on to discuss the theory of the 'second best', to show that the total independence of economic policies may be preferable to partial coordination. For example, if there is no coordination of budgetary and pay policy, it would not be appropriate to coordinate monetary policies by setting a common money supply target. On this subject *Wyplosz* observes that

irrespective of the intentions of each country's monetary authorities, European money supply growth will always be the weighted average of money growth in all member countries.

3.5. With regard to the impact which liberalization may have on the choice of intermediate targets, *de Boissieu* observes that the removal of foreign exchange restrictions will extend the empirical variability of the external counterpart of the money stock and therefore of the money stock itself. This, together with the increase in domestic currency held abroad, will reinforce the instability of the relations between the money stock and the real variables. The authorities could abandon monetary targeting or adopt a more flexible attitude both to the targets set and to their attainment.

Another solution might be to replace the money supply by different targets; however, interest rates do not seem an appropriate choice since they are increasingly determined by external rates. A nominal exchange rate target is already implicit in membership of the EMS. As for real exchange rates, they are much less controllable than nominal exchange rates. However, greater capital mobility could be a justification for reactivating, in some member countries, credit aggregates (notably domestic credit expansion) as a target.

3.6. Liberalization will also imply that the methods of monetary control are brought closer together. *Artis* observes that liberalization is likely to limit, or even to nullify, the effectiveness of direct controls; in the United Kingdom, after the liberalization of capital movements, the 'corset' was found to be biting less and less, which is why it was abolished. The ineffectiveness of direct controls under a liberalized system is due to the development of off-shore markets which are not subject to such controls.

3.7. According to the Mundell-Fleming model, under a fixed exchange rate system the liberalization of capital movements is likely to increase the effectiveness of budgetary policy. In this situation an expansionary budgetary policy is not hampered by 'crowding-out' effects since capital inflows limit the rise in interest rates. However, the increase in budgetary policy room for manoeuvre after liberalization must not be exaggerated. *Steinherr* recalls that the functioning of the model is subject to restrictive conditions (fixed prices, absence of expectations) which reduce its practical validity. *Wyplosz* observes that if an expansionary budgetary policy leads to a loss of credibility as to whether the exchange rate can be maintained, capital outflows follow, not inflows. *De Boissieu* adds that, at the present time, Member States are keen to follow a policy consolidating public finances in the medium term and this reduces the possibility of adjusting budgetary policies to the economic situation. Finally, the room for manoeuvre will subsequently be reduced for the Member States which, following liberalization, may have to bear a higher debt-servicing charge.

Comments

3.1. A distinction should probably be made between the 'absolute' independence and the 'relative' independence of monetary policy. Absolute independence means that the authorities seek the domestic market's permanent isolation from the international market so that all national saving is kept within the country. This problem has already been dealt with in the chapter concerning resource allocation. None of the consultants advocates the continuation of this type of monetary independence and the application of the exchange controls which are its consequence. Opinions are, however, more divided concerning the second type of independence which aims to preserve a certain degree of autonomy in relation to the international economic situation and the possibility of choosing a different trade-off between real growth and inflation. Commission departments agree that convergence should not be interpreted too rigidly; for example, growth rates will not necessarily have to be the same for all countries and for all periods of time; it will be possible for current account deficits to be offset by surpluses in the following years. On the other hand, it is important to avoid divergences in the stance of economic and monetary policies.

3.2. The consultants are somewhat sceptical as to whether progress can be made towards coordination. However, the theory of the 'second best' referred to in this connection by *de Boissieu* seems valid only if it is assumed that monetary policy coordination would be based on the setting of a uniform money supply growth target for all the countries. But closer coordination of monetary policies with the aim of establishing *ex ante*, at Community level, monetary targets tailored to each country, seems perfectly credible.

In this respect, in a situation in which there is complete freedom of capital movement between the participants in the EMS, a policy of non-sterilization of interventions on the foreign exchange markets assumes particular importance in enabling an element of automatic stabilization to be introduced into the system. Otherwise, in the weak currency countries, money market operations aimed at reconstituting liquidity destroyed externally will fuel additional outflows of capital and will therefore cause fresh losses of foreign exchange reserves. Conversely, attempts by the central banks of the strong currency countries to sterilize the effect on their domestic liquidity of inflows of capital by keeping unchanged the interest rate differentials with other countries, will encourage new inflows of capital.

3.3 Commission departments share the opinion of the experts that the full liberalization of capital movements will

encourage the adoption of indirect methods of monetary control and will make direct controls ineffective. The question of the impact of liberalization on the use of intermediate objectives will deserve more detailed study, especially since the choice and quantification of these objectives will have an important role to play in the coordination of monetary policies. The problem will have to be studied as part of the review of intermediate objectives which is already under way in most of the member countries, since the significance of the objectives used until now has been profoundly affected by financial innovation. Nevertheless, the most urgent need is to coordinate variations in interest rates, as *de Boissieu* stresses.

3.4. As the experts stress, the effectiveness of independent budgetary policies, in a situation in which capital moves freely, should not be overestimated. The limits to these policies are already apparent, when inflows of capital are unrestricted in most of the Member States: theoretically this should nevertheless limit the crowding-out effects connected with expansionary budgetary action. However, exchange rate stability, rendered more necessary and more difficult by the full liberalization of capital movements, requires far more attention to be paid to the compatibility of monetary policy and budgetary policy, whether within each Member State in the mix of their economic policy measures or at the level of Community coordination.

4. Solutions and palliatives

Summary

The solutions and palliatives proposed by the consultants may be divided into two categories, depending on whether they involve a reintroduction, in principle temporary, of restrictions on capital movements or whether they are based on changes to the EMS.

4.1. *De Boissieu* makes a distinction between the measures which reintroduce real exchange controls (non-price mechanisms) and those which confine themselves to throwing sand in the wheels, such as a 'Tobin tax', an 'interest equalization tax' (IET) or the two-tier exchange market. In theory, the second type of measure is preferable, but in some circumstances quantitative controls could usefully be imposed, for example in crisis periods (prohibition on banks lending in national currency to non-residents). Furthermore, the disadvantage of the 'Tobin tax' is that it hits financial operations as well as commercial operations.

The practice of the dual or two-tier exchange market captures the attention of several consultants. *Steinherr* is of the opinion that the advantages of the two-tier market are that it functions automatically, has low administrative costs, presents no obstacles to commercial flows and ensures that the weight of adjustment is distributed between a variation in interest rates and a variation in exchange rates. *Basevi* goes even further. In his opinion, the establishment and the maintenance of a dual exchange market is essential not only to respond to speculative attacks but also to avoid overadjustments of exchange rates, to give monetary policy room for manoeuvre and to avoid the misallocation of resources. *Basevi* states that the dual market is equivalent to a continually adjusting tax on capital movements; because it is regressive, this tax has a deterrent effect especially on short-term movements; furthermore, when the differential between financial and commercial rates becomes wide, long-term investors defer their purchases and wait for better times, and this produces a stabilizing effect. For *de Macedo*, recourse to the dual exchange market would make it easier for the newly-integrating Member States to participate in the EMS exchange rate mechanism. However, in the case of Spain, *Cuervo-Arango* considers it preferable for restrictions to be maintained solely on short-term capital movements.

4.2. In order to counter tensions in the EMS, *de Boissieu* proposes that the system be strengthened by a more intense utilization of available instruments: the full use of the fluctuation margin, wider recourse to monetary support instruments and more symmetrical interventions by central banks on the foreign exchange markets.

Artis proposes increasing the band width and reducing the allowable amount of realignment, at the same time keeping the new central rates within the existing bands. The EMS would thus resemble a 'crawling peg' system and speculative pressures would find themselves much reduced by this.

According to *de Macedo*, a wider fluctuation band could enable the currencies of the new Member States to enter the EMS more rapidly. *Cuervo-Arango* considers that it would be better for the peseta to enter the exchange rate mechanism later, with the normal fluctuation band, than to enter it sooner with a wider one.

4.3. *Wyplosz* proposes a more radical solution, the creation of an economic and monetary union; it is true that differences in structure make periodic exchange rate changes essential, but these changes could be replaced by taxes or subsidies.

Comments

4.1. The suggestions that temporary exchange control measures could be reintroduced fit in with the Commission pro-

gramme. In principle, these measures could also consist in the (temporary) use of the dual market, though its effectiveness must not be overvalued. The experiences of France and Italy which made use of the dual market in the 1970s brought out the difficulties of controlling the nature of operations and of preventing arbitraging between the two markets. The case of the Belgian dual market is more controversial. No doubt in periods of tension its existence has sometimes prevented large losses of reserves and/or a considerable increase in domestic rates. However, since the authorities cannot ignore the differential between the two markets, the increase in the margin of monetary policy independence is modest and temporary. If, apart from normal times, the differentials between the two markets are to remain small, the policies of the countries concerned must be coordinated. The usefulness of the dual market would therefore simply be to permit the authorities to gain time in crisis periods.

The deterrent effect of the dual market would correspond to the tax represented by the differential between the free and the official market. However, exporters of capital will not pay this tax on the amount of exported funds until the moment they repatriate their assets and only if their own currency's exchange rate has in the meantime been revalued on the non-official market. The tax effect induced by the dual market can be exerted on the yield of assets placed abroad, provided that the corresponding income, as a current operation, is obliged to pass through the official market whereas the principal is transferred through the free market. However, the deterrent effect of this tax presupposes a wide differential between the two markets: a 10% differential between the two exchange rates reduces by only half a point the yield on a placement made abroad at the nominal rate of 5%.

The application of a 'pure' dual market system — i.e. where there is a perfect dichotomy between current and capital operations — in theory means that a surplus or deficit balance on capital operations (outside the official sector) is not possible. Yet, in a situation in which capital moves freely, it is normal, and desirable for optimum resource allocation, that each of the countries can adopt, according to their structural characteristics, net positions as exporters or importers of capital.

In practice, the maintenance of a dual exchange market must be accompanied, according to circumstances, by changes in the dividing line between the two markets. The danger is that this fluctuating dividing line may not be defined objectively but only in such a way that the official market is made to handle all the (current or capital) flows necessary for its equilibrium at the desired official exchange rate. Such a practice introduces an arbitrary dimension which is not really compatible with the integration desired. The administrative complexity for the Community of a situation in which each Member State followed a different practice for its dual market can also be imagined.

In this connection, the administrative cost of operating a dual market should not be underestimated; the necessary controls bearing mainly on operations eligible for the official market, i.e. on current transactions.

4.2. The Commission believes that capital movements cannot be fully liberalized at the cost of relaxing EMS exchange rate discipline. This approach would conflict with the wider objective of establishing an integrated financial market in the Community. It would be counterproductive by giving negative signals on the credibility of the Member States' monetary policies and their coordination. In addition, the degree of convergence already achieved on inflation has significantly increased the relative width of the fluctuation band agreed when the EMS was established. To make it even wider would necessarily be perceived as a weakening of exchange rate discipline.

Conclusions

1. The consultants' contributions show that the liberalization of capital movements will not produce all its beneficial effects unless certain conditions are satisfied and certain precautions taken.

Two aspects are emphasized:

1.1. A better allocation of resources is not possible unless the markets are flexible; in particular:

(i) the national financial system must adapt and modernize itself, compartmentalization must be ended, monetary regulation and the cost of the public debt will be determined by the action of interest rates according to market rules; the result will be some redistribution of income, and, sometimes, tighter management of the public debt;

(ii) the rigidities of labour markets must be eliminated, and commercial free trade must be fully realized.

1.2. Tighter coordination of economic policies, and particularly of monetary policy will be necessary to counter potential increased tensions within the EMS which will result from the full liberalization of capital movements. The consultants' scepticism as to the possibilities of increasing coordination leads them to envisage chiefly an alternative between:

(i) a new (more flexible) operation of exchange rates in the EMS;

(ii) (temporary) restrictions on capital movements.

2. Commission departments broadly agree with this analysis but they have major differences in relation to the scale of the problems and the solutions proposed.

2.1. First of all, the progress already made in liberalizing capital movements and modernizing financial markets must not be underestimated. The degree of openness achieved within the Community is already high, particularly with respect to the free choice of productive locations (freedom of establishment and of direct investment) and with respect to portfolio investment. After decades during which rigid administrative rules were imposed on monetary and financial flows, several countries have greatly developed (sometimes created *ex novo*) large and efficient money and financial markets. This has been particularly noticeable in France and Italy, but the first concrete steps have also been taken in Spain, Greece and Portugal.

2.2. For the Commission, the solutions which consist in seeking a trade-off between liberalization and relaxing the exchange rate discipline are not acceptable. The completion of the large internal market, a stepping-stone towards economic and monetary union, requires assured exchange rate stability, extending to all the Community currencies.

The consultants' scepticism as to whether coordination can be increased is partly based on differences in economic structures. These differences represent an obstacle to the immediate achievement of a completely fixed exchange rate system, rather than to the liberalization of capital movements. It is also based on the conviction that policy coordination should immediately mean a uniform inflation rate in the Community. Commission departments are of the opinion that it is necessary to proceed boldly but gradually towards coordination as regards both procedures (decision-making process) and achievements, while maintaining the fight against inflation as a priority. On this point, the degree of convergence already achieved must not be underestimated, largely thanks to the disciplinary effect resulting from membership of the EMS. The liberalization of capital movements is likely to increase this effect.

Financial liberalization and the evolution of the EMS

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Introduction

The purpose of this paper is to study the impact of the financial liberalization process, which is gradually implemented by EC countries, on the overall stability of the EMS, the conduct and the effectiveness of monetary policy and interest rate determination.

The programme of financial and monetary liberalization within the EC will increase potential capital mobility in European countries. Its impact on the actual capital mobility will depend on private agents' behaviour, namely on the substitutability of financial assets. Mobility and substitutability are of course related, but at the basis they concern separate aspects:

(1) The mobility of capital mainly results from the legal framework. The barriers to mobility can be manifold: exchange controls, taxation of capital movements,[1] selective use of the reserve ratios imposed on the banking sector, etc. A higher capital mobility requires the phasing-out of the explicit and the shadow barriers to capital inflows and outflows. Analytically, it means an increase of the sensitivity of capital flows to price differentials (interest rate differential, tax differential, etc.), for a given level of risk premiums. In terms of the uncovered interest rate parity, perfect capital mobility is consistent with positive risk premiums.

(2) The substitutability between financial assets depends on individual situations and behaviour (tastes and endowments), and on the attitude towards risk. At the empirical level, it is often assessed by the matrix of crossed price elasticities. In the uncovered interest rate parity, perfect substitutability is obtained if risk premiums are equal to zero. A more general condition of perfect asset substitutability would be that the risk premium is exogenously given (with a value equal to zero as a special case), i.e. it does not vary with relative stocks of domestic and foreign financial assets, hence with international capital movements. The risk can derive from many sources exchange risk, political risk, etc. Let us take an example to underline the importance of the distinction between mobility and substitutability. If the financial liberalization generates destabilizing capital movements and an increase in the frequency and/or the amplitude of parity realignments, it will, compared to the present situation, extend the exchange risk and risk premiums.

In this case, the substitutability between financial assets denominated in different currencies will, *ceteris paribus*, decrease notwithstanding the gradual phasing-out of the legal restrictions to capital mobility. The level of risk premiums in the interest rate parity equation is mainly influenced by expectations of exchange rate movements. It is also determined by other economic and political arguments, among which the credibility of monetary authorities plays a key role. A more complete and formal analysis would have to illustrate a two-way causation: if capital movements condition the substitutability between financial assets, as illustrated above, they reveal portfolio behaviours which are themselves determined by asset complementarity or substitutability relations.

The three-step programme of financial liberalization in Europe will certainly extend capital mobility. Its influence on substitutability and the structure of European portfolios has to be documented more precisely.

Three topics will be tackled successively:

(i) is the EMS an asset or a hindrance for financial liberalization?;

(ii) the consequences of financial and monetary liberalization for the dynamic stability of the EMS;

(iii) the consequences of financial liberalization for monetary policy, the monetary-fiscal mix and interest rates.

The nature of the EMS and the financial liberalization process

1. Preliminary remarks

The interpretation of a monetary union like the EMS, with 'fixed but adjustable exchange rates', may vary depending whether the emphasis bears on the fixity of exchange rates, or the possibility of adjusting them. The optimum frequency of parity realignments in the EMS is a crucial and delicate question. In recent models (e.g., F. Giavazzi and M. Pagano, 1985), it is mainly determined by two elements: (i) the degree of divergence in domestic money growth rates and in the rate of inflation, and (ii) the cost of realignment. We will have to study if it is necessary to add to these variables the degree of financial integration as a separate argument. The EMS corresponds to an intermediate case between the polar situations highlighted in the literature (pure fixity — pure flexibility).

Financial liberalization in Europe has been accelerated by the financial innovation process. In many cases, financial innovation is a way to circumvent existing and costly regulations, and the 'regulatory dialectic' (E. Kane) between

[1] Like a 'Tobin' tax or an interest equalization tax. These tools will be analysed later.

regulation and innovation applies also to the regulatory apparatus used to limit capital mobility (exchange controls, etc.). Deregulation of interest rates, of financial services and capital movements reduces the gap between the legal system and the facts, recognizing the international dimension of the financial innovation process and the decreasing effectiveness of exchange controls.

The sequence of events in the liberalization process is not neutral, and it is logically based on the delimitation between non-monetary financial instruments and money flows, the latter being liberalized at the end since they are supposed to have a more direct impact on monetary policy and sovereignty than the former. It is well known that, due to financial innovation, the frontier between money and the other financial instruments has become more conventional and tenuous than ever. Then, the justification and implementation of this gradual programme are rather delicate.

Financial liberalization takes place in the context of rising capital markets and disintermediation. Therefore, the emphasis is put on negotiable financial instruments more than on the part of savings collected by the financial intermediaries. To assess the impact of deregulation in the long run and not only in the short run, it is necessary to raise this question does this process correspond to an irreversible trend, or must we expect a cyclical evolution? The answer, to be documented later, depends very much on the consequences of financial liberalization for member countries and of the possibility to resort to some kind of regulation. None the less, we have to keep in mind that financial innovation and the growth of capital markets seem to have a large cyclical component. For instance, in France, a further development of the bond market is jeopardized by interest rate expectations, and if nominal interest rates increase, there will be important shifts in portfolios, a significant portion of private savings being 'reintermediated'.

2. The EMS and financial integration

2.1. The EMS, an asset for financial integration

The EMS has been instrumental in the financial integration process in two aspects:

(i) The theory of optimum currency areas shows that the fixity of exchange rates is a crucial element for financial integration. In the seminal contribution of R. Mundell (1961), the mobility of the factors of production (labour and capital) is the criterion used to define the optimum currency area. According to the theory referred to, greater capital mobility within EC countries increases, *ceteris paribus*, the 'optimality' of the European monetary zone.

(ii) The exchange rate constraints of the EMS and the leadership exercised by the Federal Republic of Germany have induced a significant convergence in economic performances of EC countries (especially, a convergence in nominal terms: growth of the money stock, disinflation, etc.). Greater convergence is a necessary, but not a sufficient, condition to further progress in financial integration, since it will in principle reduce the scope for potentially destabilizing capital movements.

2.2. The consistency puzzle

Is it possible to reconcile fixed exchange rates with perfect capital mobility? The Bretton Woods regime had been confronted with this canonical question, and greater capital mobility in the 1960s was one of the reasons for its failure.

To simplify, let us assume for the moment that coordination of economic policies (not only monetary policies) is a prerequisite for convergence. Under fixed exchanges rates, four regimes are conceivable:

		Coordination	
		Yes	No
Perfect capital mobility	Yes		B
	No	C	

Until now, the EMS has functioned with imperfect capital mobility (exchange control regimes in France, Italy, etc.) and limited coordination. This combination, which corresponds to the no-no case, can be dynamically stable. In this case, restrictions to capital movements are the price to pay for (relatively) fixed exchange rates, without much coordination.

The yes-yes case seems also to be dynamically stable, at a level of global economic activity different from the no-no solution. Economic policy coordination would be the means to contain destabilizing capital flows, thus to maintain a fixed exchange rate regime with high capital mobility.

The situations represented by B and C raise some consistency issues. The experience of EC countries shows that the incentives to coordinate national economic policies are reduced

under imperfect capital mobility. The C situation does not correspond to the historical experience of the EMS, and its probability of occurrence is low.

On the other hand, the probability of a B regime is high if there is no significant improvement in the coordination process. B solutions have a great chance to be dynamically unstable and thus transitory, since perfect capital mobility, without enough coordination will increase the frequency and the size of parity realignments within the EMS — even if domestic interest rates share a part of the adjustment burden — and then transform the initial fixed exchange rate regime into a *de facto* floating rate regime.

What kind of coordination is required to reconcile capital mobility and fixed exchange rates? To simplify, we can distinguish three meanings for coordination, ranked in an increasing order of implication:

(i) the circulation of information among partners, concerning policy objectives and instruments;

(ii) basic agreement on policy objectives;

(iii) agreement on policy objectives, and integration of some policy instruments.

Coordination interpreted as a process of circulation of information has not been sufficient to ensure stability of the EMS under imperfect capital mobility. The success of the EMS since 1982 has been due to the passage to step (ii), and the growing consensus in favour of disinflation starting from a B-solution. The dynamic stability will require the implementation of (iii), since the coordination of policy tools would be necessary to monitor capital flows between EC countries (e.g. the coordinated use of domestic interest rates by the monetary authorities is required). A cost-benefit analysis of financial liberalization must take into account the political and economic consequences of the internalization of external effects due to the partial integration of policy tools.

2.3. The scope for coordination and the danger of non-cooperation

Is partial coordination efficient? The second-best argument shows that, in many cases, partial coordination — for example, limited to monetary policy — is not welfare-improving compared to the non-cooperative solution. Since the growth of the money stock is influenced not only by monetary policy, but also by fiscal policy, incomes policy, etc., it is difficult to justify and implement piecemeal coordination.

Is global coordination plausible? Certainly not, in the near future, if we take into account the conflict of interest between Germany and France on many issues (the role of the ECU, the transition to the 'institutional phase' of European monetary integration, etc.). Several models show that, with dissymmetries between partners, some countries may be induced to be 'free riders' and not to cooperate because they are in a better position in the non-cooperative equilibrium than in the cooperative equilibrium. Among the relevant dissymmetries, we may notice (see P. Artus, 1987) the following arguments:

(i) some shocks may be country-specific, and thus encourage other countries not to share the burden of the adjustment;

(ii) the differences in the objective-functions of rational policy-makers (e.g. Germany is much more inflation-averse than its EC partners);

(iii) the differences in the models used for the different countries (differences in the relevant parameters, etc.). Germane to this argument, the possibility that member countries don't use the same model of world interdependence (this corresponds to the 'positive economics' argument);

(iv) the domination effect of one country over the others (e.g. Germany fixing the level of interest rates for the European zone).

Financial liberalization will have some impact on some of these factors. For instance, it can accelerate the convergence of some relevant parameters (interest-elasticity of the demand for money, etc.) to common values and then reduce the dissymmetries referred to in (iii). But on the other hand, financial liberalization may reinforce certain dissymmetries (e.g. the role of London as a financial centre). I think that some arguments which explain the reluctance of some countries to cooperate will continue to be effective under perfect capital mobility. The viability of the EMS without exchange controls will be greater the sooner, and the deeper dissymmetries, and therefore incentives not to cooperate for some countries, may be reduced.

The European consensus on policy objectives has increased over the last five years (see, for example, convergent values for the weight of the argument 'disinflation' in the objective-function of the policy-makers). Therefore, one source of dissymmetry has been reduced. It is not sure that this trend will continue to work. Growing divergences in certain real indicators (see later) may induce some countries to modify the relative weights of unemployment and inflation in the government objective-function, compared to the present situation. If this evolution, which would not be a consequence of financial liberalization, took place, it would generate other incentives in favour of the non-cooperative equilibrium.

3. Convergence and coordination in the EMS

3.1. The notion of convergence revisited

The convergence refer to several phenomena. We introduce three meanings:

(a) Convergence in economic performances, especially the performances which have a direct influence on exchange rate stability. According to the recent IMF study (see H. Ungerer *et al.*, 1986), economic convergence would in the first place imply a narrowing of international differences in the development of those economic variables that have a direct impact on exchange rate stability. This is the EMS concept of economic convergence. Very often, the analysis refers to the ultimate goals of economic policy. A relevant distinction has been presented (see the 1986-87 economic report of the European Commission) between nominal convergence (reduction, among the EC and the EMS countries, in the standard deviation of inflation rates, interest rates, rates of growth of the money stock, rates of growth of nominal wages, etc.) and real convergence (reduction in the standard deviation of GNP per capita, the rate of unemployment, etc.). Empirical studies show that, since the early 1970s, nominal convergence has developed dramatically in the EC and the EMS, especially concerning domestic monetary policies and inflation rates. At the same time, convergence of some nominal variables (the fiscal stance, the current account, etc.) and real convergence have stopped or even diminished.

The evolution of real convergence is due to many factors, among which the entrance of southern countries with low per capita GNP and high unemployment has played an important role.

(b) Convergence in economic structures, particularly industrial structures. As the structure of input-output tables differs from one member country to another, the sensitivity of the domestic productive sector to a given variation in the real exchange rate varies significantly. This will remain valid even with a perfect convergence in economic performances (e.g. with perfect nominal convergence). Among the other structural aspects, the degree of flexibility on the labour market is crucial. The persistence of the present disparity, or on the contrary more convergence, will condition the dynamics of the EMS under perfect capital mobility.

(c) Convergence in the *modus operandi* of economic policy. By *modus operandi*, we mean the instruments used and their combination, and the regulatory framework. In a monetary union with perfect capital mobility, all the factors which influence the level and volatility of after-tax returns on financial assets, or the cost of resource mobilization by the banking sector have to be taken into consideration. Three issues are particularly important:

(i) the convergence in the explicit tax system applied to the financial sector (for instance, the application of the VAT to financial institutions, the tax rules concerning deposit and lending rates, etc.);

(ii) the convergence in the implicit (or shadow) tax system associated with banking regulations. Permanent discrepancies in the regulatory cost due to the reserve requirement ratio or prudential control imposed on banks will induce distortions in the mobilization of savings and in capital movements, notwithstanding the progress of convergence in economic performances;

(iii) the convergence in the instruments of monetary policy. Until now, the EC and the EMS have functioned with great disparity in domestic monetary policies.

Some countries have implemented transitory or permanent direct control procedures, especially credit ceilings (France, Italy, Portugal, Greece, etc.). In some cases, credit ceilings have been progressively phased out (France as of January 1987, Italy in 1983), but, due to the limits of indirect control procedures, the temptation is great to return to direct controls (Italy, the Netherlands). It is well known that direct controls like credit ceilings are generally a substitute for interest rate variations (they are a means of 'economizing' interest rate increases when the control of the growth of the money stock must be tight). Therefore, in countries with indirect control procedures, the domestic sources of interest rate volatility play a limited role.

In other countries, the monitoring of money growth is based on indirect controls, through interest rate variations (Germany, the United Kingdom, France since 1987, etc.). For these countries, the domestic sources of interest rate variability add to the external ones.

Under perfect capital mobility, the EC would not remain a patchwork of direct and indirect operating rules, since the removal of direct control procedures is the logical consequence of the phasing-out of exchange controls (credit ceilings are ineffective in a completely liberalized system). However, there are several types of indirect control procedures. For instance, the *modus operandi* of French monetary policy since January 1987 is not the same as the operating rule implemented in Germany. Due to persistent divergences in monetary operating rules, differences in interest rate volatility in member countries for domestic reasons could induce potentially destablizing capital flows. From this point of view, divergences in the *modus operandi* of monetary policy

could have the same effect as the time desynchronization of domestic monetary policies using the same type of operating rules.

3.2. The relevance of convergence for market operators

It is well known that convergence and coordination are not always positively correlated. On the one hand, convergence in economic performances can be obtained without much coordination. For instance, the present convergence concerning the disinflation process is more the consequence of the external constraint bearing on each country (one aspect of the external constraint for EC countries being the role of Germany and the disinflation pattern chosen by this country), than the result of a real coordination process between member countries. On the other hand, coordination may sometimes accentuate the divergence in economic performances (e.g. this is the case when cooperation leads to the implementation of the 'locomotive' model, with an active de-coupling of national economic policies).

Are market operators more influenced by convergence in economic performances or by the very process of coordination? Their expectations and their behaviour are generally conditioned by both aspects. The announcement of coordination — even before its actual implementation — can have a positive influence on expectations and may deter speculative capital movements (see for example the announcement effect generated by the Plaza agreement of September 1985). Notwithstanding this psychological impact, capital movements will remain determined under perfect financial liberalization by persistent divergences in economic performances, namely after-tax interest rate differentials adjusted for expectations of exchange rate variations.

It is likely that market operators have been, and will remain, victims of an illusion, in considering other differentials than the relevant ones. For instance, they look at the CPI when the GDP deflator would be relevant (and vice versa), or they look at prices instead of unit labour costs. The choice of the relevant signals may be indifferent for capital movements, but not always (e.g. the direction of the differential between Germany and France is totally different if we examine the CPI index or the evolution of unit labour costs.[1] We must follow market operators in their illusion, since capital inflows and outflows are explained by the differentials and the disparities actually looked at by market operators, not always by the differentials which would be relevant from a theoretical point of view.

[1] For example, this statement is valid for 1986.

The consequences of financial liberalization for the dynamic stability of the EMS

Generally speaking, financial liberalization induces simultaneous effects on the allocation of resources, the conditions of stabilization and the distribution of resources. It increases the efficiency in resource allocation (e.g. in the saving-investment adjustment process), but it may have an ambiguous influence regarding stabilization issues. Here, we will focus on a particular dimension of stability, namely the dynamic stability of a monetary regime (the EMS), which is related to, but must not be confused with, the empirical stability or instability of economic variables (exchange rates, nominal or real, the rate of inflation, etc.).

1. The impact of liberalization on portfolio behaviour

The main issue is the following: will financial liberalization induce more concentration (e.g. in DM), or more diversification of European portfolios? The answer may have a clear impact on the intertemporal stability of the EMS.

To be sure, the economies of scale argument, which leads to greater concentration in portfolios, especially in transaction cash-balances, will be reinforced by the deepening of financial integration. On the other hand, other forces may induce more diversification or more concentration depending on the empirical evolution. According to basic portfolio theory, a diversified portfolio is efficient for risk-averse agents when returns on investment in various currencies are imperfectly correlated. Concentration is rational in the case of perfect correlation of returns. Since the calculation of returns must integrate exchange rate variations and risk, the frequency and size of parity realignments in the EMS condition the degree of diversification of European portfolios. Should financial liberalization significantly increase the frequency and/or size of realignments, it would lead, *ceteris paribus*, to greater diversification of financial assets. Even in the present circumstances where inflation differential has decreased, but there still remain persistent disparities between EC countries concerning the functioning of the labour market and the formation of wage costs (see C. Goodhart, 1986), the inability of operators to forecast accurately the date and the extent of realignments may explain differences in the *ex post* returns on financial assets with the same maturity denominated in different currencies.

Since the early 1970s, some diversification in international portfolios has taken place, with the limited but progressive transition towards a multi-currency reserve system (or a

'polycentric' world). The erratic fluctuations of the dollar, the success of the ECU (especially in its private use), the importance of Germany and Japan — all these factors explain the transition mentioned. The restrictions on foreign exchange have created gaps between the optimum portfolio (according to the mean-variance analysis) and the actual portfolio, and the removal of exchange controls is welfare-improving in reducing these gaps. Whether the optimum portfolio for an EC resident will be more concentrated after liberalization than before will depend on the impact of financial integration on the correlation between tax returns and exchange rate adjusted returns, as mentioned before.

The 'polycentric' model at the world level may be an unstable form, if conceived as a perfectly symmetrical monetary oligopoly (see Ch. de Boissieu, 1986). The same kind of proposition holds for the EMS, which has little chance to correspond to a monetary oligopoly on a permanent basis. At each point of time, the operators have a weak or a strong (e.g. a lexicographic order) preference for some currencies, perhaps only one, and spontaneous forces lead to portfolio concentration and some kind of a monetary monopoly (see the domination of the DM in the EMS). This statement is consistent with the observation that individual preferences may change over time.

A detailed analysis would necessitate a split between private portfolios and central banks' portfolios. Empirical studies show that the trend towards diversification of official reserves has been limited, less developed that one could think on an *a priori* basis, when distribution effects (i.e. effects due to the evolution in the distribution of reserves between countries) are eliminated (see A. Horii, 1986).

The approach in terms of 'characteristics' is a useful generalization of portfolio theory. It adds to price arguments other relevant considerations which concern the 'quality' of the currencies and are not always reflected by their returns. In the case of the EMS, the domination of the DM has no limit during periods of speculation, but the monetary role of the German currency is diminished by structural factors: for many reasons, German monetary authorities have been reluctant to speed up the financial innovation process in their country, and permanent concentration of European portfolios in DM held in Germany is doubtful should the 'menu' of assets proposed by German banks and markets remain the same. Due to the liberalization of financial services, this scenario will not take place since the propagation of financial innovation will be accelerated, notwithstanding the attitude of German monetary authorities.

All this means that the impact of financial deregulation on portfolio diversification will be determined not only by the correlation of returns, but also by the 'correlation of services' and the speed of propagation, between EC countries, of financial product and process innovation.

2. A crucial element: the comparison between the speed of financial liberalization and the speed of convergence

Here, convergence essentially refers to less disparity in macroeconomic performances, but we know that divergences in the *modus operandi* of economic policy (especially, monetary policy) must also be considered.

If the speed of the financial liberalization process (V_L) is significantly greater than the speed of convergence in macroperformances (V_p), the EMS will be potentially destabilized by the removal of exchange controls. Since capital mobility will reinforce the fact that financial markets adjust much quicker than goods markets, the risk of 'overshooting' in the exchange rate variations will be enhanced by persistent divergences. The January 1987 realignment is a good illustration of the potential danger: with the US dollar falling rapidly, shifts in portfolios lead to concentration in strong currencies (especially, the DM), since diversification is deterred by structural differences concerning economic performances (see in particular France and Germany). Important shifts in portfolios increase the frequency of realignment and, thereby, if the actual frequency is well above the 'optimal' frequency,[1] jeopardize the internal and the external (i.e. for the rest of the world) credibility of the EMS. On the other hand, if V_p is significantly greater than V_L, financial liberalization is not in itself a potential source of instability. No doubt V_L and V_p are not independent variables. The extent of financial liberalization has some impact on the speed of convergence, but the direction of influence is an open question. Financial liberalization, as a new and significant constraint, may strengthen the present configuration where the country with the lowest rate of inflation sets the standards for the other EMS member countries. Let us consider, for instance, nominal interest rates. According to the loanable funds model, arbitrage from countries with low interest rates to high rate areas must, *ceteris paribus*, implement the 'law of one price' for financial assets.

But speculative capital movements take place the other way, from weak currencies bearing high interest rates to strong currencies with lower interest rates (especially when a parity

[1] We have already referred to the optimization model built by F. Giavazzi and M. Pagano (1985).

realignment is expected in the short run). In the short term, financial liberalization may extend, rather than diminish, the gap in nominal interest rates.

Two questions seem crucial:

(i) What is the level of divergence in macroeconomic performances consistent with a smooth functioning of the EMS under perfect capital mobility? To study 'tolerable' divergences, it would be necessary to think in terms of thresholds and turning points in expectations. Depending on the environment (evolution of the dollar, sensitivity of exchange rate expectations to the 'news'), a disparity — for instance, a significant inflation differential — can be compatible or incompatible with perfect capital mobility;

(ii) Facing the instability due to permanent divergences, what actions may some countries be tempted to implement? There, it may be relevant to use the 'exit, voice and loyalty' approach.

3. An exit, voice and loyalty approach to the EMS

The exit/voice model refers to the behaviour of individual units (agents, etc.) having growing dissatisfaction with the rules and the functioning of an organization (here, the EMS).

Financial deregulation in EC countries may lead members to resort to one of the following attitudes.

3.1. Loyalty

Here, EMS member countries respect the rules of the system. In case of speculative capital movements, five instruments are available which represent the loyalty solution:

(i) the complete use of fluctuation margins around the parities. Until now, central banks have been reluctant to act as if the band of fluctuation would be much less than the one introduced in 1979, since expectations are destabilizing actual parities as soon as the 'pivot' exchange rate is reached. The last realignment is an exception to this rule, with the Bank of France using the whole band to force the intervention from the Bundesbank.

(ii) the extensive manipulation of interest rates, as a substitute for parity realignment. With foreign exchange restrictions, central banks have an option they directly intervene on domestic capital markets (through open-market operations, etc.), or they intervene indirectly on the Euromarket of their currency (large borrowing by commercial banks at the request of the Central Bank can make the speculation very costly this situation corresponds to the French experience in March 1983). Financial liberalization will rule out all significant discrepancies between domestic rates and the corresponding Euro-rates. Central banks may continue and extend their open-market operations on domestic markets, but they will face conflicts between EMS exchange rate commitments and domestic monetary considerations. In many cases, the temptation has been great in the past, and perhaps will be greater in the future, to 'decouple' domestic interest rates from international influences, and by this means, to avoid upward fluctuations in domestic lending rates in periods of speculative attack against the currency. The possibility of an effective 'decoupling' are, by definition, reduced by financial deregulation. But some EC member countries, in order to cope with the European financial liberalization, may be inclined to implement a selective interest rate policy at home, insulating some privileged sectors from external influences. As a selective interest rate policy postulates a high degree of capital markets segmentation, it appears that we cannot exclude, in some countries, more domestic segmentation and regulation to offset, at least partially, the effect of the international financial deregulation.

The use of interest rates to delay or avoid parity realignment means that risk premiums included in nominal interest rates on weak currencies would increase, and therefore the degree of substitutability between financial assets denominated in weak currencies and those denominated in strong currencies would, *ceteris paribus*, be reduced.

(iii) the extensive use of financing facilities organized by the rules of the EMS (very short-term financing, etc.).

(iv) interventions by central banks on the foreign exchange market, to keep exchange rates within the bands. The actual efficacy of these interventions is still an open question. The January 1987 experience confirms that we meet, at the level of the EMS, the problem of the $(N-1)$ extensively studied at world level: is it justified to share the burden of the adjustment and of the intervention between surplus and deficit countries? If so, how to share the burden? The discussion is topical in the EMS, due to the reluctance of the Bundesbank to intervene in a period of domestic monetary target 'overshooting'.

(v) parity realignments are an illustration of the loyalty solution, if their empirical frequency is below a certain threshold (i.e., the level above which the global credibility of the EMS is jeopardized). According to the well-

known model of J. Melitz and P. Michel (1986), two conditions are required for dynamic stability with parity realignments: (a) the high-inflation country (for the two-country case), having lost reserves before the realignment, must build up its reserves immediately after the realignment, and (b) the high-inflation country authorities must, compared to the low-inflation country, be more concerned with their reserve targets rather than the output targets. As far as the first condition is concerned, it is interesting to contrast the April 1986 and January 1987 realignments. In the latter case, contrary to the former, the stability condition is not satisfied, since reserves lost by the Bank of France before the modification of parities have been recovered only partially and after an unusual delay.

3.2. Voice

The 'voice' solution refers to the different types of 'reregulation' which are compatible with the basic rules of the EMS. They will be implemented by member countries if it appears that, in face of persistent divergences, individual costs of financial liberalization significantly outweigh the actual and expected benefits.

(a) The degree of reversibility of financial liberalization

We have already argued that financial deregulation is more a 'cycle' than a trend. Some experts, looking at the experience of the UK and Japan, claim that, due to the conjunction of several ratchet effects, there is here an inherent irreversibility. But the problem is different for the UK and Japan on the one hand, and countries belonging to the exchange rate mechanism (ERM) of the EMS on the other hand. Japan and the UK are not constrained by fixed exchange rates, and they illustrate the complementarity between financial deregulation and floating rates. On the other hand, it is likely that countries of the ERM, at some point, will have to trade off between the fixity of exchange rates and financial liberalization, and also, as we have argued, between domestic and international financial liberalization. Even a crude cost-benefit analysis will lead member countries to stay in the ERM, and to implement some kind of reregulation.

(b) The non-price mechanism

Capital controls are included in the non-price mechanisms, even if they can be in certain circumstances interpreted as a tax on holding of foreign securities, or as transaction costs added to the price of currencies subject to such controls.

The EC Commission has agreed to permit recourse to the safeguard clause defined by Articles 108 and 109 of the Treaty. The clause is meant to be temporary and limited to special circumstances, even if, in practice, it has become 'permanent' in some Member States (France, Italy, Ireland for example). According to the dominant interpretation, 'special circumstances' refer to (i) the case of an exchange rate or balance of payments crisis or (ii) the case of a large instability in the domestic financial sector. A third case is currently under discussion in relation with the future liberalization of short-term capital movements, namely the case of a money supply 'shock' created by large capital inflows and by the ineffectiveness of sterilization policy. This third case can be considered as a subset of (i) where large capital inflows may induce an exchange rate crisis or (ii) where they may generate financial instability. Facing persistent divergences (in economic performances, in labour market flexibility, etc.), the reintroduction of some capital restrictions will be perhaps the price to pay for keeping the exchange rate mechanism of the EMS. If this is the case, the Commission must keep normalizing the use of the safeguard clause.

The adoption of the new safeguard clause concerning short-term capital movements may have positive effects in limiting the scope of the reregulation process: some countries confronted with shocks and external disequilibrium will implement this clause (and stay in the exchange rate mechanism of the EMS), without discarding the other elements of the financial liberalization process.

The distinction between temporary and permanent capital controls is crucial, but difficult to implement practically. These controls can limit speculation only if at the time of their implementation they are considered as permanent. Otherwise, if market operators consider them *ex ante* as transitory, capital restrictions will have a pure calendar effect, delaying but not eliminating speculation. Until now, the financial obstacles to capital mobility have been announced *ex ante* as transitory measures, but in fact have been rather permanent. Perhaps the best solution is obtained when capital controls are judged permanent by the operators on an *ex ante* basis and thereby influence their expectations, but *de facto* remain effective during a short period. But the first part of the condition is clearly incompatible with the Treaty and the very idea of a common market in financial services, since permanent controls are ruled out, even if they are 'notional' (*ex ante*) and not actual. To limit calendar effects, it would be required not to specify, *ex ante*, the time horizon of the reregulation of capital movements, and this seems inconsistent with the new legal framework.

(c) Price mechanisms

Facing dynamic instability due to perfect capital mobility, some Member States may be induced to have recourse to the 'Italian solution', i.e., to widen the fluctuation margin around the parity. If generalized, this alternative would transform the EMS into a target zone area, a system which, according to J. Frankel (1987), 'might encompass the worst of both worlds — the instability of flexible rates and the unsustainability of fixed rates'. Introducing more flexibility of exchange rates within the EMS can be considered only as a substitute for policy coordination, and would, over a certain threshold of fluctuation margin, jeopardize the very essence and functioning of the EMS.

Price mechanisms to limit capital mobility are numerous:

(i) a Tobin tax (see J. Tobin, 1978), to increase the cost of all foreign exchange operations (in the various proposals, the tax is uniform and low);

(ii) an interest equalization tax, which can be used either to deter capital inflows or capital outflows. The IET is a special case of a Tobin tax, since it concerns only financial operations;

(iii) the two-tier exchange market, the purpose of which is to insulate commercial transactions from speculative movements and to reduce the dominance of capital account transactions over domestic real activity and inflation.

The efficacy of these different devices depends on the price elasticity of capital movements. In many cases, expectations concerning the social and political situation in member countries tend to reduce relevant price elasticities in a period of crisis. Nevertheless, the actual working of the price mechanisms mentioned above means some form of financial protectionism, and it can be used by some countries as a justification for commercial protectionism. The experience of dual rates in France and in Belgium suggests that in calm periods, the premium on the financial rate is low, perhaps nil (see the present situation in Belgium), and in a period of crisis, the premium may rise up to a point where the efficacy of the whole system diminishes rapidly with the development of 'disguised' operations (which tend to blur out the delimitation between the two compartments of the foreign exchange market).

As financial liberalization is supposed to take place *erga omnes*, will financial reregulation do the same? Due to the new regulatory framework in the EC, there will be the temptation to discriminate by the use of dual rates or of a Tobin tax. But, practically, it will be very difficult for member countries to combine functional compartmentalization (between markets, types of operation, etc.) and geographic discrimination.

(d) The cost-benefit analysis of the various mechanisms

Insulating domestic interest rates from international rates allows retention of some fiscal autonomy and not complete subordination of domestic monetary policy to exchange rate targets. It is well known that capital controls and taxation also generate costs, due to the distortions in resource allocation and the loss of welfare associated with the implementation of second-best or third-best solutions. From a welfare economics viewpoint, the problem is to compare second-best solutions and to discard mechanisms which are very inefficient.

The split between occasional and permanent measures, with the two possible interpretations already mentioned (the *ex ante* and the *ex post*), has to be complemented with another criterion, namely the distinction between global and specific measures. Some capital restrictions seem to be inconsistent with the development of trade and the increasing openness of countries. For instance, some constraints imposed on importers and/or exporters (authorized delays for the repatriation of receipts, rules concerning hedging operations, etc.) are cleary costly and inconsistent with an efficient allocation of resources. On the other hand, some constraints on 'pure' financial operations (i.e., transactions not related at all to trade) may be more acceptable. Undoubtedly, in the French experience of capital controls, the impossibility for residents of lending French francs to non-residents has been less distorting than the regulation concerning the repatriation of funds for traders.

Combining the two criteria (the time horizon and the field of application), we get four cases:

Measures	Occasional	Permanent
Global	1	2
Specific (concerning 'pure' financial operations)	3	4

Compared to other mechanisms, a Tobin tax is more third-best than second-best, since it globally concerns all transactions (including commercial transactions). The comparison between the interest equalization tax and the two-tier

exchange market is delicate. Both measures generate tax evasion and strategic behaviour by private agents, and they postulate a certain degree of market segmentation. For some member countries, the use of dual rates may constitute the second-best mechanism in order to cope with speculative capital movements. It has to be considered as an illustration of case 3. We saw that the legal definition (but *de facto*, not the application) of the safeguard clause of the Treaty excludes situations like 2 and 4.

(e) The threat of reregulation

Will the threat of reregulation, through capital controls or other restrictions, be sufficient to deter speculative behaviour and to warrant the dynamic stability of the EMS under perfect capital mobility? Certainly not, and this question leads to a few remarks:

(i) The threat has to be known by market operators. This question relates to the efficiency of the information process.

(ii) What is the credibility of the threat and how to increase it, if necessary? The recent literature on reputation and credibility in a game-theoretic setting is relevant here.

(iii) What will be the impact of the threat? The uncertainty of operators about the date and the form of future controls reduces the degree of substitutability between financial assets in different countries. The impact of the threat on speculation is more ambiguous. In some cases, the threat of foreign exchange reregulation may deter speculation. In other cases, especially if the action of the monetary authorities is rationally expected by private agents, the threat may generate strategic behaviour. Studying the discontinuous credit ceilings regime that we had in France in the 1960s, I have shown that firms were able to anticipate the reintroduction of credit ceilings rather accurately. On several occasions they raised their demand for credit during the periods without the ceilings, to circumvent them more easily later. The same effect may apply to foreign exchange restrictions: if they are expected, private agents will take protective measures. The effectiveness of reregulation will be low, perhaps nil, due to private strategic behaviour. To maintain some efficacy for the reregulation process, monetary authorities would have to adopt a strategic behaviour themselves, i.e. to create uncertainty about the form and the timing of their intervention.

3.3. The exit solution

At a certain point in time, some countries confronted with persistent divergences in economic structures (e.g., the flexibility on the labour market) and/or performances, may have to choose between fixed rates and financial liberalization. The exit solution consists in leaving the exchange rate mechanism while keeping financial openness and deregulation. It leads to the present situation of the UK, but this country corresponds to the no-entry case. I claim that if there is an option between the ERM and financial liberalization, it will be preferable for most of the countries and for the system itself to accept second-best solutions, i.e. some type of financial reregulation (specific capital controls, dual rates etc.) rather than to take the risk of widespread floating rates.

Some countries may be tempted to use the threat of exit from the ERM to get larger financial assistance or to catalyse policy coordination. The debate in France just before the March 1983 realignment was very much in this line. But the threat of exit is an ambiguous tool: if it is used too often or under inopportune circumstances, its effectiveness will be low, and the 'player' misusing it will lose reputation and credibility.

3.4. The ECU and the dynamic stability of the EMS

Is the development of the ECU a means to reconcile capital mobility and fixed exchange rates? This question leads to two observations:

(i) The promotion of the ECU will perhaps speed up the convergence of Member States concerning economic structures, performances, etc. But this has not been rigorously demonstrated. Looking backward over the last five years, we see that progress in convergence has been due to many other factors than the dramatic development of the private use of the ECU.

(ii) Further developments of the European currency, its transformation as a 'complete' money (which would require, *inter alia*, a complete articulation between the private market for ECU and its official role, and the possibility to use the ECU as a general means of payment), would imply a degree of policy coordination between EC members such that the question of consistency between financial liberalization and fixed exchange rates would be automatically solved. The chronological and logical order does not go from a complete European currency to an extended policy coordination. Economic coordination, which is necessary to limit the dynamic instability of the EMS under perfect capital mobility, is a prerequisite for the transition to the second 'phase' of European monetary integration and to a complete European currency, not a consequence of it.

Consequences of financial liberalization for monetary policy, the monetary-fiscal mix and the determination of interest rates

1. Consequences for the autonomy and the effectiveness of monetary policy

The impact of exchange controls on the autonomy of monetary policy is a controversial issue. However, many empirical studies show that in countries having used exchange controls extensively (France, Italy, etc.), the variability of real exchange rates and official reserves has not been significantly reduced. The segmentation between the domestic money market and the Euromarket for the same currency authorizes large gaps between interest rates on the two markets, notwithstanding loopholes in exchange controls and the willingness of private agents to circumvent regulations. In France and in Italy, the differential between domestic and Euro-rates has been sometimes very large (e.g., the French example just before the March 1983 realignment). But even if, in statics, foreign exchange restrictions give some degree of freedom to interest rate policy, domestic interest rates in Italy, France, etc., have been highly correlated with international rates.

1.1. The efficacy of sterilization policies

The EC countries now lifting exchange controls are going to face a paradoxical situation:

(i) On the one hand, the development of capital markets, the growth of public debt and technical improvements in the compulsory reserves mechanism give extended levers to monetary authorities: with deep and resilient financial markets, the tools of open-market interventions are more diverse, and their volume and price-effects more effective. For example, in France — but the example is more general — open-market policy has been until now limited, due to the thinness of financial capital markets (France, like many EC countries, was until recently an 'overdraft economy', i.e. an economy where financial intermediation is predominant and capital markets have a residual role) and the prevalence of direct monetary control through credit ceilings. The scope for open-market interventions is widely enlarged with the new financial instruments, the development of securitization and the outstanding volume of Treasury bills and bonds;

(ii) On the other hand, the efficacy of open-market policy concerning sterilization of capital inflows or outflows will be reduced significantly, to zero if financial liberalization induces perfect asset substitutability. For instance, sterilization of capital outflows means purchases of negotiable paper (outright purchases or repurchase agreements, etc.) by the central bank, in order to provide liquidity to the money market. This intervention will induce a drop in domestic interest rates, this under perfect asset substitution, new capital outflows and, under fixed exchange rates, additional losses in official reserves. Sterilization of capital inflows or outflows generate here dynamic instability.

The divorce between the improvement in the open-market techniques and the decreasing efficacy of open-market interventions due to the removal of exchange controls can be reduced only in the situation, not to be excluded on an *a priori* basis, where perfect capital mobility goes with imperfect asset substitutability.

1.2. Monetary targeting without exchange controls

The lifting of exchange controls will accentuate the current crisis in monetary targeting, mainly initiated by financial innovations and the deregulation process. Due to their openness and the limited efficacy of sterilization policies, small open countries have been reluctant to announce monetary targets (e.g., Belgium, Scandinavian countries etc.). In other EMS countries, frequent 'overshooting' of monetary targets reduces the credibility of the procedure and the positive announcement effects which might be attached to it.

The removal of foreign exchange restrictions will extend the empirical variability of the external counterpart of the money stock and therefore of the money stock itself in the context of ineffective sterilization policies.

Generally speaking, two criteria have been referred to for the selection of the intermediate target of monetary policy:

(i) the (indirect) controllability of the intermediate target, which relates to the links between the instruments (compulsory reserves, open-market, etc.) and the intermediate target;

(ii) the predictability, which is conditioned by the degree of stability of the links between the intermediate target and the ultimate goals.

The choice of intermediate target results from a trade-off between controllability and predictability; the first criterion leads to variables close to the instruments, whereas the second criterion promotes variables close to the ultimate goals.

The phasing-out of exchange control measures will, in the same time, diminish the controllability and the predictability

of monetary aggregates (M1, M2, M3, Mn, the monetary base and the concepts derived from it). First, national monetary authorities will face statistical difficulties relating to the measure of the money stock: as the proportion of domestic currency held abroad by residents and non-residents will be higher and more volatile, and as foreign banks abroad will not be obliged to report to national monetary authorities, the calculation of domestic currency held by residents will be much more complicated. Secondly, larger shifts in portfolios may reinforce the instability of the relationships between money stocks and nominal GDP.

Confronted with this new situation, monetary authorities face several alternatives:

(i) The abandonment of monetary targeting. This solution corresponds to the extrapolation of the present trend and a geographic extension of what is occurring in Canada, in the UK, etc. The end of monetary targeting would oblige the monetary authorities to implement new communication channels with the private sector, and to find new vehicles for the propagation of announcement effects. It must be added that the abolition of monetary targeting in countries belonging to the ERM has to be a coordinated decision: if a country took this decision alone, it could induce speculative capital flows against its currency.

(ii) The prolongation and the accentuation of the 'soft' targeting of monetary aggregates, which is now prevailing in many EC countries. 'Soft', since 'overshooting' is easily explained (by financial innovations, the deregulation of interest rates, the removal of exchange controls, etc.) and more generally accepted than 10 years ago. The drop in the velocity of money, which is mainly a cyclical evolution caused by disinflation, explains the change in the attitude of several European central banks. Monetary authorities prefer to keep some 'fixed points', even if they overshoot announced targets (the loss of credibility and reputation would be greater in the case of abolition than it is with 'overshooting'). It is very likely that the need for 'fixed points' would be reinforced, rather than diminished, by the lifting of exchange controls.

(iii) A change in the announced targets. Leaving monetary aggregates, monetary authorities may choose one of the following targets:

(a) Interest rates. Under perfect capital mobility, domestic interest rates do not satisfy the controllability criterion, since they are, in a small — or medium — open economy, mainly determined by external rates. And a lack of controllability generally undermines the credibility of monetary policy. Thus, there is no justification to shift from monetary aggregates to interest rates (nominal or real) in a financially liberalized environment.

(b) Nominal exchange rates. By definition of the EMS, nominal exchange rates are already announced targets or constraints for member countries of the ERM. We have argued that the removal of exchange controls in the case of persistent divergences will induce higher instability, thereby lower controllability, for nominal exchange rates. As for real exchange rates, contrary to what some advocates of 'target zones' claim, they are much less controllable than nominal exchange rates.

(c) Credit aggregates, like domestic credit expansion (DCE, defined here as the sum of the domestic counterparts of the money stock). The (indirect) controllability of DCE is not influenced by the abolition of exchange controls. The new possibility for residents to borrow and lend on international markets without limits will undoubtedly diminish the predictability of the links between DCE and the ultimate targets (real growth, inflation, etc.), since in a fixed exchange rates regime, foreign lending and borrowing influence the external counterpart of the money stock, not the growth of DCE. Credit aggregates are not immune from 'Goodhart's law',[1] but the analysis and the experience show that they are more sheltered from financial innovation and deregulation than monetary aggregates. I think that greater capital mobility is a justification for reactivating, in some EC member countries, credit aggregates.

1.3. Some supplementary remarks on the operating rules of monetary policy

The removal of exchange controls and the transition in many EC countries to indirect instruments of monetary policy are clearly associated changes. The abolition of quantitative constraints (mainly credit ceilings) will leave market forces, i.e. interest rate variations, to influence the behaviour of banks and non-banks. In some circumstances, it is likely that economic and social constraints will limit the upward flexibility of nominal and/or real interest rates and will necessitate, instead of interest rate adjustment, a temporary reactivation of credit ceilings. The recent experience in Italy and the Netherlands confirms that we cannot extrapolate the present transition to market-orientated instruments of

[1] According to Goodhart's law, statistical regularities tend to loosen, sometimes to vanish, as soon as they are used for policy purposes. Goodhart's law is an application of the well-known Lucas critique.

monetary policy. Even in the case of reactivation of intermediate solutions (like 'soft' credit ceilings based on the use of compulsory reserves bearing on credit expansion, etc.), it would be necessary at the same time to reactivate some form of foreign exchange restrictions. Situations where domestic interest rates consistent with exchange rate expectations do not correspond to the level required by the internal targets of monetary policy will induce some EC countries, historically well acquainted with credit ceilings, to resort to them temporarily (at least, on an *ex-ante* basis).

2. Consequences for the monetary-fiscal mix

One important lesson drawn from the Mundell-Fleming model is that the respective effectiveness of monetary policy and fiscal policy is conditioned both by the exchange rate regime and the degree of capital mobility. With fixed exchange rates and perfect capital mobility, monetary policy is ineffective whilst fiscal policy has a great impact on domestic real activity. The gist of the argument lies in the fact that fiscal expansion without monetary accommodation induces a rise in domestic interest rates, then capital inflows up to the point where domestic rates return to the level of international rates and 'crowding-out' effects disappear. In the present situation, EC central banks are firmly resisting the monetization of public deficits. For an individual member country, the temptation could be great to reduce unemployment through an expansionary fiscal policy which, in the case of no-monetization, would generate capital inflows and very limited crowding-out effects. But here we face another dimension of the coordination puzzle: like competitive devaluations, 'competitive' expansionary fiscal policies have a very high social cost. Through the coordination process, we must design institutional mechanisms which would limit the incentive for fiscal authorities to be 'free riders'.

The Mundell-Fleming conclusions give a partial picture of the situation, since in practice many factors may put obstacles in the way of the equilibrating mechanisms which are supposed to take place. For instance, it would be necessary to introduce announcements effects and the credibility issue. If a country initiated a reflating fiscal policy, whereas most OECD countries have been trying to reduce the ratio of government deficit over the GDP, it would create perverse announcements effects and capital outflows, instead of capital inflows. Here again comes the question of international budgetary and fiscal coordination, but in a perspective different from the one suggested by the Mundell-Fleming approach.

The enlarged assignment of monetary policy to external equilibrium and the present rigidities of fiscal policy in most EC countries may lead policy-makers to have more extensive recourse to a countercyclical use of structural policies, such as incomes policy (in its traditional forms or in its more recent versions) or employment policy (measures intended to increase labour flexibility, etc.). But the extended revival of domestic structural policies, to offset at least partially the impact of financial liberalization, would be perhaps detrimental to economic performances, since structural measures are quite inadequate when we are facing short-run internal or external shocks.

3. The consequences of financial liberalization for interest rates

3.1. The influence on the level of interest rates

A direct consequence of the abolition of exchange controls is to narrow the gap between domestic and European interest rates to negligible values, often to zero, due to unlimited possibilities for arbitrage. For countries which have liberalized for several years, the differential between domestic and Euro-rates, for a given maturity, is rarely over 15 basis points. Generally, there is no gap, or it is under 10 basis points. Risk premiums on the Euro-dollar or the Euro-deutschmark are most of the time close to zero for all maturities. If they persist with perfect capital mobility, gaps between domestic and Euro-rates may be explained by political considerations (and the risk premium associated), by minimum reserves and deposit insurance schemes applied to domestic deposits, etc.

The recent French experience could be relevant. Just before the last parity realignment, the risk premium on the Euro-franc interest rates reached 500 basis points (the rates on 7 January were 14 % for the one-week Euro-rate and 9 % for the corresponding domestic rate). In February 1987, we still have a risk premium close to 25 basis points (37,5 basis points for the six-month maturity). Persistent differentials between domestic rates and Euro-rates in the case of France, Italy, etc. give an indication not only of the assessment of political risk by international markets, but also of the remaining obstacles to capital mobility and international arbitrage. To be sure, the causation between Euro-rates and domestic rates is complex. But even for currencies with a rather limited Euromarket (e.g., the examples of the Euro-franc and the Euro-lira markets, which are not 'deep and resilient'), the dominant causation goes from the international to the domestic rates, and this asymmetry in the adjustment process will be reinforced by the abolition of exchange restrictions.

The decompartmentalization of domestic capital markets means a globalization of the adjustment process between saving and investment. Financial deregulation will generate a more efficient allocation of capital in European countries. It is likely that a portion of loanable funds invested abroad, particularly in the United States and Switzerland, will be kept within EC countries after the lifting of exchange controls. It is quite impossible to derive a general proposition concerning the impact of financial globalization on the average level of interest rates in member countries of the ERM. We present here only a piecemeal analysis. Let us assume that real interest rates are determined by the forces of 'thrift and productivity'. The removal of exchange controls may influence the two components:

(i) Due to the announcement effects created by the financial deregulation process, firms could be more optimistic and there would be an upward shift in the investment curve which would, *ceteris paribus*, raise the equilibrium level of real interest rates.

(ii) The effect of financial deregulation on private saving is more ambiguous. On the one hand, deregulation might increase the volume of domestic saving, through repatriation of funds kept abroad. On the other hand, the current experience with financial innovations and liberalization suggests that they are more influential on the distribution of private saving (between real estate, financial assets, cash-balances, etc.), than on the propensity to save which is mainly conditioned by the cyclical evolution of real incomes.

If we turn now to individual countries, the phasing-out of foreign exchange restrictions has no clear-cut effect on the level of nominal and real interest rates. For some member countries, exchange controls, like credit ceilings, have been a means of 'economizing' on the level and volatility of interest rates, since administrative constraints have been used as a substitute for upward movements in domestic rates to limit capital outflows. For these countries, the lifting of exchange controls may, during a transition period and especially for weak-currency countries, raise actual interest rates up to their equilibrium values (corresponding to 'shadow' interest rates). Empirically, as some countries are at the same time leaving exchange controls and credit ceilings, and as both measures may have the same direction of influence on interest rates, it will be difficult to separate the two effects. The experience of financial liberalization in Denmark suggests a different sequence of events: in this country, the credibility of policy-makers has been increased by financial deregulation, and domestic rates, instead of rising, dropped after the abolition of exchange restrictions. The respective weights of the opposite arguments just mentioned are conditioned by the time horizon of the analysis: the steady-state influence of financial liberalization on nominal and real rates is clearly distinct from its transitory consequences.

3.2. The influence on the volatility of interest rates

For EC countries just starting financial liberalization, two sources of additional interest rate volatility will be added: the internal volatility due to the passage from direct to indirect methods of monetary policy, and the external volatility introduced by greater capital mobility. Generally speaking, it would be helpful to separate interest rate flexibility (i.e., potential variability) from interest rate volatility (i.e., actual variability). The two measures will coincide in the pessimistic scenario where perfect capital mobility leads to destabilizing capital movements and incessant adjustments of interest rates, substituting for parity realignments (and sometimes associated with them).

For EC countries having already liberalized, 'feedback' effects are to be expected. The international propagation of interest rate volatility will also concern the leading country of the EMS, even if the dominant causation within the monetary zone goes from German interest rates to other member countries' rates.

The increased volatility of interest rates could have some effect on their level. Extension of the interest rate risk may be hedged through several devices, one of them being the introduction of high risk premiums into nominal rates. Should this be the case, financial liberalization could create some downward rigidity in the level of nominal interest rates, with high interest rate risk premiums.

3.3. The influence on the yield curve

Perfect capital mobility and the liberalization of financial services (securities, mutual funds, deposits with banks and non-bank financial intermediaries, etc.) will open infinite room for arbitrage operations. It is likely that these operations will continue to be determined by after-tax return differentials adjusted for expectations of exchange rate variations, and that they will become more and more sensitive to the services offered (we have already argued that the analysis in terms of 'characteristics' is a helpful generalization of the conventional portfolio theory, when it is necessary to take into account the 'quality' of monetary and financial assets). The direct consideration of services (liquidity, acceptability, etc.) is required if return differentials are biased estimates of service differentials (this may be one aspect of market inefficiency).

Generalized arbitrage has two effects on the yield curve:

(i) At the domestic and at the international level, interest rate expectations will determine the term structure of interest rates. Any activist policy, as for instance a 'twist' operation, would be totally ineffective except if it succeeded in influencing private agents' expectations through announcement effects. After financial deregulation, the reputation and credibility of monetary authorities will become the privileged content of the analysis of the yield curve.

(ii) As the arbitrage process will concern every portion of the yield curve, the international propagation of movements between medium- and long-term interest rates will be direct. Up to now, due to exchange controls, and the obstacles to the internationalization of financial instruments and services, short-term interest rates have been the main channel for the propagation of influences between national yield curves. Even if causation continues to run from short- to long-term interest rates, financial integration means also integration of the entire yield curve, with infinite possibility for intertemporal and geographic arbitrage.

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Liberalization of capital movements in the European Community: A proposal, with special reference to the case of Italy

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Introduction

The group of experts was asked to explore two main points:

(i) the gains, in terms of production and employment, that could result from the liberalization of capital movements, because of increased competition and more efficient mobilization of savings towards investment;

(ii) the costs and problems, during the period of transition, for the conduct of monetary policy and for keeping balance of payments equilibrium, as well as the long-term implications for exchange rate stability within the Community.

In addition the group of experts was also asked to explore a wider range of problems, i.e.:

(a) the transitional costs possibly connected with the issue of private versus public sector financing, and with the issue of coordination of monetary policies;

(b) the permanent reduction of monetary autonomy that would result from capital liberalization;

(c) the implications of capital liberalization in terms of the possibility that some member countries may lose from that process.

Finally, during the initial meetings, the group was also reminded that, in the view of the Commission, liberalization should be *erga omnes*.

The reason for listing here the terms of reference for our group is less to organize the following analysis around these themes than to bring to light the stand taken by the Commission. The Commission seems to be of the opinion that, aside from problems of transitional adaptation, the process of liberalization of capital movements should improve the economic situation of the Community at least in the long run. Although this position is widely shared by economists, it seems worthwhile to analyse it briefly, in order not to transform into an uncritical assumption what might instead be an analytical conclusion.

1. A preliminary issue

It seems, therefore, necessary to raise from the beginning a preliminary question: does capital liberalization necessarily imply a more efficient allocation of resources, even in the long run? The answer to this question is generally taken for granted in the affirmative sense. And yet it is more than 30 years since the so-called theory of second-best has been developed and applied with particular emphasis in the field of international economic policy. [1] The central message of that theory is that the elimination of a sectoral distortion, such as an obstacle to international capital mobility, does not necessarily improve the efficiency of the system, when other distortions remain in it. On the contrary, when these cannot be eliminated, it is possible that the introduction of countervailing distortions might improve the economic situation, relative to the one that would otherwise obtain with the original distortions but without the additional ones. The fact that large sections of the economies of industrialized countries do not work according to efficient rules of resource allocation — and this is so particularly for the labour market, where wages are not flexible enough to be able to clear instantaneously the market — is a sufficient reason to take either one of two positions:

(a) aim at eliminating all inefficiencies, and in particular make the labour and products markets as efficient as the textbook auction markets;

(b) recognize that, for reasons that are both economic and social, the first position is not viable, and then accept that compensatory interferences with the free working of the market must be allowed.

In my view, these considerations suggest that a framework for controlling capital movements among the countries that are members of the European Community may be needed even in the long run, at least until either:

(a) the economic structures of all the members of the Community are perfectly homogeneous;

(b) a system of economic or political compensations is created within the Community in favour of the countries or sectors that would be damaged by full liberalization of capital movements.

With respect to relations with countries outside the Community, as both these conditions seem unlikely or undesirable, it appears even more desirable to keep ready at hand a system of controls of capital movements also for the long run. In other words it follows that liberalization of capital movements *erga omnes* is theoretically not justified, even though technically it might be difficult to envisage liberalization or controls designed to discriminate geographically between members and non-members of the Community.

[1] See Meade (1955).

2. A strategic approach to capital liberalization

2.1. As I find it theoretically justifiable to keep a framework for controlling capital movements, and possibly (i.e., if it were feasible) also for discriminating with respect to countries or currencies outside those of the Community, it is worthwhile to ask why the authorities of the Community and of most member countries have definitely chosen to move ahead towards liberalization of capital movements, full and *erga omnes*.

The analysis of this question — i.e., of the motivations behind this new wave of liberalization — is not meant to satisfy a sterile curiosity, but to give political, and not simply economic advice on the more appropriate ways to implement the proposed liberalization of capital movements.

A preliminary question is whether the authorities of member countries — here those of Italy in particular — have indeed changed their position with respect to capital liberalization. It is important to know this in order to understand the meaning and extent of their commitment to the new enterprise, and to design ways that facilitate its success.

Not too long ago the Governor of the Bank of Italy declared[1] that:

'... the road towards international opening cannot suffer obstacles on the front of the exchange of goods and services; a system of stable exchange rates, even though adjustable, is the complement of it. In foreign relations these are irrenounceable priorities; in order to respect them it may be necessary to use mechanisms that break the velocity of capital movements, particularly those at short term that are more exposed to the inducements of changing expectations. (...) Between countries belonging to areas more closely integrated, from the economic point of view it is conceivable and desirable to tend more decisively to full financial, in addition to commercial, integration. This is the case for the European Community, which enshrines such an objective in its founding Treaty. (...) The economic and institutional logic that governs the behaviour of the individual countries would be transferred to the Community level. That logic implies: the further reinforcement of the European Monetary System and of the procedures of coordination of macroeconomic policies; the full acceptance of the mobility of labour as a factor of production in parallel with that of the capital factor; the transfer at the Community level of those instruments of control of capital mobility that would still be necessary.'

More recently and not too differently, the Minister of the Italian Treasury has asked for Community initiatives that may tend to:

'(a) strengthen the coordination of economic policies between Member States (...); (b) develop the financial and procedural instruments — and, if needed, to create new ones — in order to promptly meet with situations of tension in the exchange markets and the balance of payments, as well as with difficulties in monetary management, both deriving from destabilizing capital movements, thereby preserving the cohesion in the (European) exchange system'.[2]

Given such recent statements, similar in content and reiterated at the interval of about a year, it is natural to wonder about the depth and extent of the Italian monetary authorities' new commitment to liberalization of capital movements.

It does not seem that this commitment could be explained as a reflection of the widely diffused wave of deregulation of money and financial markets. A more convincing interpretation of their present stand appears to be a further example of a strategy that the Italian monetary authorities have followed on previous occasions internally, and that they may now be playing externally, together with the authorities of the European Community.

Internally, since the time of the letters of intent to the International Monetary Fund, and thereafter with the so-called divorce between the Bank of Italy and the Treasury — whereby the former is no longer compelled to take up unsold Treasury bills at the monthly auctions (an obligation that used to create monetary base beyond the Bank's direct control) — and, again, with the abandonment of quantitative controls on credit ceilings, the strategy of the Italian monetary authorities appears to have been partly determined by the desire to tie their own hands. In fact these were all instances in which the authorities limited the number of instruments at their disposal to those more directly involved in a restrictive definition of their policy objectives, and did so with the aim of underlying the terms, but also the limits, of their responsibility in preserving monetary stability. The authorities were thus throwing on other Government authorities, on Parliament, and on the social partners, the responsibilities that belong to them in the field of public expenditure and its financing, of the distribution of income and its growth. In so doing, the monetary authorities were breaking away from a tradition, according to which, although well aware of the proper institutional aims of its

[1] At the Annual Congress of the Forex Club, Milan, 26 October 1985. (The translation and omissions are mine.)

[2] Quoted from the newspaper *La Repubblica*, 18 November 1986. (The translation and omissions are mine.)

policy, the Bank of Italy had for years been compelled to take care of various and often mutually inconsistent objectives, and thereby to suffer the damaging consequences of being unable to control a sufficient number of instruments.

At the external level, the strategy may partly disguise the attempt to force the hand of other partners in the Community, by eliminating the remnants of financial *dirigisme* that have for a long time characterized Italian economic policy in the international field — as well as the French one, for which a similar interpretation may be suggested. In fact, these remnants have in the past easily lent to the more liberal partners of Italy (specifically Germany) an argument with which to oppose Italian (and French) requests for a higher degree of cooperation and mutual surveillance in monetary policy, on the grounds that such cooperation would first require from Italy (and France) a more liberal attitude in this field, and a convergence to the lower European standards of inflation and of growth of public debt.

Still at the external level, another element for explaining the new stand taken by the Italian monetary authorities is to consider it in the light of a policy to build up their international credibility. In fact, a more stringent set of rules in the EMS, accompanied by full, even though possibly premature, elimination of capital controls, could be a way to impress on other countries' authorities and, more importantly, on the markets, the seriousness of their new commitment to monetary responsibility. This may indeed be a rational strategy to follow for an authority which, in the past — even though as a result of faulty behaviour of other policy makers within the country — has had to disinvest in monetary credibility. In other words, the acquisition of credibility involved in becoming members of a demanding and exclusive club may reinforce the policy leverage of monetary authorities at both the national and international level.[1]

If the strategic interpretation of the Italian monetary authorities' new policy stand, as suggested above, is at all valid, and if this interpretation is also applicable to the authorities of the European Community, which appear to invest much of their stock in this venture, then an important consequence follows at both the Italian and the European Community levels. This consequence results from the fact that such a strategy contains an element of hazard, and therefore requires a fall-back solution, a safety net, in case it were not to achieve its objectives, i.e., in case it failed, internally, to change the behaviour of the other Italian authorities and pressure groups, and, externally, failed to impress other member countries so as to induce them to submit their national economic policies to a higher degree of Community coordination.

In other words, the Italian economic and socio-political fabric may be unable to move further towards harmonization with the European standards of inflation, public deficit, etc. Similarly, even after the full liberalization of capital movements is accomplished, the authorities of other European countries may not bow to the need for coordinating more strictly their policies with those of their partners. If this were the case, then new exchange crises would explode in the EMS, putting at strain the results reached until now, and possibly also the new ones that are being pursued in the field of capital liberalization.[2] The credibility of both the Italian and Community authorities would not be enhanced by such unfortunate but not wholly unlikely events. This is why, in my view, a safety net must be supplied by the Italian monetary authorities during the process of capital liberalization. This net should be deployed in agreement with the European authorities and jointly with other member countries. It should however be designed independently, in case the necessary consensus could not be rallied behind a common European approach in this direction.

2.2. The interpretation given above suggests an additional justification for the liberalization policy pursued by the authorities of the European Community. In fact this interpretation indicates that a rationale for their policy may be found in the same 'second-best theory' argument that was used above to criticize their stand in favour of complete capital liberalization. In the past, and particularly in the 1960s and early 1970s, the authorities of the European Community pushed ahead with ambitious projects — particularly in the monetary area with the Werner plan, but also in more politically sensitive areas, such as those implying a higher degree of budget autonomy for the Commission — in order to force the hand of Member States and induce 'quantum' jumps towards European economic and political unification. Without discussing here the political merit of such a strategy, it is to be noted that, if successfully pursued in the monetary field and, more specifically, with respect to capital liberalization, this strategy may do away with the criticism expressed above. According to that criticism, moving towards full efficiency in one field — such as capital markets — may take us further away from economy-wide efficiency, because of persistent structural distortions in

[1] For a theoretical analysis of this argument, see Giavazzi and Pagano (1987).

[2] The strained monetary relations between France and Germany before the parity realignment at the beginning of 1987 are a timely example of such a possibility.

other fields and particularly in the labour markets, where the degree of flexibility varies internationally and is in any case far from matching the flexibility and efficiency of financial markets. The counter-argument suggested here — which was the argument behind the so-called 'monetarist' as opposed to 'economist' position in the debate of whether and at what speed to move towards European monetary unification at the time of the Werner plan — is that forcing the hand of national policy-makers by imposing on them a strait-jacket in the monetary field, may put pressure on their policy in other fields, and thus induce them, for example, to eliminate the inefficiencies in the labour and products markets.[1] A possible answer to this application of the counter-argument is that the aim of reducing the labour markets to perfectly efficient conditions is socially costly and politically difficult to accept, because homogenization of the European economies may be inconsistent with full mobility of factors of production within the Community. In this respect, the long historical experience of European countries such as Italy, where regional differences have probably been enhanced by monetary unification and full labour mobility at the national level, should be kept in mind.

2.3. In any case, whether applied to the Italian or to the Community authorities, the interpretation of the present liberalization policy in terms of strategy *vis-à-vis* their own political partners internally or their European partners externally, is instrumental for deriving four conclusions:

(a) if successful, the strategy might invalidate the criticism addressed above to the policy of capital liberalization and based on second-best theory;

(b) if the strategy is unsuccessful, the cost of failure is a damaging loss in credibility; therefore, a safety net must be provided to insure against the risk of such a loss;

(c) this safety net must be deployed in parallel with the process towards capital liberalization, in order to avoid the loss of credibility that would result from the hurried provision of it, or of other restrictive arrangements, at a later stage and probably at a time of crisis;

(d) for the same reason, the safety net must take the form of a mechanism that comes into play in an automatic way if needed, so that the authorities, national and international, would not appear to break any part of their commitment to capital liberalization when the situation would require falling back on the safety net.

[1] See Basevi (1987), and Basevi, Delbono and Denicolò (1987) for a more extended analysis of this counter-argument.

3. Liberalization of capital movements and microeconomic efficiency in the long run

I have dealt with the implications for macroeconomic efficiency that derive from the highly flexible working of international financial markets. It is now time to discuss the implications from the microeconomic point of view.

There is no question that, in itself, the move to liberalization of international capital transactions is an improvement in the microsectoral allocation of resources. This should benefit savers as they would be able to invest their funds in forms that they consider preferable in terms of their portfolio diversification by borrowers and currencies. Similar considerations apply to borrowers of funds.

However, two issues arise that must be set on the other side of the balance sheet in a cost-benefit analysis of these implications.

3.1. The first issue concerns the sectoral losses in employment of labour, capital, and other factors of production, that some countries and their financial centres might experience, following the concentration of the industries that provide these services in a fewer number of financial centres. While this issue concerns more the effects of financial deregulation — effects that fall outside the terms of reference submitted to our group of experts — I think that, as generally happens in the case of industrial and sectoral reallocations brought about by a more efficient organization of an industry (particularly when it is subject to economies of scale), the gains to the consumers will more than compensate the losses to the producers that are pushed out of the market. This process will surely imply international redistribution of income among the producers of these services, and possibly require temporary assistance and compensations. However, it does not seem to pose a problem needing different treatment to similar problems often encountered in international specialization of production. The important point is that assistance, if necessary, should be temporary and not such as to interfere with the efficient long-term reallocation of productive resources. From the Italian point of view, in particular, the comparative advantage should not be tilted in a direction where the country has no chance of attracting major international money or financial centres. On the contrary, the occasion should be taken to introduce elements of wider competition in the banking and other connected services, too long characterized in Italy by their inadequate diversification and inefficient provision to the consumers. But here again, the matter trespasses into the area of the incoming freedom of bank establishment within the EC — an area that goes beyond the specific terms of reference of this report.

3.2. This first issue is strictly connected with a second one. As emphasized at more length below, liberalization of capital movements should not be pursued as a step in a deregulatory process that, wishing to eliminate all interferences with the free working of markets, also does away with the set of rules that are required to make markets work in an orderly way. This is particularly important in the case of international money and financial markets, where elements of risk are unavoidable, as they cannot all be internalized by the market in appropriate forms of insurance. Although regulating the behaviour of agents in these markets is in their own individual interest, it cannot be left to them, as it has the nature of a public good, that no individual agent has an effective interest to provide in competition with other individual agents. Thus such a need has long been recognized as one of the main duties of monetary authorities. The fact that it is more difficult to enforce such duties internationally, and that the short-sighted interest of some countries might tend to reduce the international level of controls to the minimum provided by the least responsible country, is only a reappearance at the macroeconomic level of the problem already met at the microeconomic level. Thus countries at the macro-level, as individual agents at the micro-level, may be tempted to play the deregulatory game up to a dangerous level of risk. The European Community, and its members, should therefore mistrust the gains from attracting these risky types of venture, and follow a conservative approach in a field in which — particularly at times of uncertainty and recurrent shocks as the ones that characterize international markets at present — the dangers of sudden breakdowns in the fabric of international monetary, financial and commercial relations are not to be dismissed too lightly.

4. Liberalization of capital movements and control of macroeconomic policy

4.1. Section 2 has already presented the main economic argument for a critical approach to liberalization of capital movements by the EC countries: this argument is essentially based on the theory of second-best.

Recent versions of this argument often refer to James Tobin's suggestion of the need 'to throw some sand' in the wheels of the international monetary system by taxing international capital movements.

'Any appraisal of the efficiency of our financial system must reach an equivocal and uncertain verdict. (...) Here, as elsewhere, many regulations have been counterproductive. But the process of deregulation should be viewed neither as a routine application of free market philosophy nor as a treaty among conflicting sectoral interests. Rather, it should be guided by sober pragmatic consideration of what we can reasonably expect the financial system to achieve and at what social cost. (...) I fear that, as Keynes saw even in his day, the advantages of the liquidity and negotiability of financial instruments come at the cost of facilitating nth-degree speculation which is short-sighted and inefficient.'[1]

Already Keynes before Tobin, and, more recently, Modigliani and many other economists,[2] have argued against full liberalization of capital movements. However, it is not enough to invoke an *ipse dixit* argument in favour of an unpopular position: it could in fact be counter-argued that the situation has much changed since the times of Keynes, and even since the more recent times of the authors referred to above. International money and financial markets have been profoundly changed by contractual innovations and the diffusion of electronic communications. Moreover, trade in financial services has reached an unprecedented large share of, and intimate compenetration with, trade in products, while trade in financial assets (capital movements) dominates by far the foreign exchange markets. Thus the reasoning of these eminent authors might have become wholly obsolete.

The point, however, is that these authors were indeed referring to modern developments as potentially dangerous in the presence of full liberalization of international capital movements. In fact, among the recent positions in favour of throwing sand in the wheels of international financial transactions, the best known is probably the one based on Dornbusch's formalization (Dornbusch, 1976) of the phenomenon of overshooting exchange rates, which is typically a consequence of modern development of financial markets. In a world of efficient money and financial markets, and of relatively rigid labour and products markets, exogenous and unexpected shocks generate temporary over-reaction of real exchange rates or interest rates. These overshooting phenomena are costly for the economy, as they produce temporary but substantial divergences of production and employment from their new equilibrium level. These temporary divergences may also induce lasting and costly distortions in the productive structure of a country. Because of these distortions, free trade and perfect capital mobility lead to second-best solutions, as already emphasized above. Thus, taxes on trade or taxes on capital movements, or both, may generate superior levels of welfare. As taxes on trade are, for economic and political reasons, to be excluded from the set of usable instruments (at least within the European

[1] Tobin (1984), pp. 14-15.

[2] See Keynes (1936), Modigliani (1972), and, among others, Bergsten (1984), Buiter and Miller (1982), Cooper (1973), Dornbusch (1986).

Community), the argument turns in favour of taxing capital movements, or of some equivalent means for slowing down capital mobility. As it will be discussed presently, the particular means proposed in this report is a double foreign exchange market.

From this point of view, it is not surprising that the wide fluctuations of real interest and exchange rates that have characterized the 1970s and 1980s have revived protectionist forces in international trade. Thus, in order to keep trade free from new taxes and subsidies, it may be necessary to regulate capital movements. Such controls are fully consistent with free choice in the allocation of financial portfolios. Indeed, they may favour a sounder liberalization of capital movements, particularly for those countries, such as Italy and France, that for long have been deprived of such freedom; at the same time, these controls avoid the need to make use of trade interferences as means to offset temporary changes in the real exchange rate, and, therefore, in the international competitiveness of a country.

4.2. The case for regulating capital movements is based not only on the second-best theory coupled with the modern theory of exchange rate determination. It is also based on the argument — due to Mundell (1963) — that in a world of perfect capital mobility, fiscal and monetary policies alternatively lose their effectiveness as means to control aggregate demand, under flexible and under fixed exchange rates respectively. This is a well-known argument, at least with reference to monetary policy and fixed exchange rates, as it implies the inability to keep control of the supply of base money (or of the level of interest rates) when the central bank is compelled to undo through its open market window what it is trying to do, in defence of the exchange rate, through its foreign exchange window.

What is perhaps less frequently considered is the fact that the other side of Mundell's argument -- i.e., the side that implies the ineffectiveness of fiscal policy under floating exchange rates and perfect capital mobility — when coupled with the side related to monetary policy, suggests a double exchange market system as a way to escape the dilemma of the alternative ineffectiveness of the two policies. The effectiveness of both policies (monetary and fiscal) is restored by adopting, through a double exchange market, a system which partakes of both fixed and flexible exchange rates regimes. In fact, the adoption of a double exchange market, by breaking the link between capital movements and commercial transactions, prevents the former from backfiring, through the latter, upon the objective of controlling monetary aggregates, because the Central Bank is now compelled to defend the commercial exchange rate only, and not a unified (commercial and financial) rate. Similarly, a fiscal policy oriented, for example, to expand demand and employment, is no longer made ineffective by the higher interest rates it induces. Without a double exchange market, these attract capital, appreciate the exchange rate and thus reduce net demand from abroad by an amount just equal to the expansion of demand originally induced by fiscal policy. With a double exchange market, the commercial rate does not react to the higher interest rates induced by the expansionary fiscal policy: the capital movements that would be induced by those higher rates find an automatic brake in the appreciation of the financial exchange rate.

Therefore, although with reference now to macroeconomic policy effectiveness, rather than to microeconomic efficiency in the allocation of resources, it is arguable again that full deregulation and perfect mobility of capital are not conducive to a 'first-best' situation. Moreover, the double exchange market is thereby indicated as the natural arrangement to deal with both aspects of the problem.

Before further elaborating on this proposal — i.e., on the adoption of a double exchange market by Italy, and possibly by a larger set of European countries — it is useful to dwell on the persistent need for exchange rate realignments in the EMS. The issue boils down to the question of how close the EMS comes to an optimum currency area.

I have elsewhere (Basevi and Giavazzi, 1987) analysed a number of situations in which, among three ideal countries (dubbed the USA, Germany and Italy), cooperative, uncooperative, or partly (as limited to Germany and Italy) cooperative strategies lead to different welfare rankings of monetary arrangements between the European countries.

Some conclusions emerge from that study, that may be useful to report here:

'The process of economic integration among European countries today has two principal objectives: the abolition of barriers to capital movements within Europe and the gradual transformation of the European Monetary System from a system of adjustable parities into a system of irrevocably fixed exchange rates.

The two objectives are not independent: the experience of the EMS shows in fact that in a system characterized by periodical realignments, the anticipation of a realignment gives rise to speculative attacks against the reserves of the central banks. These have two ways to defend their own reserves: to accept a high volatility of the interest rates or to impose controls on capital movements. Until now the choice has always been tilted in favour of capital controls.

The experience of the EMS suggests therefore that the abolition of the barriers to capital movements cannot be accomplished independently of the transformation of the EMS into a system of irrevocably fixed exchange rates.

The important question therefore is: how much does it cost to renounce the realignment of exchange rates as an instrument of economic policy? In a world in which variations of exchange rates have real effects, a realignment can take place for two reasons.

First, even though the European countries were perfectly identical (in their economic structure) and hit by common external shocks, a realignment of the intra-European exchange rates can simply be the result of non-cooperative management of monetary policies (by the member countries). Notice that the degree of cooperation requested is not limited to the cooperation of decisions with respect to exchange rates, but must also extend to the decisions with respect to the monetary policy of *each* country belonging to the system.

Second, if the macroeconomic structures of the various European countries are not identical, or in presence of regional (European) shocks, realignments of intra-European exchange rates become part of a cooperative reply to exogenous shocks.

In itself, the fact that realignments could simply result from non-cooperation (at the European level) would render a system of fixed parities particularly attractive; fixed exchange rates in fact enforce the cooperative solution. From this point of view, far from being a cost, the abandonment of the use of exchange rate changes as an instrument of economic policy would only present advantages; it avoids the losses that derive from non-cooperative behaviour and allows the integration of financial markets.

However, in the real world, the presence of structural differences among European countries and of regional shocks imply that the decision to keep exchange rates fixed implies a choice. Fixed exchange rates allow financial integration, but do not allow the use of realignments as an instrument for redistributing the effects of regional shocks, or also of common shocks in the case of structural differences (among the European countries). In the present reality, therefore, the thesis in favour of adjustable parities is grounded simply on the fact that, in presence of asymmetrical shocks or of structural differences, Europe does not yet constitute an optimal currency area. What is new, relative to the traditional debate on optimal currency areas, is the trade-off between cooperative realignments and liberalization of capital movements (...).'

Indeed, some authors[1] go as far as to suggest that the success of the EMS so far has been due in large part to the existence of exchange controls, particularly in France and Italy.

In any case, according to this argument, the structural peculiarities of a country — Italy in our case — are a definite obstacle to liberalization of its capital movements. Notice that the structural differences that are relevant are not only the labour market rigidities, which may be higher in Italy than in the other European countries, but also some differences that directly impinge on the mobility of capital.

Two of them are of particular importance in the Italian case.

The first is the fact that, because of the long history of capital controls in Italy, of its relatively less-developed financial markets, and of the large accumulation of public debt, there could be in this country a large backlog of potential desire for currency and country diversification of financial portfolios, that seems dangerous to release suddenly. This argument is not new, it has probably been overplayed, and in any case its importance is likely to have diminished in the recent period, with the diffusion of investment funds and the gradual liberalization already accomplished through them. In any case, it would be illogical to argue that capital liberalization cannot take place because it has not been allowed in the past. The system must be changed at some point in time, if and when the change is deemed desirable. Thus these are really arguments for gradualism and automatic safety valves. As such they will be considered again in Section 5.

Second, the economic structure of Italy is different with respect to the other major European countries for the large share of its public debt indexed to short-term interest rates, even though formally issued with a long-term maturity. In this situation, when, with perfect capital mobility and in the absence of realignments of exchange rates, the burden of regulating exchange relations within the EMS falls on interest rates, the control of fiscal policy would be endangered. Indeed, as the Italian public debt is such a large share of GDP, its service has already made it difficult, in recent years, to effectively use fiscal policy for stabilizing the economy.

In any case, full coordination of economic policies and convergence of the economic structures of the European countries are unlikely to be achieved in the reasonably near future; hence the need to deploy a safety net for the liberalization of capital movements. Without such a net, we risk

[1] See, in particular, Melitz and Michel (1986), Rogoff (1985), Wyplosz (1986).

losing much of what has already been accomplished in the monetary field in Europe, and damaging the credibility of the national and Community authorities that have embarked on such an enterprise.

4.3. The position that has been taken here, therefore, is not one *a priori* opposed to liberalization of capital movements. It is a position from which, given the present economic and institutional structures of Italy and the European countries, liberalization by itself is seen as not necessarily improving the efficiency of their economies, and yet involving the authorities in a risky predicament, from which they would lose much if they had to withdraw. Hence the proposal of a safety net, to be explored in more detail in this section. First, however, I would emphasize that liberalization must not be confused with deregulation. This distinction is important for two reasons, one related to the same philosophy that has inspired the supporters of deregulation in recent years, the other being more specific to Italy.

As to the first reason, let us remind ourselves that, as stated 40 years ago by one of the most eminent representatives of the school of thought to which those in favour of deregulation generally belong:

'(...) Government must provide a monetary framework for a competitive order, since the competitive order cannot provide one for itself. (...) This monetary framework should operate under the "rule of law" rather than discretionary authority of administrators.'[1]

Thus, deregulation is accepted, within the liberal approach to monetary institutions, if aimed at the elimination of discretionary interventions by the monetary authorities, but rejected if interpreted as the elimination of all rules of the game.

The second reason derives directly from this first one, and is of particular importance in the case of Italy. In fact, in this country, even aside from the requirements of the European Community, a process of revision of the intricate set of laws and regulations that control capital movements has been under way for a few years. The fundamental principle on which the framework for revising the law prepared by Parliament and to be defined by Government is inspired has, with much publicity, been expressed as the opposite of the principle governing Italian intervention in these matters until now, i.e., the principle that all that is not explicitly allowed is *ipso facto* prohibited in the field of international capital movements. This principle would be reversed into the principle that all is allowed that is not explicitly forbidden.

Now, beyond the apparently impressive reversal of principle, it is clear that the two statements can be made equivalent if a basic premise is not changed, according to which authorities in this field keep discretionary control of what is either allowed (under the old principle) or prohibited (under the new principle). Thus the real issue is to limit as much as possible the discretionary power of authorities in this field, rather than to deregulate *sic et simpliciter*. From this point of view — as I have already argued elsewhere (Basevi and Cavazzuti, 1985) — the framework of law prepared for the Government by Parliament[2] seems unsatisfactory.

The proposal to provide a safety net resembles only superficially the suggestion expressed in most documents submitted by the Commission to this group of experts, according to which there is a case for considering new safety clauses as the most appropriate way of dealing with difficulties in the process of capital liberalization. The proposal must also be distinguished from the idea emphasized in some documents of the Bank of Italy, according to which it is useful to distinguish, at least for the case of that country, between temporary and permanent controls of capital movements.[3] In fact, the proposal to provide a safety net, and more specifically one in the form of a double exchange market, implies:

(i) that it should be kept in place before its need actually arises;

(ii) that, therefore, it should not be considered as either temporary or permanent; its existence only should be permanent, while its use and effectiveness would be temporary, as it is only in case of crises that the potential of the safety net will come to work.

Here the metaphor of the safety net is indeed so close to reality that it may be worthwhile to emphasize it. In a circus the net is put under the swinging acrobats for safety and in the hope of never having to use it. Clearly, in order to be useful, the net must be in place before the acrobats start swinging over the admiring eyes of the public. Clearly, also, its eventual use becomes effective and temporary in the unfortunate case of an acrobat missing his grip. Pushing the metaphor somewhat further, we may also have observed that the public of a circus — at least the true lovers of such shows — are not in the least less pleased and impressed by the ability of the acrobats when there is a net under them, and that the freedom and elegance of the acrobats are not impeded by the presence of the net.

[1] Friedman (1948), p. 370.

[2] Such was the situation at the time when this report was prepared. Since then, the Italian Government has regulated the matter by a decree (September 1987), which will soon be followed by a comprehensive revision of the whole law (March 1988).

[3] See, for example, Micossi and Rossi (1986).

5. The double exchange market

5.1. It is time to conclude this report by extending the analysis to the advantages and disadvantages of the proposal to install a double exchange market, as a safety net accompanying the liberalization of capital movements in a country such as Italy. The general justifications for such a proposal have already been presented in the preceding sections. What is needed here is consideration of some specific aspects of the proposal.

These will be organized in terms of objections to it on the one hand, and its main advantages on the other hand. As for the more technical aspects of the system, I refer to the extensive literature on the theoretical and empirical aspects of double exchange markets,[1] as well as to my own work (Basevi, 1985).

In any case, before considering the pros and cons of such an arrangement, let me restate that a double exchange market does not limit the freedom of capital movements; quite the contrary — it is a means to make such freedom possible, while avoiding its negative consequences on the allocation of real resources and allowing the effective use of monetary and fiscal policies.

5.2. Objections

(a) Some authors criticize the double exchange market by arguing that the system becomes ineffective in the long run, as loopholes are found through which arbitrage between the two markets makes their separation useless. While the existence of loopholes cannot be denied, their significance should not be misunderstood. In particular, a double exchange market of the type used or envisaged in industrialized countries, is not such as to imply a permanent tax on capital outflows in the form of a discount of the financial, relative to the commercial, exchange rate.

First, although the way the market is sometimes organized is such as to bias it towards depreciation of the financial rate relative to the commercial one, the system in principle could be perfectly symmetrical, and it could therefore open a wedge either in the form of a tax or of a subsidy on capital outflows. This, by the way, indicates that the market can also be a substitute for the possible introduction of new safety clauses, alluded to in the documents of the Commission, as a means to keep capital out of strong currency markets.

Second, the wedge opens only in case of crises. In normal times the spread between the two rates can be insignificant, and it may be managed through exchange intervention by the monetary authorities in both markets. The fact that the wedge is insignificant means that the tax (subsidy) is not a permanent one, and that the system may be sustained even in the long run. Thus, the recent criticisms raised by Dornbusch (1986) are correct if they are addressed, as they are, to the way double exchange markets have been used in developing countries to keep, for long periods of time, misaligned exchange rates and disequilibriated balance of payments situations, thus feeding rather than choking speculative attacks and fostering the final breakdown of the systems. Similarly the criticism by Frenkel and Razin (1986), according to which 'intertemporal considerations cast serious doubts on the long-run viability of such exchange-rate regimes'[2] is correct but beyond the point, as the authors themselves recognize, by adding that 'even though dual exchange rate regimes may not be viable in the long run, they can be sustained in the short run' — which is indeed all that is required.

(b) Still on the issue of loopholes, it is sometimes difficult to distinguish current account from capital account transactions, so that the possibility of arbitrage through over- or under-invoicing, leads and lags, and other operations related to current account transactions is undeniable. However, the argument is in practice overstated, as experience shows again and again that in case of crises substantial differences arise between the commercial and the financial rates. Arbitrage cannot be so successful or else such wide wedges would not be observable.

(c) The question of loopholes and the need to separate the two markets effectively raises the issue of bureaucratic machinery and its costs. The issue, however, must be looked upon from a relative point of view; relative, on the one hand, to the existing degree of administrative and discretionary controls in a country such as Italy, and, on the other hand, to the anarchic deregulation already criticized above. However, it must be allowed that the actual implementation of a double exchange market requires the formal maintenance of an apparatus of controls. This disadvantage is, in my view, balanced by the fact that the system allows an effective liberalization of capital movements, as they would be completely free within the financial market.

(d) A double exchange market is sometimes criticized for giving clear signs to potential speculators on the way the commercial rate is bound to be changed when a revision

[1] See the many references in Frenkel and Razin (1986), and in Gros (1986).

[2] Frenkel and Razin (1986), p. 33.

of parities comes. These signs would feed destabilizing speculation, safely encouraged by the one-sided nature of the market, that bounds the possible losses in case the expected depreciation does not materialize.

However, this argument is valid for a type of double exchange market where the separation works only in one direction (as, for example, in the case of Belgium-Luxembourg, where purchases of foreign exchange for capital transactions must take place in the financial market, while sales have the option of going into either market). The double exchange market proposed here should work both ways; this symmetry, by the way, is required if the system were to be adopted not only by a single country, such as Italy, but by at least two countries in the EMS. Moreover, in so far as signals would still come from the financial rate to indicate that the commercial rate is misaligned, the double exchange market would lend credibility to the central bank, because this could less easily keep a misaligned commercial rate for long periods of time. Thus, by adopting such a system, a central bank would commit itself more credibly to policies that are consistent with a fixed parity.

5.3. Advantages

(a) The main advantage of a double exchange market is that it provides an automatic control mechanism that reproduces equivalently that of a continuously adjusted tax or subsidy on capital movements. The system would thus work without imposing on the authorities the impossible task of having to change and adapt such wedges to continuously changing economic situations. From a more technical point of view, this aspect is explored at length by various authors.[1]

(b) As just stated, a double exchange market is equivalent to a continuously adjusting tax (subsidy) on capital movements. While a system of taxation of capital movements is preferable to a double exchange market if the purpose is to keep a permanent wedge between domestic and foreign real interest rates, a double exchange market system is more efficient than the alternative when there is a need to fine-tune an instrument so as to avoid temporary jumps in the real exchange rate. Moreover, the nature of the market itself, by implying a tax (subsidy) on capital movements, rather than on their returns, discriminates automatically against short-term and speculative movements of capital, i.e., those that aim at reaping fast and repeated gains from moving in and out of a currency. Long-term investments are minimally impeded by a double exchange market; on the contrary, the complete liberalization of capital movements that the system allows is an incentive to avoid speculative motivations behind long-term investments. For them, the avoidance of bureaucratic controls sets a premium over the attraction of speculating on the best moment at which to make the purchase or sale of currency in the financial market. For example, if, because of a crisis, the financial rate were to depreciate substantially relative to the commercial rate, the longer-term investors in need of foreign currency had better wait for quieter periods, while the burden of taking risky chances is left to speculative short-term capital. Thus, demand for foreign currency withdraws from the financial market when the domestic currency is under attack, with stabilizing consequences.

(c) As hinted above, the perfect freedom of action that the double exchange market allows to capital transactions, provided they are conducted through the financial market, is another main advantage of the system. From this point of view, early adoption of the system is the best way of accompanying a gradual and eventually full liberalization of capital movements for a country like Italy, and possibly for other major countries in the EMS.

(d) Last but not least, the system has the valuable advantage of diverting from the authorities the mark of unsuccessful policy that is attached by national and international opinion to the reintroduction of capital controls in a hurried way and at times of crisis. If a double exchange market system is set up in advance and smoothly steered through in the initial period, with interventions aimed at keeping the two rates rather close to each other, and used only to reduce the pressure on exchange rates in both directions (as is the case in the unbiased version proposed here), then no risk of defaulting on promises authoritatively made, and no consequent loss of credibility, are involved, neither at the national nor at the Community levels. This, from an institutional and wider political point of view, appears to be the main advantage of the system proposed here, in the interest of both the Italian and the Community monetary authorities.

6. A comment and an afterthought

6.1. The comment

The comment is addressed to Wyplosz's contribution to this group. In his paper he states the proposition that, out of the three conditions:

(i) a fixed exchange rate system (such as the EMS);

(ii) full capital mobility, i.e., no capital controls;

(iii) long-run monetary independence,

[1] See Buiter and Miller (1982), Liviatan (1980), Basevi (1985).

just two are compatible. Then, by leaving aside the abandonment of the EMS (i.e., the abandonment of (i)), two possibilities are left:

(a) EMS with full capital mobility, but without long-run monetary independence;

(b) EMS with long-run monetary independence, but with capital controls.

Wyplosz analyses both possibilities, and does not come out in clear favour of one or the other. The proposal presented in my paper falls under possibility (b).

The set of choices, however, is larger than that proposed by Wyplosz. This is clearly understandable as soon as we distinguish between currencies and countries; as soon as we recognize that, whereas capital mobility and monetary independence (conditions (ii) and (iii)) may apply to either countries or currencies, fixed exchange rates (condition (i)) necessarily apply to currencies only. Clearly the two-dimensional structure of the domain of application of conditions (ii) and (iii) multiplies the number of possibilities.

6.2. The afterthought

The afterthought results from the comment above. The additional possibilities that may be interesting to explore are those in which:

(a) the domain of application of monetary independence is kept with respect to control of money supply expressed in domestic currency, but lost with respect to additional supply of money within the country when the supply takes the form of foreign currency or ECU;

(b) full capital mobility is preserved with respect to capital transactions that residents make in money and financial instruments denominated in foreign currency or ECU without moving in or out of domestic currency; it is not preserved with respect to capital transactions that residents make by moving in and out of domestic as opposed to foreign currency denominated instruments.

In other words, a double exchange market (or other equivalent forms of capital control) could be introduced as a means to preserve monetary independence with respect to control of the supply of domestic money. At the same time, however, full freedom would be left to residents to make capital movements in assets denominated in foreign currencies or ECU.

This is the 'parallel' currency approach, that has taken various forms in the past,[1] and which is here reconsidered together with a double exchange market applied to transactions in and out of domestic currency. The double exchange market component would allow a less traumatic introduction of the parallel currency (or currencies) within a country, as it would essentially provide the Central Bank with an automatic mechanism to protect the gradual reduction of the field of application of its independent national monetary policy.

It goes without saying that this scheme, as the parallel currency approach in general, implies:

(i) liberalization extended to monetary and not just financial instruments, and

(ii) giving up the Central Bank's monopoly of foreign exchange. This is a step that does not yet appear in sight in Italy.

The recently revised Italian law on foreign exchange transactions will have to be modified again to incorporate these revolutionary principles, if Italy really agrees to move into the second phase of liberalization that the European Community has set for 1992.

[1] See, in particular, *The Economist* (1975), Optica (1976), Optica (1977).

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Capital flow liberalization and the EMS: A French perspective

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Introduction

The EC plan to foster further integration of capital markets is certain to create new opportunities for the Member States but also further constraints on their ability to shape domestic economic policies.

This report covers a wide range of issues of relevance to the proposal, bringing to bear recent developments in economic analysis while not attempting to present a model or even a coherent framework. The main proposition is presented in Section 3, and asserts that one cannot maintain simultaneously the EMS, long-term monetary independence through differences in steady-state inflation rates, and full freedom of capital movements. The implications of this proposition are very serious. The objective of full liberalization represents a high risk for the EMS. The risk should not be dismissed lightly. A certain number of solutions exist. One possibility is to set up some 'safeguard clauses', the codeword for temporary capital controls, but of course this goes some way towards undermining the very objective which it is meant to support. Alternatively, the EMS needs to be adapted. Section 4 considers three other possibilities. One possibility is to adopt a softer version of the EMS with more frequent realignments and larger margins of fluctuations. Two other possibilities represent a strengthening of the EMS, the first one by increasing the pooling of national reserves, the second one by going the full way to a monetary union.

Section 1 considers distribution issues as well as the temporary costs of a full liberalization of capital movements and the steps to be taken to achieve full financial integration. Section 2 prepares the more substantial arguments summarized above as it considers the constraints imposed by the EMS. Overall, the EMS is seen as a most useful arrangement which should not be endangered by unwarranted expectations about the benefits of financial integration.

1. Distribution effects

1.1. Borrowers versus lenders

In order for financial markets to be fully integrated arbitraging possibilities must be complete, i.e., not restricted by considerations other than profit making. It must be noted at the outset that this need not lead to perfect asset substitutability across currencies of denomination. Indeed, exchange risk will normally imply some degree of imperfect substitutability, no matter whether currencies are floating or part of a fixed but adjustable regime like the EMS. The important implication though is that portfolios will be optimally diversified so that all non-diversifiable risks (including exchange risks) will be optimally spread within the total market, fundamentally achieving the best possible allocation of resources. This will be the case, of course, only if each domestic market is free of distortions, an important provision to be discussed at a later stage.

Full integration does not actually require that *all* existing restrictions be lifted; it is enough that one side of the market (demand or supply) be free to operate. For example, it is not necessary that borrowers be allowed to operate in all markets. One could imagine the extreme case where borrowers may only borrow on their own domestic markets. Yet if lenders are free to buy liabilities no matter where they are issued and in any currency, the desired integration of all financial markets will be achieved. For example, French firms could be forbidden from floating stocks and bonds abroad. But if foreign financial intermediaries are allowed to freely subscribe to issues on French markets, and if French financial institutions may buy securities issued abroad, French markets would effectively be fully integrated.

The previous argument does not say that capital movements can be restricted to operate in one direction only. Quite to the contrary, as the example shows, integration requires two-way freedom of movement. It only says that when institutional reasons (for example tax-related issues) require some form of restriction (maybe because some degree of harmonization is required across countries and may be hard to achieve soon enough), full integration still remains possible, and should not be postponed because of false pretexts. Quite clearly, if the objective is full integration, no restriction is better than some restriction. But full integration is possible with some restrictions, provided that they are carefully analysed.

Obviously, there are transaction costs involved, and as the previous example amply suggests, it may matter for cost effectiveness how the liberalization process is enacted. But the previous example shows how intermediaries would enter the picture and how competition among them would drive costs down to the point where it would hardly matter which side of the market has been freed.

There is still a question of incidence: in the previous example, one would expect that the costs would be borne by the lenders as they gather information and/or pay fees to the intermediaries. This might then suggest that, according to how integration is achieved, different groups may end up bearing the costs of trans-border operations. As a consequence, one might obtain the following implications: if it is the lender who bears the cost, the process of liberalization

will tend to reduce *ceteris paribus* the flow of savings; if it is the borrower who bears the cost, aggregate investment will be hurt.[1] Yet, as always when we deal with incidence issues, the above presumption need not hold under any condition and market pressures may well shift the burden from one side of the market to the other. In addition, one would expect intermediaries to play on both sides of the market and even cut out the incidence.

Finally, the main point of this section is that freedom of transactions may be restricted to a limited segment of the financial markets: as long as the national markets themselves are fully integrated (for example between the short and long maturities, as has been recently achieved in France), opening up one segment (e.g. the long maturities) is sufficient to achieve full integration. But, as noted by the Commission's staff, it is true that such a limited liberalization will affect the performance of the financial intermediaries as an industry.

1.2. Foreign versus national interests

Opposition to free trade in assets sometimes stems from fears that domestic savings will be diverted to finance productive and employment-creating investments abroad. Such fears are founded only if it is *net* outflows which result. For that to happen, it must be the case that returns on foreign investments exceed domestic returns. But in that case, the country suffering from net outflows should benefit as a whole since it will acquire assets of higher value: financial integration is Pareto-improving.

There is no denial that foreign investment may have domestic distributional effects, particularly affecting employment while benefiting asset holders. But what must be recognized is the reason why returns on investment are lower at home than abroad: in principle, this is because the domestic capital-labour ratio is higher or because subsidies have pushed down the required rate of return on investment. In the first case, in most European countries and my best guess is in the case of France, the presumption is that high capital-labour ratios arise from various rigidities and inefficiencies in the labour market which result in excessive labour costs. In that case, the 'first-best' solution is to address the origin of the distortion, not one of its symptoms, so that imposing further distortions to the capital market can only be assumed to be welfare-reducing, that is unless a specific case can be made that such restrictions are of a second-best nature. In the second case, that of subsidies or other regulatory restrictions, the same rule applies, namely that interventions in the capital market ought to be explicitly related to existing distortions.

Another frequent argument against free movement of capital, and one that enjoys considerable support in France from government to government, concerns foreign ownership of domestic corporations. One first embodiment of this argument is that strategic military considerations make it necessary to control the production, and sometimes the confidentiality, of specific goods. This may be a valid argument, although one suspects that it concerns only a very narrowly limited list of instances and actually is being vastly overblown. The second embodiment of the argument concerns the need to protect infant industries in growing markets. Here again, this is a valid argument in theory but an often grossly overused one.[2] A last variation is that foreigners are being attracted by returns on investment which exceed the foreign level and ought to benefit domestic savers. This can happen when the domestic capital-labour ratio is lower at home than abroad: in that case foreign investment should be welcome as it compensates for a lack of accumulated savings which results in lower real wages. Note that this latter case cannot occur simultaneously with the case, discussed above, of capital outflows creating jobs abroad: returns at home must be either lower or higher than abroad, not both at the same time unless domestic capital markets are highly inefficient.

Finally it is worth noting that returns at home may differ from returns abroad for yet another reason: when there exists a monopoly power of either lenders or borrowers. This is a good argument in favour of liberalization of capital movements since a most likely effect of these movements is to reduce such distortions.

1.3. Public versus private sectors

In France, it has been argued for a long time that real interest rates ought to be kept low so as to reduce the burden of servicing the public debt. This in turn has often been used as an argument in favour of capital movement restrictions. As of 1 January 1987, the Banque de France is changing its operational procedures and a large number of measures aimed at deregulating domestic financial markets have been taken or are being currently prepared. The end result should be a situation where the Treasury does not enjoy any more the advantage that it used to organize for itself. Therefore, the following might be a moot issue, at least as far as France is concerned, yet a few remarks may be warranted.

[1] Both investment and saving flows are normally expected to grow as a consequence of the integration process. What is discussed here is which side of the market would benefit most.

[2] For a discussion of many of these issues, see Jacquemin and Geroski (1985).

What is true under these circumstances is that bond holders pay an implicit tax which substitutes for higher taxes which would have to be otherwise raised in order to service the public debt. The real issue, therefore, is one of the domestic tax structure and the associated income transfers, and there may be valid reasons for choosing such a pattern of taxation. However this cannot be construed as a case against capital movements as any structure of taxation may be achieved through explicit taxes-cum-subsidies: doing so implicitly through capital movement restrictions is an inefficient, and presumably costly, way of achieving otherwise valid objectives. There remains the facts that, if and when trade in assets liberalization forces the Treasury to resort to other sources of financing to service its debt, it ought to recognize the associated income transfers: for example, if it simply raises income taxes to match the increased burden of the debt, it may hurt households at the lower part of the income scale, who do not save and will not benefit from higher returns on bonds, yet pay taxes, and will pay more of them.

1.4. Domestic financial agents

In general, the presumption is that opening up to trade should be welfare-improving, at least in the long run. This will be true unless there is an identifiable market failure, so that one should indeed try to seek whether such failures currently exist. Two such potential failures or market imperfections are examined.

Many European countries, including France, have deemed it necessary to set up often complex systems of reduced interest rates (*taux d'interet bonifies*) designed to subsidize corporations and households. What is the implication of such schemes for the liberalization programme? As long as such discounts are directly recuperated by financial intermediaries from the Government, one would not expect liberalization to create major problems. The issue is different though when the implied transfers are only indirectly compensated. This is the case in France where a large number of pricing decisions by banks are regulated by the monetary authorities: charges for overdrafts, yields on popular savings schemes, rates on borrowings by households, etc. Clearly these rates are set in order to allow 'normal' operating profits for the financial intermediaries, particularly keeping in mind that they are 'asked' to grant concessionary loans to a large number of privileged customers chosen by the authorities. The French authorities have stated their intention of dismantling at least a large portion of this web of indirect transfers, and have already started to do so. But even the most enthusiastic believer knows that this process is not likely to evolve easily to a situation where all subsidies will be eliminated: after all, there may exist valid reasons for subsidizing certain categories of economic agents. Inasmuch as the liberalization programme implies free interest rates, it follows that the current transfer system is in jeopardy. This is not an argument against liberalization, however, since the existing systems of 'implicit' transfers can easily be replaced by explicit subsidies or by tax concessions aimed directly at the desired beneficiaries. In fact, such a change would be beneficial from an economic point of view, first, as it would make the costs of the transfers visible and therefore easier to evaluate and, second, as it would eliminate a factor of reduced competition among financial intermediaries.[1]

Another concern with the effect of the liberalization programme is that (foreign) powerful intermediaries may use the enhanced market system to build up dominant positions. It would indeed be ironic should a liberalization programme result in less competition! While such a scenario cannot be ruled out on *a priori* grounds, and is beyond this report, it seems safe to believe that the risks are quite limited. Monopolies typically emerge when there exist increasing returns to scale and/or barriers to entry are easy to erect and to protect. There do exist increasing returns to scale in branch-banking, but the current situation is better characterized by monopolistic competition: allowing new players to enter is only likely to increase the intensity of competition, not to reduce it. As far as entry barriers are concerned, all we seem to know from financial activities is that they are very hard to set up and even harder to protect as the fixed costs are quite limited (that is outside the business of branch-banking).

1.5. Foreign versus domestic financial centres

Quite reasonably, some countries may worry about the redistribution of cards among financial centres that would follow the shake-up that enhanced competition will trigger. More precisely, French financial agents and the French authorities may feel that Paris is not in a position to compete on an equal footing with, say, London. In order to evaluate this issue one must start by asking why is Paris unable to compete with London (or Frankfurt or Milan, etc.). Three reasons are immediately apparent: first, regulatory conditions differ across countries; second, tax systems also differ; third, competitive advantage, or know-how, may exist.

[1] To take one obvious, and well-known example, the Credit Agricole is given a monopoly for certain types of banking activities in rural areas in return for reduced-cost loans to farmers. Other banks have long complained about this element of unfair competitiveness. Successive French Governments have resisted requests to dismantle this system and replace it by explicit subsidies to farmers which would raise a host of issues ranging from domestic costs to compliance with EC agricultural policies.

Clearly, one reason why Paris has not emerged as a major financial centre is that it has long been subject to a considerable number of competition-reducing regulations. This has now been officially recognized and the authorities are moving forcefully to eliminate the most glaring restrictions, including those affecting foreign exchange transactions. Consequently, there is currently no contradiction between the EC plan and deregulatory activities in France; quite to the contrary they act as mutually reinforcing factors. Yet this leaves us with the fact that different countries may find different levels of regulation optimal, maybe because of inherited traditions, industrial and social structures, etc. Therefore, it may well be that competition will be unequal.

The same issue arises with regard to taxation. We do not know how to 'design' an optimal tax system practically, so that, even if all countries were alike in some general sense, they might well end up with sharply different tax systems. This is why opening-up to trade invariably raises issues of tax harmonization.

There are two answers to the problems of tax and regulatory harmonization. The first one is that, of course, preliminary harmonization is the 'first-best' solution. But one should be extremely cautious not to jump to the unimplied conclusion that harmonization is a precondition for liberalization. As the example of trade liberalization has shown, taxes and regulations can and do evolve over time. This actually brings about the second remark: national tax and regulations ought to be left to compete with each other so that, in time, harmonization will emerge as a by-product. Given current knowledge, it is impossible to assert that the emerging pattern will be inferior to the one which could be agreed upon via preliminary negotiations. On the contrary, it is altogether likely that such preliminary negotiations may fail to reach an agreement.

The third and last issue concerns relative competitive advantages and the possibility that some financial centres which have long operated under less constrained conditions have accumulated a know-how which will enable them to increase their market shares as a result of the liberalization process. This is precisely the reason why international trade is welfare-improving: it allows the most effective producers to deliver the best products at the lowest costs. It is therefore not unlikely that London will emerge as a yet more powerful financial centre, with smaller 'regional' centres in Paris, Frankfurt, Milan, Brussels, etc. catering to more specific needs of their local customers. The strong presumption is that such a process will be *eventually* welfare-improving.

There remain two issues: while the final result of this complex competition between financial agents, as well as between national tax and regulatory systems, will be beneficial to the EC as a whole, some countries may feel worse off; second, a certain number of casualties are likely to occur during the transition period. As far as the first point is concerned, it is hard to see why a given country should not share in the total advantage: simple theorems of trade liberalization assert that each country stands to gain, and there is no *a priori* reason to believe that such a result does not apply in the present case.

The issue of transitory costs is a more serious one. Indeed, it is hard to believe that a major increase in competition will not drive out a certain number of financial intermediaries, some of them of very significant size. In fact, this is part and parcel of the benefits from the programme that the least effective agents be either eliminated or forced to streamline their activities. Given the particular dangers associated with bank or financial intermediary failures, the matter ought to be taken very seriously. But there is not much more to be said about it except that national and community authorities should be prepared to exert their function of lenders of last resort when problems arise. They should do that swiftly and resist the temptation to bail out failing agents since this would actually negate the whole purpose of the liberalization programme.

In addition, there is a fear that such a process of streamlining will result in dismissals, worsening an already bleak unemployment situation. This is also likely to happen, but one must recognize, again, that unemployment is not being adequately fought through measures which actually make some industries inefficient: there are real costs to such efforts at protecting jobs, and concealing them is an expediency which has no economic justification. On the contrary, the presumption is that reducing inefficiencies will eventually result in job creations, unless the labour market is badly distorted: then the distortions must be treated directly.

2. Monetary and fiscal policies' independence under the EMS

2.1. The simple Mundell-Fleming model

In this section, I briefly recall the standard results under the assumption that the EMS is best approximated as a fixed exchange rate system. In the next section, I will depart from this assumption.

First it may be argued that EMS countries actually operate in a flexible exchange rate system as their currencies, although fixed to one another, fluctuate *vis-à-vis* the world

major currencies such as the US dollar, the yen, and the pound sterling. It would be grossly misleading to conclude that the EMS countries thus escape the implications of a fixed exchange rate system. Indeed, the crucial constraint of a fixed exchange rate system is that the monetary authorities are forced to intervene any time their exchange rate falls out of line relative to the currencies to which they wish to maintain a peg. This constraint does exist within the EMS.[1] The power of the constraint is not related to the additional fact that EMS countries are very strongly tied to each other via trade and financial flows while relatively closed *vis-à-vis* the rest of the world. Even if an EMS country was mainly trading with, say, the US, the smallest deviation from its declared parity would force its authorities to intervene and, in the presence of sufficient capital mobility, the pressure of a misalignment would be as overwhelming as for any other EMS member country.

Under this condition, the standard result is that, if capital is freely mobile, monetary policy independence is lost. The well-known mechanism is as follows: any change in monetary policy exerts pressure on the exchange rate which, in turn, triggers capital movements. Monetary authorities will have to reverse themselves unless they are able and willing to spend (or absorb) a sufficient amount of reserves, while at the same time sterilizing in order to maintain their policy stand. But it is clear that each intervention provides the exchange markets with more ammunition to continue exerting pressure, so that there is no doubt that in the end the choice is between abandoning the initial policy change or accepting the necessary exchange rate correction, i.e., abandoning the existing parity or float.

Fiscal policy, on the contrary, is quite powerful. Consider, for example, an increase in government spending without monetary financing, a so-called 'pure' fiscal expansion. As it puts an upward pressure on the interest rate, capital flows in, which both keeps the interest rate constant and provides an indirect financing of the budget deficit, i.e., it avoids the offsetting crowding-out effect. Furthermore, the capital inflows compensate for the associated current account deficit and help maintain the exchange rate parity.

These results are summarized here as originally stated by Mundell and Fleming. Recent extensions, incorporating dynamic elements such as cumulated fiscal and current account imbalances or (rational) expectations leave the main qualitative conclusions unchanged.[2]

[1] This constraint is relaxed only when all EMS currencies are identically affected by a given disturbance. In practice, this occurs when a major currency (e.g. the US dollar) undergoes a fluctuation of its own *and* leaves the intra-EMS parities unaffected, a rather infrequent occurrence.

[2] For such extensions see, for example, Sachs and Wyplosz (1984).

2.2. Reformulation for the EMS

The EMS differs from the simple textbook version sketched above in at least two important respects. First, it explicitly allows for realignments; second, it allows for margins of fluctuation. As it turns out, these two characteristics do not strongly modify the standard conclusions.

It might appear that these two characteristics would allow a country at least some degree of monetary independence as the domestic interest rate may depart from rates in other EMS countries. But this is mostly an illusion as the interest rate completely incorporates the expected rate of fluctuation within the band and the eventual rate of change at the time of realignment. Consider a country which wishes to run a more expansionary monetary policy than its partners. I assume that money is neutral in the long run, so that the ultimate effect of this shift will simply be a higher steady-state inflation rate. But I also assume that in the shorter run, money may have real effects via reduced nominal long-term interest rates (and also real rates as expected inflation is presumed not to adjust instantaneously) and increased level of Tobin's q. Exchange markets will, however, recognize the eventual need to realign because of the long-run increase in the inflation rate so that the long-term nominal interest rate must rise by the full amount of the expected rate of depreciation, which in turn should equal the higher rate of inflation (assuming that purchasing power parity holds). The upshot is that the real long-term interest rate remains unchanged and that monetary policy has no effect, except inasmuch as the associated outflow of money increases the total stock of money, and reduces the real rate of interest, in the EMS as a whole, which is a function of the relative size of the country which has attempted to expand.

The existence of a band of fluctuation does allow some room for manoeuvre, but only for those minute changes which do not imply that the exchange rate moves out of the allowed margins. Furthermore, this can only be exploited in the very short run as any attempt to maintain permanently a lower rate of interest requires a continuously increased rate of money growth, the case discussed in the previous paragraph.

A last issue is whether less than perfect asset substitutability offers any scope for policy independence. This is the standard presumption in textbook versions of the Mundell-Fleming model. For countries like those in the EMS, imperfect asset substitutability may only arise in two cases: first, when significant, recurrent exchange rate changes create sufficient exchange risk; second, when capital restrictions, or the threat of them, result in a significant political risk as

described by Aliber (1973).[1] The second channel is the one that is to be erased precisely by the proposal under review. As for the first one, empirical work[2] on the major developed countries has shown that the exchange risk, if it exists, is small, highly volatile, not explained by policy actions, and therefore not exploitable to achieve monetary independence.[3]

The conclusion, then, is that the EMS provides policy independence in two limited respects: in the very short run for infra-band interventions designed to cope with temporary disturbances of small magnitude; in the long run to accommodate different rates of steady-state inflation. Most importantly, over the medium run, the horizon relevant for policy-making, the EMS effectively prevents member countries from conducting independent monetary policies.

However, the value of the long-run monetary independence should not be belittled. What it means is that the EMS allows member countries to opt for different steady-state inflation rates. Such a flexibility is quite important in several respects. First, because the costs of reducing inflation have proven to be high. Second, because we know little of what is the optimum inflation rate so that divergences of objectives are likely to remain, particularly as they relate to differences in economic structures and historical experiences. Third, because it is not clear how these differences can be reconciled, so that it is quite crucial to maintain a system which accommodates such divergences, as compared to a system which either eliminates them or breaks down. Finally, because we ought not to be overly influenced by the recent past: in the future, real and nominal disturbances *will* occur, and it is clearly illusory to pretend that we can build contingent rules to cope with them which will always be optimal.

2.3. Fiscal policy: a guarded assessment

The independence of fiscal policy within the EMS is likely to be considerably less than suggested by the simple theory sketched above. First, a fiscal policy expansion is only efficient if it does not leak massively abroad. For very open economies, its effectiveness is likely to be so limited that the costs (in terms of servicing the public debt as well as the external debt created by current account deficits) may well be too large relative to the benefits.[4] This is certainly the case for the smaller European countries such as Belgium or the Netherlands, less so for the larger ones.

There is, however, another important consideration, illustrated by the French experiment over 1981-83.[5] If a fiscal expansion is to be entirely financed by public borrowings, it exerts an upward pressure on interest rates which, in turn, triggers a capital inflow. This capital surplus amounts to a financing of the budget deficit and offsets the current account deficit. If the budget deficit is to be financed by monetary creation, however, this is tantamount to an attempted accompanying monetary expansion, which has been shown to be incompatible with a given EMS parity. Actually, given that exchange markets are forward-looking, what matters is less the government's true intentions about the financing of its fiscal expansion than the markets' expectations. This is the much talked-about *credibility* issue: if the authorities are not credible, i.e., if the markets expect an eventual monetary financing, the fiscal expansion is immediately incompatible with the existing EMS parity. There follow capital outflows, not inflows, which on top of the normal current deficit results in an exchange crisis which only stops when the fiscal stance is reversed. The conclusion, then, is that any fiscal move which puts a member country out of line quickly faces the credibility wall. Credibility, in turn, depends on the perceived commitment of the monetary authorities to the existing parity, itself a function of the track record of the authorities and of the cost of a realignment.[6]

2.4. Credibility and time consistency

The notions of credibility and time consistency have received considerable attention recently in academic literature. It is too early to draw definitive conclusions, and empirical work remains to be done to pass judgment on the relevance of

[1] Capital restrictions, in addition, prevent full capital mobility. This is different from asset substitutability. Capital mobility restrictions do offer some degree of independence, a point discussed at length in Section 3.

[2] See for example Frankel (1982) and Hodrick and Srivastava (1984).

[3] Technically, earlier models relied on a portfolio balance model representation of imperfect substitutability. Modern finance theory has shown this formalization to be misleading. See Frankel (1979) and Adler and Dumas (1983).

[4] One should mention at this stage the well-known neutrality proposition of Barro (1974), according to which fiscal policy does not have real effects because the private sector, foreseeing the future tax implications, exactly offsets the government action. This proposition is currently quite influential in the United States despite the lack of any empirical support.

[5] This experiment is studied in Fonteneau and Muet (1983) and in Sachs and Wyplosz (1986).

[6] Giavazzi and Pagano (1986) argue that the EMS has so far forced realignments which imply a real exchange appreciation as the nominal devaluation typically does not fully compensate for the cumulated inflation differential. If true, this mechanism raises the cost of a realignment and strengthens devaluation-prone countries' credibilities. Unfortunately, it makes the EMS unsustainable in the longer run, short of a complete convergence of inflation rates.

these issues. Yet a brief review may be warranted as it proves to be an argument in favour of the EMS and of freely functioning capital markets.

These concepts concern policy rules, i.e., a number of guiding principles which stipulate what the authorities are to do in given situations. Essentially, a policy rule attempts to limit policy actions to a feed-back function, where a limited number of variables (e.g. inflation, unemployment, the exchange rate, etc.) are enough to fully determine the policy instrument setting. A crucial aspect is that once a policy rule is defined, it is meant to remain unchanged: in the future, the same circumstances will provoke the same policy actions as today. Examples of policy rules abound: fixed money growth, balanced budgets, cyclically balanced budgets. More complex rules can, in principle, be designed. In practice, when we estimate the reaction functions of given authorities, we implicitly assume that the authorities have been following a rule of the type being estimated.

While rules are rarely observed in practice, they have been advocated with increasing intensity over the recent years. One reason for this renewed popularity is the disappointment with the fine tuning of discretionary policies. Another reason is related to the rational expectations hypothesis. As is now well-known, an implication of rational expectations is that 'only surprises matter', so that conducting discretionary policies boils down to engineering unexpected, therefore fundamentally stochastic, policy actions. This is not the place to review one of the liveliest debates of the last decade: what matters here is that policy rules have been described as a way to forego policies which may be ineffective, yet a source of uncertainty.

As is often the case, things are more difficult than they appear. Much recent work has shown that even policy rules are troublesome. At a given moment a well-meaning government may design an optimal policy rule. This rule is optimal in the sense that, if carried forever thereafter, it will deliver the highest possible welfare in a present value sense.[1] The difficulty arises when we wonder what will the optimal policy look like some time further in the future. If the policy rule has been wisely chosen, surely the situation will have improved by then. In general it will not be the case that the 'old' policy rule is still the best. When this happens, the policy rule is said to be 'time-inconsistent'

An example may prove useful. Consider a central bank which cares about both inflation and unemployment, but starts from a situation of unacceptably high inflation. It will want to announce a low rate of money growth. The public understands that a low rate of money growth implies a correspondingly low rate of inflation, but is not certain that the central bank will stick to its guns. It is therefore optimal for the public to assume a non-zero probability of slippage, and to raise prices faster than implied by the announced policy rule. Knowing that, the central bank will want to let money grow even more slowly: it adopts an over-contractionary policy, and this policy is optimal both for the authorities and the public. Later on, when inflation has abated, such an over-contractionary stance does not make sense anymore. Both the central bank and the private sector will have an interest in shifting to an easier monetary policy. What was once optimal is not so any more: the rule is time-inconsistent.

Are all policy rules necessarily time-inconsistent? In general, it is possible to design time-consistent policies, i.e., rules which once set by the government, will be adhered to, not merely because the government has promised to do so, but because it is, and will be, in its best interest. This can be done simply by ruling out time-inconsistent policies, i.e., by restricting the authorities to choosing the next best policy rule which will always be optimal.

The main result here is that an optimal time-inconsistent policy is often superior, after proper discounting, to an optimal time-consistent one. The reason is quite intuitive: a time-consistent policy is chosen by imposing the restriction of not choosing a time-inconsistent one. In the previous example, the central bank may adopt a less restrictive policy, which will bring inflation down more slowly: overall, the economy is less well-off over time, and this is the cost of adopting the time-consistent rule.

In general, therefore, both the authorities and the public would prefer to see time-inconsistent policies adopted. However, this is normally impossible without further arrangements. Indeed, if the policy is known to be time-inconsistent, the public will anticipate its eventual abandonment and act accordingly: the policy ceases to be optimal. In our example, sensing that monetary policy will be relaxed, the public will not settle for the same sharp deflation that it would accept if it believed in the permanence of the over-contractionary stance: the economy gets more inflation and more unemployment.

The question then is to devise arrangements which will guarantee that the optimal, time-inconsistent policy will be adhered to in the future, even if at some point it will be

[1] Put another way, the government acts like a firm which optimizes its present value. The firm has a clear objective: its profitability. The government is supposed to have identified its own objectives, for example a weighted average of inflation and unemployment targets, with increasing costs as the outcomes deviate further from the targets.

profitable to abandon it. The best possible solution is for the government to credibly precommit itself never to change the policy in the future, even if it would be in its best interest to do so some time later. This is what lies behind proposals to limit the range of options open to any government (such as a constitutionally fixed money growth rule). Short of institutional changes, the desirability of precommitments takes practically the form of credibility. An authority is credible when the public believes that it will stick to its announced policy rule, even if the rule is time-inconsistent. Thus credibility is seen as an important asset worth investing in.

The applicability of these concepts is wide. It has received attention in the areas of budgetary and monetary policies. A natural application is exchange rate policy. When the monetary authorities care about exchange rate stability, it would be useful for them to be credible in the exchange market, that an announced precommitment to maintain a given parity be unquestioned. One way of attempting to do that, of course, is to enter into a fixed exchange rate system or, even better, to join a monetary union. It the authorities further pursue a disinflationary policy there is a potential added advantage of such arrangements. This will occur when the system, or the union, is dominated by a country, or a set of countries, whose government has achieved credibility as an inflation-fighter. In that case, the exchange rate precommitment is also a commitment to follow monetary policies consistent with those pursued by the credible authority. In particular, it is often asserted that France, and other countries also, mainly benefit from the EMS because they 'buy' the undisputed credibility of the Bundesbank.

Can one look at the EMS as a precommitment? Clearly not as long as realignments occur frequently and easily. In the next section, however, I shall argue that capital controls make realignments easy to operate and actually are necessary for the survival of a system of fixed but periodically adjusted exchanges rates. This view suggests that the complete removal of capital controls would make realignments hard to organize. This, in turn, leads some to believe that full liberalization of capital movements will transform the EMS in a precommitment and thus allow superior time-inconsistent policies to be credible.

There is a problem with this line of argument though: it practically relies on one country (the Federal Republic of Germany) to be wise enough to provide the fundamental policy rule which ties everybody's hands. It remains to be proved, however, that such a rule, even if optimal for Germany, also serves the best interest of the other EMS countries. Yet it is entirely conceivable that the other countries, while interested in 'buying' Germany's credibility, would like Germany to adopt a different rule: there is a genuine trade-off between the gains from borrowed credibility and the constraint imposed by so tying one's hands. Of course, the same eventually occurs at each country's level and this is but a reflection of the time-inconsistency problem. What is not explained is why the external constraint is better suited to bring credibility than domestic ones (presumably, here we shift to considerations of political economy). Also, the trade-off raises an interesting, but so far unsolved, coordination issue: as countries negotiate over what credible rule Germany should adopt, is the coordinated outcome with credible time-inconsistent policies preferable for them to the uncoordinated outcome with time-consistent policies? In my view, there is no presumption that this is always the case. In plain language, it remains to be proved that France, and other EMS member countries always benefit from accepting Germany's leadership and borrowing the Bundesbank's credibility, rather than adopting their own (time-consistent, hence inferior) policies. It is unclear also whether Germany benefits from exerting such a leadership.

Summarizing the arguments, this section has suggested that one benefit of capital flows liberalization is to strengthen the discipline aspect of the EMS by making realignments impractical. The evidence from the experience so far suggests that Germany's leadership would be reinforced, the other member countries accepting it as the price for buying the Bundesbank's credibility. This view is one interesting possibility, but only a possibility. Its theoretical foundations have not been fully worked out and its empirical basis is, so far, inexistent. Going for a full-scale, real-life test is not innocuous because of the risks that would be imposed on the EMS and which are discussed explicitly in the following section.

3. The central dilemma: EMS or liberalization?

3.1. The role of capital controls

Efficient controls allow domestic interest rates to differ from those in the other EMS countries; this is the procedure referred to in France as *déconnexion*. If they were perfectly tight, such restrictions would restore full freedom to monetary policy even in a system like the EMS. For example, should a country decide to expand its rate of money growth and reduce its interest rate, capital controls would prevent the otherwise normal response of financial markets: an outflow of capital seeking better yields abroad, which results in loss of exchange reserves and an eventual offset of the monetary expansion. In reality, for convertible currencies, controls can never be tight enough to deliver such a strong

effect. It is interesting to briefly summarize the French experience, as capital movement restrictions have been the rule for most of the postwar period.[1] Indeed, over the years, the French monetary authorities have built up an increasingly efficient administration to enforce capital controls.

For a long period of time, and with few exceptions, France has been a devaluation-prone country with a keen interest in limiting exchange rate fluctuations. It has been devaluation-prone because monetary policy has been mainly concerned with growth objectives via low real interest rates. However, the simultaneous concern with exchange rate stability would have required relatively high nominal interest rates so as to compensate for the expected rate of depreciation. Caught in this dilemma, it seemed only natural, then, to resort to capital controls to reconcile both objectives locking in national savings. Consequently, the restrictions have been designed to limit capital outflows.

The restrictions have been in place for most of the post-war period. They were lifted first between January 1967 and late May 1968. This period had been dominated by the weakness of sterling and the US dollar, so that the French franc was seen as a relatively strong currency and could sustain low interest rates. The political events of May 1968 instantaneously reversed the situation and led to a reinstatement of severe controls. When the pressure eased in September of the same year, controls were lifted again. By then, however, inflation was on the upswing following the *accords de Grenelle* (large wage concessions), so that a devaluation was perceived as unavoidable. A tide of speculative attacks rose in November. Capital controls were quickly put back in place, yet were only able to push back the eventual devaluation until August 1969. The situation changed progressively thereafter. The US dollar gradually emerged as the weakest currency. Consequently, French capital controls were gradually dismantled for the third time, and actual briefly shifted towards the prevention of inflows. It was during this period that France experimented with a two-tier market, from 21 August 1971 (in the aftermath of the decision by President Nixon to free the US from their obligation to convert officially-held dollars into gold) to 24 March 1974. By then the first oil shock had struck and moved the franc to its more usual status of weak currency and, after it was forced to leave the snake arrangement in January of that year, capital controls designed to repeal ouflows were restored. With varying degrees of severity (see next section), they remained in force until a gradual lifting started in 1985.

The fact that controls have been occasionally lifted should be surprising for two reasons. First, there have been instances where the French franc was not under stress: this happened because other currencies were then in the front line (the dollar, sterling, and often the Italian lira too).[2] Second, and quite importantly, even when the franc assumes a weak currency status, speculative pressures need not apply permanently. Indeed, the record shows that, most of the time, capital controls are not 'biting': domestic interest rates are larger than abroad (in a proper average sense), incorporating the expectation of a depreciation. As the expected time of the devaluation is remote, however, the difference is small. When the probability that a depreciation will occur in the near future rises, so do the expected gains of moving out of francs: a speculative attack gains momentum and would, in the absence of controls, require a corresponding increase in interest rates, which is what the monetary authorities want to avoid. This is when controls bite.

A speculative attack works along two main lines: first, direct capital outflows, as residents wish to sell domestic assets and acquire foreign ones, and non-residents wish to acquire franc-denominated liabilities; second, leads and lags, as French exporters delay the repatriation of foreign earnings and foreign importers similarly delay payments of franc-denominated invoices. This is why the crucial components of capital controls prevent: (i) acquisition of foreign assets by French residents; (ii) borrowings (acquisition of franc liabilities) by non-residents; (iii) leads and lags.

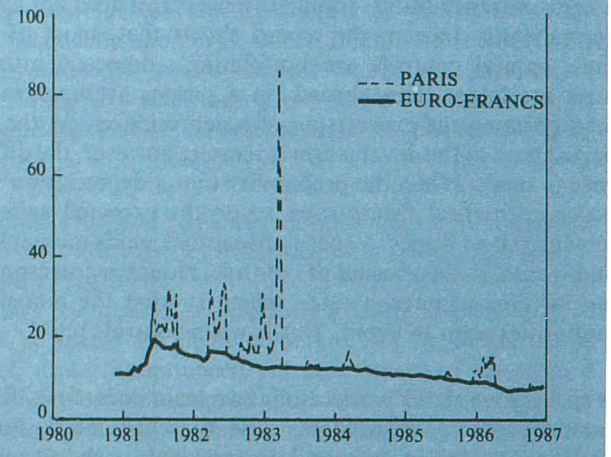
The speculative attack is highly visible on off-shore markets: Euro-franc interest rates rise and become disconnected from internal rates.[3] Arbitrage between these markets is prevented from operating efficiently. In normal periods, i.e., in the absence of an impending depreciation, there are enough loopholes to generate a sufficient flow of funds to ensure approximate equality between Euro and domestic rates. In a crisis period, these loopholes are not wide enough to allow full arbitraging; capital controls 'bite', not because they are tight, but because they put an upper boundary on the volume of capital movements per unit of time. If the crisis lasts, the capital movements gradually fill in the gap, and put an increasing pressure on domestic rates as can be seen in Graph 1.

[1] For detailed studies of the French experience, see Mathis (1981), Claassen and Wyplosz (1982), Neme (1986) and Loubergé and Van Tiel (1986).

[2] It must be noted that when speculation against other currencies tended to push the franc upward, as in 1970-73, controls were brought back in force, but of course were put to work in the opposite direction.

[3] The ability to shield domestic rates from Euro-rates is a function of the effectiveness of capital controls and of the length of time during which the pressure is on. The authorities can, to some limited extent, choose to react to an attack by a combination of controls and increases in the domestic rates.

GRAPH 1: **Domestic and Euro-market interest rates (1-month inter-bank rates on French francs — Weekly data)**



Source: Data Resources Inc.

The conclusion is that capital controls are only useful during crisis periods, and only if these periods do not last too long. (As can be seen in Figure 1, during much of 1981 and 1982 French authorities have had to partly give in, allowing domestic rates to rise towards the Euro-rates). During tranquil periods, all that is left is the political risk component, admittedly small and generating some degree of imperfect substitutability. Yet, as noted in Section 2, this is not a factor which can be exploited systematically to regain much policy independence. At the same time, it is a source of inferior allocation of resources.

3.2. Main proposition

It would be highly unjustified to conclude from the preceding section that capital controls are generally useless and actually harmful. What is suggested by these considerations is that the role of capital controls can only be understood in the context of exchange rate crises. The theory of crises of the balance of payments has been developed recently following the seminal work of Krugman (1979).[1] For the present purposes, the main result which emerges from this literature is that a fixed exchange regime is bound to collapse in a crisis if the underlying monetary policy is incompatible with the existing parity. This is a very strong statement, especially worrisome as far as the EMS is concerned since it states that the EMS can only survive if monetary policies are fully coordinated, to the point where inflation rates are identical in all member countries.

The reasoning behind this result is as follows. A lasting inflation differential between two countries linked by a fixed exchange rate is gradually eroding the competitiveness of the country with the higher inflation rate. So, sooner or later its current account is turning into a deficit which, for a given capital account, implies an eventual overall deficit for the balance of payments. As the monetary authorities intervene to defend the existing parity, exchange reserves are being depleted. This process mut continue until complete exhaustion of reserves unless monetary policy is altered in such a way that the external price competitiveness is restored. With efficient markets, operators cannot fail to understand that when reserves will have been exhausted (and reserves may well include credit facilities obtainable from other countries as is the case within the EMS) the monetary authorities will not be able to peg their exchange rate any more, so that an eventual depreciation is a certainty. Under these conditions, before exchange reserves are exhausted, a crisis will occur: operators will sell short the domestic currency in order to benefit from the depreciation, which on impact yields an infinite rate of return, and the depreciation will occur instantaneously as reserves will be fully lost as a consequence of the crisis. Thus, attacking the currency is a sure bet, so that the volume of speculative capital is virtually unbounded and the monetary authorities have no way out. The essential pont is that reserves will have been entirely exhausted at the time of the attack, and can only be rebuilt gradually through cumulated current account surpluses. Consequently, for some time after the attack, the exchange rate will have to float as the monetary authorities will not have any reserves to back up a declared parity.

How then is it possible to reconcile this strong result and the fact that the EMS has already survived numerous bouts of speculative attacks? Two explanations have been offered. Giavazzi and Pagano (1985) show that if domestic interest rates are allowed to rise sufficiently to make up for the eventual capital loss associated with a depreciation, and provided there is some uncertainty about the exact timing of the parity change, the crisis may be thwarted. This is so because the interest parity condition, inclusive of the expected rate of depreciation, is maintained so that no capital outflow need take place. Consequently, all that the monetary authorities need to do is to raise the interest rate and choose

[1] Some references useful for this discussion are Obstfeld (1984), Flood and Garber (1984) and Wyplosz (1986).

the time of the devaluation some time before exchange reserves will have been depleted through the current account deficit. The problem with this strategy is that in the predevaluation period monetary independence is lost and, more importantly, the required increase in the interest rate may be considerable. Indeed, in order to maintain the interest parity condition, what must be taken into account is the expected rate of depreciation adjusted for the time horizon: for example, a 10 % depreciation expected to occur one week ahead requires an interest rate increase of 520 percentage points (per annum). While this is technically feasible, it is quite unlikely that monetary authorities would accept such movements in their short-term interest rates, if only because they worry about the implications for stock prices, with attendant risks of massive capital losses. One way of making this strategy more acceptable is to increase the level of uncertainty, both about the timing of the devaluation and the exact level of exchange reserves: the more diffuse the market's expectations, the lower the required rate of interest can be at any moment in time. Indeed, we know that monetary authorities do attempt to introduce a high degree of uncertainty during crisis periods.

The other explanation, presented in Wyplosz (1986), relies on the existence of capital controls in virtually all devaluing countries of the EMS. The discussion in Section 3.1 of how capital controls operate has already shown that they only matter in times of crisis, and that they work by limiting the amount of speculative capital which can be put to work during a given period. If this upper boundary is less than the exchange reserves available to the monetary authorities, it is immediately clear that reserves will not be entirely exhausted by the attack, thus providing the authorities with some degree of freedom to choose the timing of the devaluation, as well as leaving them with sufficient ammunition to back the post-devaluation parity.

Summarizing so far, it appears that a fixed exchange rate system with less than full coordination of monetary policies can only survive if one of the two following conditions are satisfied: either the monetary authorities are prepared to raise the interest rate so as to maintain the parity condition, or else they must resort to capital controls. Currently we do not have formal evidence as to which of the two explanations has been operative in allowing the EMS to survive. More casual evidence, as in Figure 1 for example, points to the assessment by Rogoff (1984) and others that capital controls have been playing the key role. If this true, then it is possible to state the following proposition:

Of the three following conditions, two, and at most two, are compatible with each other:

(i) a fixed exchange rate sytem (such as the EMS);

(ii) full capital mobility, i.e., no capital controls;

(iii) long-run monetary independence, i.e., different steady-state inflation rates.

For our purposes, the implication of this proposition is that the elimination of all restrictions to capital movements will lead to a breakdown of the EMS if monetary policies do not fully converge. Alternatively, one could say that a natural consequence of the proposed liberalization is a complete coordination of monetary policies within the EMS, to the point of being indistinguishable from a full monetary union. Given the foreseeable difficulties of establishing a monetary union, we must therefore weigh the costs and benefits of the two alternatives, and this is the object of the next two subsections.

3.3. The case for the EMS

If it is true that the proposed liberalization requires such an extreme form of loss of monetary independence that even the steady-state inflation rates must be equalized so as to rule out any realignment,[1] one must make the case that the EMS is highly desirable. It is generally agreed that one of the main advantages of the EMS has been the stabilization of relative prices. This comes against the background of numerous empirical studies which have failed to detect any significant adverse effect on the volume of international trade of exchange rate fluctuations.

It must be then that the main benefit of exchange rate stability stems from the possibility that relative price fluctuations trigger costly reallocation of resources, for example between the traded and the non-traded goods sectors. Indeed, the recent experience in the United States, illustrated by the rise of the protectionist tide, indicates that this may be a real problem. Similarly, there is now mounting evidence that a similar process of resource reallocation may be under way in Japan. What makes this process costly is that factors of production are industry-specific, in fact often firm-specific. Consequently, capital which is being scrapped somewhere is lost, and is unlikely to be put back into operation when the relative price change is reversed. Similarly, human capital may also be dissipated as workers go through retraining, particularly if they move in search of new job opportunities.

[1] This leaves out other reasons why a realignment might be necessary since the implicit argument is that PPP is the normal equilibrium situation. Permanent deviations from PPP are needed if the EMS countries undergo real asymmetric disturbances. Within a monetary union, such adjustments may be dealt with with fiscal policy actions such as labour taxes (if the disturbance is an increase in labour costs), corporate taxes (if the disturbance affects firms' profitability), or particular subsidies.

It may well be then that, given the large degree of openness between EMS countries, the EMS fulfils an important function, one which is desirable enough to warrant sacrifices elsewhere. The proposition of Section 3.2 means that either monetary independence ought to be given up or else that some restriction to capital movements should be maintained. Indeed these two alternatives are discussed in the concluding section.

3.4. The case for liberalization of capital movements

As amply discussed in Section 1 above, it is quite hard to find valid arguments against the liberalization proposition. With due account to the fact that such a process should imply non-negligible transitory costs, it remains that its permanent effects cannot fail to be positive. What is not known, and impossible to measure *ex ante* (and also probably *ex post*), is the magnitude of these beneficial effects. We simply do not know enough about the distortionary effects of capital controls.[1]

The only, and quite casual, observation that I could venture at this stage is the following. France is a country which, during most of the post-war period, has lived not only under capital controls but also under an amazing variety of regulations that, most economists would agree, are quite detrimental to an effective allocation of resources: credit controls and, more generally, a very regulated banking and financial system; price controls; subsidies to corporations and individuals etc. These inefficiencies notwithstanding, France is one of the European countries which has experienced the fastest growth rate. The best contrast is with its neighbour, Switzerland, a country known for its commitment not to regulate markets unless absolutely necessary, particularly as far as financial markets are considered.[2] Table 1 compares the growth rates of France and Switzerland since 1950. Whether measured in absolute terms (real GDP), or on a per capita basis, there is no doubt that France has outperformed Switzerland by a wide margin: between 1950 and 1985, GDP per capita has been multiplied more than three times in France and only by a factor slightly above two in Switzerland.

Table 1

Growth performance between 1950 and 1985

	France	Switzerland
Real GDP (level of 1985/level of 1950)	4,27	3,00
Real GDP per capita (level of 1985/ level of 1950)	3,23	2,19
Real GDP (level of 1985/level of 1970)	1,51	1,20
Real GDP per capita (level of 1985/ level of 1970)	1,40	1,15

Source: International Financial Statistics Yearbook, 1986.

Obviously, comparisons of this sort require considerable caution, and initial conditions do matter. In particular, the reconstruction effort in France immediately after World War II required an altogether different growth rate. This is why I also present data for the period 1970-85. If indeed the main reason lying behind the superior French performance is the post-war catch-up effect, it must be that this effect, as still operating some 40 years after the end of the war, is larger than the efficiency costs of restrictions on market forces. What this admittedly crude evidence indicates is that the benefits from financial liberalization may well be overestimated at this juncture. It may be, however, that the benefits mostly lay elsewhere, namely in the pressure for coordination.

4. Conclusion: three options

The central proposition asserted in Section 3.2 claims that we cannot simultaneously have a system of fixed and adjustable exchange rates like the EMS, long-run monetary independence allowing for different steady-state inflation rates, and completely free trade in assets. The implication is that we have to choose which of these three desirable properties has to be abandoned in order to retain the other two. A reasonable position is that the EMS performs a useful role in stabilizing relative prices throughout Europe and that the benefits it thus delivers in terms of allocation of resources are not trivial; that the liberalization of capital movements must be welfare-improving, in the long run at least, but that the benefits are likely to be limited; and that a *total* convergence of monetary policies is not necessarily superior (in the sense of Pareto) to some degree of long-run independence, given both the costs of deflation and the difficulties of reaching a fully coordinated agreement. Consequently, this concluding section takes the view that the EMS ought

[1] For an attempt to measure them indirectly, see Claassen and Wyplosz (1982).

[2] It is true that Switzerland has not been so shy in tampering with goods markets, in particular various protections from free trade. But apart from this, Switzerland has only briefly resorted to capital controls, does not have price controls, and the Bank of Switzerland is known to be one of the most free-market oriented. An excellent overview of the Swiss economy can be found in Danthine and Lambelet (1987).

to be preserved. The remaining choice is between long-run monetary independence with some limits to capital movements and liberalization of trade in assets accompanied by a modification of the current EMS arrangements.

4.1. Option number one: coordinated safeguards

This option considers that the benefits from the EMS are paramount and that the EMS should not be jeopardized by an overly ambitious liberalization programme. It explicitly assumes that full convergence of inflation rates among member countries, to the point where realignments would be unnecessary, while external imbalances created by real disturbances would be taken care of by fiscal policy measures, is either undesirable or unattainable for political reasons.

Under these conditions, we remain in the present system, with occasional realignments required to return to PPP. The theory of crises of the balance of payments suggests that some restrictions to capital movements ought to be maintained. But the experience with capital controls shows that such restrictions are only useful, and needed, in times of crises. The implication is that the liberalization programme ought to be considered seriously but should explicitly include safeguard clauses to be put into effect when widely expected realignments trigger speculative crises. The rest of this subsection considers the principles which could guide the design of such safeguard clauses.

4.1.1. *Temporary restrictions*

Because capital controls are only needed sporadically to cope with short-term capital movements while their continued existence is detrimental to the allocation of long-term capital, it is logical to consider restrictions which may be put in place quickly, and lifted once the situation has been cleared up.

During crisis periods, what is needed is the ability to limit the volume of speculative capital below the level of reserves available to each EMS country, including the automatic borrowings currently part of the system.[1] When such a crisis erupts, a country expected to devalue is under considerably higher pressure than a country expected to revalue so that controls are more crucial to the first country. Yet, should controls be applied at both ends, they would need to be less severe in the devaluing country, another illustration of the general proposition that coordination is welfare-improving. Safeguard clauses should be therefore symmetric, and triggered simultaneously by all EMS member countries.[2]

The desired limit to speculative capital movements is to be understood per unit of time. The longer the crisis lasts, the more controls must be tightened up, and the more it becomes worthwhile to circumvent them, while their administrative and allocative costs rise. Consequently, it is in everyone's best interest to agree quickly to a credible realignment, i.e., a realignment of sufficient magnitude to restore the system's stability.[3] This can be encouraged by limiting the duration of allowed capital controls, especially if they are indeed symmetric as suggested in the previous paragraph, so that the pressure to realign will bear upon all EMS member countries.

The time dimension also has implications on which transactions should be concerned by the safeguard clauses. Typically, speculation proceeds along two main channels: leads and lags on commercial transactions, and outright capital movements including position-taking in the forward market. Leads and lags are necessarily bound by the volume of trade, so that with proper reserves and a prompt realignment, they need not be subject to restrictions. This is quite desirable given the importance of shielding the real sector, hence international trade, from financial disruptions.

A related implication is that long-term capital, the one crucial for allocation of resources and unlikely to move forcefully because of a crisis, should also be, as much as possible, outside the scope of restrictions. This leaves us with the need to restrict temporarily short-term capital movements and the problem of how to do it. The general principle is that acting through prices is less distortionary than quantitative limitations, so that temporary taxes, if feasible, represent the best course of action. An example is to tax short-term capital flows out of devaluing countries as well as into revaluing countries. This can be done by taxing all outflows with a clause guaranteeing reimbursement of the tax, inclusive of an interest service, if the capital is not repatriated within a given period (say, at least a year). Similarly, inflows could be taxed if put in liquid assets.

[1] This means that increasing the volume of these available borrowings reduces the severity of the needed capital controls. This observation is at the root of proposition number four below.

[2] As part of the capital leaving the devaluing country goes to non-EMS countries, unlikely to agree to a symmetric scheme, it remains likely that a devaluing country will face more pressure than a revaluing country.

[3] The conditions for a realignment to be credible are formally stated in Wyplosz (1986).

4.1.2. *Two-tier exchange market*

A two-tier exchange market, which treats separately commercial transactions, at a pegged rate, and financial transactions, at a freely floating rate, is quite appealing. It achieves three desirable objectives: first, it completely shields international trade, and this can be done efficiently if the crisis is of limited duration for the reasons presented above in Subsection 4.1.1; second, it relies on non-quantitative restrictions; third, if adopted by all EMS member countries simultaneously, it offers nice symmetry properties.

The main problem is that it typically requires some administrative investment. Consequently it is not well suited to be used in an on-off fashion. On the other side, if it is a permanent feature, incentives to circumvent it by investing in adequate schemes grow, so that it may require supplementary quantitative measures, as found in the Belgian case.[1]

A cost-benefit analysis of such a system is beyond the scope of this report. *A priori* it appears as an interesting system which ought to be considered seriously. In particular, it could be a permanent one, 'biting' only in crisis periods. It is hoped that past experiences with two-tier exchange markets will offer a better view of their advantages and limitations.

4.2. Option number two: a monetary union

A monetary union is a natural implication of the proposed liberalization of capital movements within the EMS. As already explained, realignments with full capital mobility constitute a major risk for the EMS. In order to remove the likelihood of realignments, EMS countries would have to quickly reach identical inflation rates, which requires full coordination of monetary policies.

With independent monetary authorities, such a coordination is hard to put in place. Indeed, within a fixed exchange rate zone consisting of n countries, there exists only n-1 degrees of freedom as money growth in each country will be the weighted average of money growths in all member countries. The well-known Bretton-Woods response to this difficulty was to put one country formally in a central position. This is, of course, possible in the case of the EMS, but obvious political considerations (as well as the issue of seigniorage, a real issue, although of limited quantitative importance) are likely to make it a non-starter.

In the absence of a nth country solution, the cooperation game resembles the familiar 'battle of the sexes' example of game theory.[2] Each country has a preference for a given money growth rate, yet in the end (in the absence of realignments) it will achieve the average growth rate of the zone. Hence a tendency to 'overdo it', in a futile attempt to move the average towards one's preferred direction, and a non-negligible risk of total breakdown if realignments become unavoidable. As a consequence, such a system is likely to be very unstable.

On the other hand, once it is recognized that monetary independence is lost, even in the long-run sense developed in Section 2.2 above, why not go all the way to a monetary union, with a single central bank internalizing all the externalities which make the cooperative solution so hard to achieve? This solution raises delicate political difficulties which might make it appear beyond reach. Yet the following considerations, necessarily superficial, are offered to prompt further discussion of a too easily dismissed solution.

The traditional economic argument against a monetary union is that it forces member countries to absorb real, asymmetric disturbances through adjustments which may be costlier than a realignment. In particular, such disturbances often require a reallocation of factors of production, possibly across borders. When it comes to labour, it is immediately obvious that in a multinational system, with severe differences in terms of languages, social and cultural habits, the fixed costs are overwhelming. This is why a monetary union requires an elaborate system of regional policies, for which the common agricultural policies offer a very unappealing blueprint.

Further thinking of what can be done with national fiscal policies suggests that the system has much to recommend it. Indeed, it may be asserted that there is hardly anything which is achieved through exchange rate changes that cannot be done through fiscal policy measures.[3] For example, an asymmetric increase in labour costs can be dealt with by a reduction in labour taxes. Or a loss of competitiveness because of lagging investment in more advanced technologies can be taken care of by adequate subsidies. The list of examples is limitless but the main idea should be clear: exchange rate changes work by modifying relative prices, which can be achieved instead by modifying relative costs of production. The main problem with such a scheme is the

[1] The French experience has not been much studied. As noted above in Section 3.1, it was used for a relatively brief period, at a time when the franc was 'strong', and simultaneously with quantitative restrictions.

[2] This issue is discussed by Hamada (1985).

[3] Arguments along these lines are presented in Cohen, Melitz and Oudiz (1987).

danger of developing a fiscal system which in time becomes overly complex and also subject to too many pressures from interest groups. The easy answer is that fiscal systems will end up competing with each other (as long as no attempt is made to coordinate them, as with the CAP), so that the most distorted ones will either be readjusted or bring about disaster.

4.3. Option number three: a softer EMS

Repeatedly in this report, the argument has been made that perfect capital mobility may deliver a fatal blow to the EMS at the time of a realignment. This argument, rooted in the theory of balance of payments crises, is entirely based on the idea that a discrete jump in the exchange rate cannot be anticipated by free, well-functioning, exchange markets: the markets will anticipate it and beat it in a speculative attack. The main proposition presented in Section 3.2 drew the implications of this analysis by ruling out either free capital mobility, or realignments, or the EMS. There remains two attractive possibilities which are presented in this section and the following one.

The first possibility is to guarantee that realignments do not involve discrete jumps. This can be achieved under one condition, namely that the change in the central parity of any currency be smaller than the width of its allowed margin of fluctuation. Under such conditions, the exchange rate would move within the band and will not jump at the time of the realignment, it will simply keep moving within the new band. The reason is that markets will expect that the realignment does not require a jump. Accordingly, when they expect a realignment to occur, they will position the exchange rate at the expected post-realignment rate, which by construction, will be within the pre-realignment band.

Practically, this requires either or both of two alterations to the current working of the EMS. One alteration is to increase the size of the band. The other alteration is to formally agree that realignments cannot exceed the width of the band, which means that they occur more frequently, *ceteris paribus*. Both changes may be made simultaneously, the frequency of realignments being inversely proportional to the size of the band.

Of course, such a modification weakens the EMS which, on the surface of it, draws some praise from its ability to reduce the frequency of realignments. As discussed earlier, there is no empirical evidence that the EMS has reduced the variability of exchange rates: the benefits come in the form of more predictable rates (De Grauwe et Verfaille (1987), Rogoff (1984)), a feature likely to survive the alteration under discussion. More importantly, as noted above, the EMS has so far avoided significant intra-European misalignments. That feature, too, would be preserved.[1]

4.4. Option number four: a stronger EMS

The conclusion that a fixed exchange rate regime collapses at the time of a speculative attack is predicated upon the argument that the exchange reserves of the country whose currency is under attack will be exhausted. It must be noted, however, that the maximum amount of speculative capital which can be used to exhaust reserves is bounded by the size of the country's money base. Indeed, speculators must first acquire the domestic currency before unloading it on the exchange markets. What can effectively be mobilized, then, is the money base, leaving of course the possibility that the commercial banks face a run as their reserve ratios get dangerously close to zero. As will be argued, though, this should not happen.

The difference between the money base and the official exchange reserves is, of course, the domestic credit component of the base. Option number four is to set up a system of automatic loans among monetary authorities which would guarantee to each central bank automatic and immediate access to other countries' currencies in excess of the domestic credit component of the money base. Under such an arrangement, it is known to all would-be speculators that the monetary authorities have access to a volume of foreign reserves larger than their domestic currency liabilities: an attack is bound to be defeated and becomes pointless. And because it is a one-way bet that the speculators are sure to lose, the attack will not occur. Nor will there be any associated run on banks.

Similar automatic credit lines are already a part of the EMS arrangement. The crucial point, however, is that they fall considerably short of the amounts required to thwart speculative attacks. What is envisioned here is not, therefore, a formal transformation of the EMS as it now stands. Of course, it implies credit lines of huge amounts by current standards, and the conditions of such arrangements (term, rates, currencies, etc.) need to be carefully thought out. But for those who are not enthusiastic about the three other alternatives, and still wish to go ahead with the liberalization programme without putting the EMS in jeopardy, this option deserves careful appraisal.

[1] An appealing aspect of this proposal is that it would go some way towards meeting the British requests for joining the EMS (see Artis and Miller (1986)).

4.5. A pragmatic synthesis

The four options outlined above are not mutually exclusive. While each of them is able to meet the requirements implied by the main proposition of Section 3.2, they can be put to work to reinforce each other. A pragmatic approach would be to use all of them in various degrees over time. A moderate widening of the allowed margins of fluctuation, coupled with more frequent realignments such that discrete jumps of the exchange rates are ruled out, would help dissuade the markets from testing the effectiveness of the credit line arrangements. Conversely, the credit line arrangements will make the pledge not to allow discrete realignments more credible. In a period of transition, safeguard clauses may be maintained as a last resort threat, which should be progressively recognized as useless and can eventually be eliminated without anyone really noticing it. Then the increased competition among financial systems will gradually evolve towards a private 'financial market union' which will make it obvious that a monetary union implies the abandonment of a monetary independence which will have become only formal.

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Financial liberalization: The Spanish perspective

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Introduction

The Commission's plans to advance the financial integration of the EEC countries by fostering further liberalization of capital movements raises a whole set of issues of both technical and political significance. However, the scope of this report is voluntarily limited. Thus, in accordance with the indications set forth by the Directorate-General for Economic and Financial Affairs, no attempt is made here to deal with the general issues of financial liberalization, its effects on resource allocation, welfare and the like, as well as the theoretical aspects of its relationship with the stability of exchange rates within the EMS. I would rather concentrate on issues of macroeconomic policy and monetary control and the effects of the liberalization of capital movements on the structure and performance of the financial system, and that only in relation to the particular position of a country like Spain, which does not yet belong to the EMS but has already embarked on an extensive process of liberalization of capital movements according to the provisions established in the Accession Treaty.

To sum up, the report considers the implications and possibilities of a full liberalization of capital movements in relation to the external accounts of the Spanish economy and the structure and functioning of its financial system, and faces as well the thorny question of the compatibility and timing of the somewhat contradictory processes of financial liberalization and participation in the EMS.

The report is structured in three parts. The first focuses on restrictions posed by the Spanish foreign accounts in the way of further liberalization of capital movements. The second deals with the structure of the Spanish financial system and its possibilities of meeting with success the new competitive situation. Finally, the third and last part considers the compatibility and timing of the two processes involved in the advance of Spain towards full integration in the Community: liberalization of capital movements and integration in the EMS.

1. Implications of Spain's foreign accounts for the liberalization of capital movements

It seems suitable to begin the discussion with a brief overview of the recent evolution of Spain's balance of payments and the process of external indebtedness.

As Table 1 makes clear, the first important trait of the balance of payments is the recurrent deficit in the trade balance. Indeed, to the chronic weakness of the export flows have been added, since the accession to the Community, the implications of the progressive dismantling of the protectionist system built up over the years, to configurate a situation of greater dependence of the relative competitive position of the country and the evolution of the import flows of its main trading partners.

In the recent past the trade balance deficit has been more often than not compensated by the surplus in the services and transfers accounts, to render a current account balance that presents important surpluses in the last few years. These, in conjunction with strong inflows in the capital account (see Table 1) have led to a substantial accumulation of reserves which, however, is not a historical trait of Spain's foreign accounts. It could be argued, though, that the situation just depicted is going to persist, due both to the extensive process of reduction of internal disequilibria going on in the country and to the new position that it has obtained in the international arena, due in its turn to the success of the economic policy pursued in the last years and the accession to the EEC.

In any case, be those the structural traits of Spain's external position or not, it is certain that they have led to difficulties in two areas that concern us here:

(i) They have generated appreciation pressures on the currency that the Bank of Spain has been forced to absorb, in the context of the dirty flotation of the peseta, to prevent further deterioration of the export flows.

(ii) They have generated undesirable base money growth, required sterilization measures and put in jeopardy the management of monetary policy.

Facing those constraints and difficulties, Spain's policy has been directed in several related ways:

(i) A strong anti-inflationary stance, to maintain competitiveness in the wake of strong appreciation tendencies of the currency.

(ii) Renewed impulse to the structural change of the Spanish economy, reducing rigidities, restructuring obsolete sectors and promoting export-oriented industries frequently linked to foreign capital.

(iii) Accelerated pace of repayment of the external debt, so as to reduce the pressure on the currency and to facilitate the conduct of monetary policy.

(iv) Increased liberalization of capital movements, over and above the requirements of the Accession Treaty, so as to promote the possibilities of investment abroad by residents.

Table 1

Balance of payments (selected items)

(million USD)

	1983	1984	1985[1]	1986[2]
Trade balance	− 7 672,5	− 3 990,0	− 4 379,0	− 6 267,0
Invisibles balance	4 993,9	6 344,0	7 032,0	10 523,0
Current-account balance	− 2 678,6	2 354,0	2 653,0	4 256,0
Short-term capital	94,7	− 97,6	− 120,2	− 178,3
Long-term capital	3 104,6	3 331,0	− 1 540,8	− 1 414,8
Central reserves	325,7	− 4 486,8	1 912,1	− 2 700,4

[1] Provisional.
[2] Advance.
Source: Bank of Spain.

However, these policies have not always been fully compatible. The presence of a very important fiscal deficit (see Table 2), not always financed by recourse to the market, has meant a continuous upward pressure on real interest rates and, at times, has cornered the Bank of Spain into an impossible situation, endangering the continuity of the tight monetary policy it was pursuing and damaging its credibility. On the other hand, in a country in which growth infallibly leads to strong import increases, the Bank of Spain has had to raise interest rates in an effort to curb the growth of internal pressures that risked excessive deterioration of the current account, thus aggravating the problem of the capital inflows.

Nevertheless, the relative flexibility that the Spanish monetary policy has enjoyed so far has been possible in good measure because the country does not yet belong to the EMS, thus enabling the Bank of Spain to pursue a combination of monetary and exchange rate policies that would have been impossible otherwise. Now, recent declarations of the Governor of the Bank of Spain and other authorities seem to imply that one of the medium-range objectives of Spain's policy is the full integration in the EMS structure, be it with an expanded fluctuation band for the peseta like Italy or with the general fluctuation band of the other currencies. This development, if implemented, would certainly pose new problems of the kind already discussed at length by other consultants and to which we shall refer briefly in the third part of this report.

Irrespective of the potential participation of Spain in the EMS, are there special problems posed by the foreign accounts in the way of the liberalization of capital movements? Probably not with respect to long-term flows linked to investments and portfolio decisions, as long as Spain continues to enjoy a degree of exports and an influx of foreign investment sufficient to prevent any undue growth of foreign indebtedness. The situation regarding short-term capital movements entails more complexities.

During the transitional period prior to full integration in the EEC, Spain has to dismantle progressively its system of tariffs and other restrictions to commercial flows. This process could not fail to provoke important changes in relative prices at a time in which many other facets of Spain's economic structure are suffering extensive modification (labour relations, industrial restructuring, etc.). Together, these developments are likely to pose recurrent difficulties to the current account and the exchange rate which, in presence of a full liberalization of short-term capital flows, could endanger the execution of a monetary policy geared towards the reduction of the inflation rate and the careful regulation of internal demand.

Table 2

Deficit of the public sector (excluding public firms)

(% GDP)

1978	1980	1982	1984	1986
1,8	2,0	5,6	5,5	5,7

Source: Bank of Spain.

In this situation, the Bank of Spain will need every bit of flexibility it can muster and it seems that part of that flexibility should come from a judicious curtailment of those capital movements likely to be used as vehicles of speculative attacks against the currency.

In summary:

(i) Spain's balance of payments presents a difficult equilibrium whose soundness depends in good measure on the maintenance of a degree of support to the exchange rate.

(ii) The exchange rate policy collides frequently with the anti-inflationary stance of the monetary policy, which must on occasion reduce the growth of internal demand.

(iii) Over all the previous difficulties, the public sector finds it difficult to manage and to reduce the level of its deficit which sets a permanent upward pressure on real interest rates and poses additional problems to monetary policy.

(iv) The Spanish economy will suffer a continuous stream of real shocks during the transitional period of integration in the EEC due both to the dismantling of the system of taxes, tariffs and other protectionist measures of its foreign transactions and to the inescapable changes in its economic structure that shall have to be implemented to face with success the new competitive situation.

(v) Within this framework it seems difficult to take strong steps in the way of full liberalization of short-term capital movements. Not so, however, for the further liberalization of long-term capital transactions pertaining to investment flows and portfolio decisions by foreigners and residents alike.

2. The Spanish financial system in the new competitive situation

The main point considered in this part is whether the Spanish financial system is prepared, by the institutions that make it up and their way of operation, to face the competitive situation that will follow the foreign aperture imposed by the Accession Treaty, whose main transitory period will linger until 1992, and other additional liberalization measures the Commission could propose. To consider this point, I will present a brief overview of the main financial institutions and markets already in place and the transformations to which they are subjected nowadays, including important ones in the conduct of monetary policy. As will become clear, it is my opinion that the Spanish financial system is reasonably well prepared to face the added competence consequent to its foreign aperture and that its weak points could well be removed by certain changes in the regulatory framework, aimed at establishing the domestic financial institutions on a similar footing to their competitors.

Since 1978, when they were first allowed to do so, some 38 foreign banks have been established in Spain. They are subjected to a special norm, already in the process of being phased out, prohibiting them from opening more than three offices, from obtaining in the internal market resources exceeding 40 % of the value of their internal credit investment, except in the interbank market, and forbidding them to have in their portfolios securities other than bonds, public and private. This set of restrictions forced the foreign banks in Spain to gear their activity towards the wholesale market and excited their ingenuity in devising new products and activities that could allow them to circumvent their operative limitations. [1]

Thus, the foreign banks have accomplished a very important role in the innovation and development of the Spanish financial system. They promoted a new deepness in the interbank market, started the syndicated loan market in pesetas, participated actively in the development of the commercial paper market and, in general, were always at the forefront of the innovation process followed by the Spanish financial system in the last few years. This way, they were able to raise its participation in the assets of the whole banking system, excluding thrifts, to 10,68 % in 1983 and 11,78 % in 1986.

The main institutions in the Spanish financial system are the private banks and the saving banks (thrifts) whose shares in the banking system as a whole are approximately 48 % and 40 %, respectively. By different roads, both sets of institutions have converged to the general pattern of universal banking, although the bigger banks are busy setting up and training subsidiaries devoted to investment and merchant banking activities.

During the last few years the domestic banking system (both banks and saving banks), albeit with very different intensity and dedication, has participated in the introduction and development of new lines of activity, under the push of the foreign banks but also on its own initiative. This has meant a continuous pressure to reduce transformation costs and to make a better use of the base of cheap resources provided by the very extensive network of offices at their disposal.

[1] On foreign banks and their operations, see Gonzalo Gil (1985, 1986) and Francisco J. Abad Hernando (1987).

Until 1987 the interest rates of a whole range of short-term deposits were fixed by the regulators which made those a very cheap source of funds and provided one of the main competitive advantages of the domestic institutions. However, at the present time all interest rates are free in Spain and this is forcing a strategical reorientation of the institutions away from growth by itself and to be more concerned with profitability and return on assets.

Other than the competitive advantages enjoyed by the domestic banks is their very low level of foreign risk, a result of the stringent set of regulations that prevented them from participating in the growth of international lending at the beginning of this decade. Nowadays the banks have a relatively reduced but growing foreign activity that amounts to USD 23 814 million in assets and USD 25 409 million in liabilities, both at the end of 1986, which represent only a share of 0,80 % and 0,86 % in the total foreign assets and liabilities exposure of the international banking system, respectively.[1] On the other hand, the savings banks have a negligible foreign activity.

Next to those competitive advantages of Spanish banks, there are also distinct competitive disadvantages with respect to their foreign competitors. Probably the most important is the small dimension and low capitalization of Spanish institutions. Only 13 institutions appear among the 500 institutions recorded by Euromoney in its last survey, 10 banks and 3 savings banks, and the first one only in the 58th position.

On the other hand, Spanish institutions are still burdened by an extensive set of coefficients — 19 % required reserves ratio and 11 % special investments ratio, 10 % of which in Treasury bills — linked in the main to the financing of the public deficit, that reduces their operating possibilities and their return on assets.[2]

In relation to existing financial markets in Spain it is best to divide their treatment according to the money and capital markets classification. I have already referred to the fully-fledged and developed interbank market, trading in 1986 a daily average of USD 5 200 million. Next to this is the short-term Treasury market, very active in both term and 'repo' operations and which is one of the main channels of monetary policy's influence. Also, since 1983 a thriving commercial paper market has been gaining ground, whose outstanding issues of about USD 4 200 billion in 1986 places it third in the world ranking: there is now the project of setting up a self-regulatory association of dealers in this market as well as a clearing system serving it, both of which measures shall result in an increased volume with a better protection of investors.

The situation is not nearly as rosy with respect to capital markets, traditionally less developed in Spain than monetary markets. The combination of the coefficients imposed on the savings banks, forcing into their portfolios certain kinds of private bonds, and the fiscal credit due to private investors that kept in their portfolios during three years the bonds acquired, was a permanent restraint to the growth of a strong secondary bond market in the last years. Thus, there is not in Spain a real long-term market for private issuers, although it is to be hoped that the phasing-out of the two said regulations in 1986 will mean a progressive change.

In this respect the experience of the Euromarket and the new possibility, already a fact, of creating a Euro-peseta market, should mean a great deal for the corresponding domestic efforts; also, the development of the new public debt market, to which I will refer shortly, is going to be relevant.

For its part, the stock market is taking bolder steps in the way of its rehauling. Thus, a new law is already under discussion, that, if approved in line with the project, will result in the creation of a unified national stock exchange and the implementation of new operating structures based on the Anglo-Saxon model of brokers and dealers. On the other hand, the government has already announced its willingness to allow quotation of foreign firms in the existing exchanges, without exhausting the transitional periods provided for in the Council Directives.

However, the market that is already more advanced in its restructuring process is the public debt market. In June of this year the Treasury finally set up a book-entry register for all its issues that will be managed by the Bank of Spain. This is only the most apparent sign of a deeper process that is going to change completely the structure of the Treasury market and that could very well be called Spain's 'mini Big-Bang'. In addition to the book-entry system, this will include a new discipline for the Treasury issues, the establishment of market-makers and inter-dealer brokers and, in time, a complete restructuring of the conduct of monetary policy.

To the Treasury, the new public debt market will offer a deepness that permits a diversified covering of its financing needs, lengthening maturities; it shall also allow a reinforced

[1] On the foreign activity of Spanish banks and its likely increase following the lifting of restrictions in 1987, see Antonio Sánchez-Pedreño and Gonzalo Gil (1987).

[2] On regulations pertaining to banks and other financial institutions, see Gonzalo Gil (1986).

reliance in the market conditions for its issues and should even permit a reduction of costs. To the Bank of Spain, the new market offers a swift instrument through which to implement its open market operations acting on a fuller range of maturities.

The last important topic that is left in relation to the Spanish financial system and its opening to foreign competition is related to the implementation of the monetary policy.

As early as 1974 the Bank of Spain decided to structure its monetary control activity on the two-level principle. Thus, at the first level it sought to control a monetary aggregate linked to nominal demand and at the second level pursued the control of that aggregate by means of the monetary base. With minor modifications this is the system still in use and it should be said that is has fulfilled its promise rather well, providing an instrument of monetary regulation reasonably flexible although somewhat lagged in response and needing at times an intensive handling of interest rates.[1]

However, from the beginning, the method suffered some structural imperfections; for instance, the mechanism of liquidity injection through competitive action was always effective, but when the situation called for a drainage of base money, the Bank of Spain frequently found itself lacking adequate instruments. To these technical difficulties there have been added others of a more basic nature, linked in the main to the recent process of financial innovation that increases the liquidity of some assets and blurs the frontiers of the monetary control aggregate. On the other hand, at times of strong shifts in the demand of different financial assets, included or not in the monetary aggregate, the Bank of Spain has had to revert to a more direct control of interest rates, abandoning temporarily its quantitative objectives for the sake of a better control of internal expenditure.

Nowadays, both the developments just discussed and the added availability of intervention instruments linked to the new public debt market, seem to promote a new reliance on two-way open market interventions as a means of regulating liquidity and interest rates. Indeed, we are just attending to the first movements in that direction with a general balance of success.

Still, it must be said, and emphasized, that like so many other aspects of the economy, the Spanish monetary policy lives under the pressure of the continuing budget deficit and the vagaries of the Treasury in its financing. The Bank of Spain is forced by law to extend free credit to the Treasury up to a certain amount and, in practice, this has been a continuous cause of worry to the conduct of monetary policy.[2]

As previously, I will finish this section stating some conclusions:

(i) Spain's financial system is reasonably well prepared, or it will be shortly, in terms of markets and institutions to adapt itself without excessive turmoil to the new competitive situation that will arise with the lifting of controls of establishment and operations and the liberalization of capital movements that shall take place on or before 1992.

(ii) However, a smooth transition would require some regulatory changes during the transitional period, mainly the phasing out of the investment coefficients that burden most domestic financial institutions, and a stricter limit to the credit rights of the Treasury against the Bank of Spain. Both regulatory changes are linked to a reduction of the public deficit.

(iii) The inexistence of a long-term bond market in Spain appears as the main drawback that could make competition difficult for domestic institutions in some markets.

(iv) Anyway, a process of mergers and takeovers should be expected both among domestic firms and by their foreign competitors, all the more likely because of the low capitalization of Spanish institutions.

3. Two legs of integration: Stability of exchange rates and freedom of capital movements — The case of Spain

The question here is that of compatibility between freedom of capital movements and the structure of fixed exchange rates that constitutes the EMS, taking into account the particular position of a country like Spain which does not yet belong to the EMS but is already embarked on a rather broad process of liberalization of its capital flows.

In general terms, it seems well established that the EMS and full liberalization of capital movements are only compatible within a framework of integration of the monetary policies of the member countries. This is the well known result of the Mundell-Fleming model that states that under free capital movements a country that participates in a fixed exchange rate system, like the EMS, loses its monetary independence.

[1] On the working of Spanish monetary policy, see Carlos Cuervo-Arango and José Trujillo (1984). On its recent history, see Beatriz Sanz (1987).

[2] On the relation between fiscal and monetary policy in Spain, see Carlos Cuervo-Arango and José Trujillo (1987).

It is true that the EMS allows a fluctuation band for each currency and that this feature lends some flexibility to national monetary policies, but inasmuch as domestic interest rates incorporate the market expectation about the course of inflation and the fluctuation of the currency within the band, the room for manoeuvre is greatly reduced and strictly confined to short-term reversible movements.

Is it likely that the EMS countries would take bold steps in the way of integration of their monetary policies? Possibly it is, since what is required is advancing from the actual coordination of general policies to a more detailed agreement about domestic objectives of policy, for instance about the growth of monetary aggregates. Certainly this line of action would be much more positive that alternatives like increasing the flexibility of operation of the EMS by widening the fluctuation bands, for instance.

In any case, without relying on advances in the way of fuller coordination of policies, at least in the short run, the alternatives for Spain should consider the relative merits of the two legs of integration we are considering: commitment to the process of liberalization of capital movements and integration in the EMS.

I have already referred to the advantages that would stem from liberalization of the capital movements for a country like Spain: modernization of the financial system; growth in the investment funds available and better terms for them; new impulse to needed structural changes in labour relations and some industrial sectors; better management, by necessity, of the public debt, etc. Thus, it is clearly my opinion that, in general, terms, the advantages of liberalization greatly outweigh its dangers and that consequently this is a train not to be missed, allowing of course for all the gradualism and safeguard measures that could be needed.

Now, the question is whether the train of liberalization of capital movements could collide with the stability of exchange rates that brings participation in the EMS. Should Spain renounce such participation? Certainly not, for many reasons, some of which I discuss in what follows.

It is clear from the start that by reducing short-term movements in exchange rates and, at the same time, allowing accommodation of long-term structural changes through the realignment of parities, the EMS constitutes one of the main building blocks in the execution of a great internal market at Community level. If only for this reason, Spain could not envisage a policy of permanent renouncement to join the EMS.

But joining the EMS presents other clear advantages for Spain. For one thing, it would reinforce the domestic anti-inflationary policy by linking more directly the internal and external rates of inflation, in practice by forcing the country to maintain its parity with the mark. On the other hand, participation in the EMS should give an added credibility to internal policy by making it clear to all agents the losses of competitivity which the country would incur should it renounce the anti-inflationary stance, be it because of excessive labour demands or lack of care with the dangers of continuous fiscal deficits. In other words, I would go as far as saying that, in a sense, losing some monetary independence is not necessarily a bad thing in a country as structurally inflation-prone as Spain and as long as the discipline of the EMS is geared towards maintaining a low rate of inflation. It is in this sense that I argue that participation in the EMS would give new credibility to domestic monetary policy and more arguments to its executors facing pressures from other social agents and instances of policy.

Thus, since it is clear to this consultant that Spain should join the EMS, the question is then the timing of its joining.

As I have already discussed in the first part of this report, during the transitional period previous to its full integration, Spain will suffer a programmed, continuous string of real shocks due to the elimination of quantitative restrictions to trade and to the dismantling of its protectionist tariffs system. The real resource reallocation this process is bound to generate constitutes a powerful argument for retaining during that period the flexibility of nominal exchange rates that allows the present flotation of the peseta.[1] On the other hand, Spain is embarked right now on a long-range transformation process of whole parts of its industrial network. All these factors and the relative price changes they are going to produce call for a reasonable waiting period until it should become clear what is a sensible parity for the peseta within the EMS system. It could be supposed, though, that such a waiting period should not extend beyond 1993, the year in which Spain's tariff system would converge with that of the Community.

During the period until integration in the EMS, Spain must resolve its disequilibria, in particular those concerning the trade balance, the level of its public deficit and the rigidity of the real wages, and should adjust its inflation rate to that prevailing in the Community. This is in fact a precondition to integration in the EMS in the same way as a failure in the reduction of the public deficit could very well jeopardize the whole process.

[1] On the convenience of a certain flexibility in nominal rates of exchange as a buffer to real changes in parity, see José Viñals (1987).

The aforesaid factors, though, show only just a fraction of the wealth and income redistribution processes that will accompany the linkage of the Spanish economy with the internal market at Community level. Progress in the liberalization of capital movements could only exacerbate them during the transitional period until integration in the EMS. Redistributive policies within the Community are thus of great relevance, implying in particular the strengthening of the structural funds available and their careful allocation to the more fragile and less developed economies.

Finally, it should be kept in mind that liberalization of capital movements is already an ongoing process in Spain. If it is true that some of the arguments that call for retarding full participation in the EMS also apply for the regulation of short-term capital movements, in particular those related to speculative attacks against the currency, it is also true, as I have mentioned in the first part of this report, that there is no reason for not advancing in the liberalization of the capital movements linked to real and portfolio investment. From this point of view, there is a sense in which not participating in the EMS should be construed as an advantage for Spain in the way of liberalization of capital movements, since it would permit a relative freedom of the tensions between stability of exchange rates and liberalization of capital movements that the countries already linked by the fixed exchange rates system will probably encounter.

In summary, as to the relation between participation in the EMS and liberalization of capital movements we could state some conclusions:

(i) Spain should participate in the EMS and should liberalize its capital movements. Inasmuch as there is a certain incompatibility between those objectives, it should be resolved through tighter coordination of policies and the establishment of safeguards to some monetary operations. In particular, neither a dual exchange market nor the widening of the fluctuation bands seem suitable solutions, at least for Spain.

(ii) Spain should not enter the EMS until completion of the reduction of tariffs and lifting of quantitative restrictions processes. Only then, and once the relative price changes involved are considered, could the sustainable rate of exchange of the peseta become clear. In this respect is would be better, in my opinion, to enter later but with the regular fluctuation band than sooner with a wider one.

(iii) During the transitional period previous to the full integration in the EMS, Spain could proceed to dismantle most present restrictions to capital movements, except those strictly linked to very short-term movements that could be used as instruments of speculative attacks against the peseta. In other words, Spain could join the general process of liberalization of capital movements at Community level, perhaps with some special safeguards related to its transitional position.

(iv) The reduction of the important disequilibria that mar the Spanish economic structure is imperative and a prerequisite to integration in the EMS. In particular, reduction of the inflation rate and the public deficit should be the main order of business as well as correction of the rigidities in real wages and labour relations. These objectives should be accomplished by the end of the transitional period around 1993.

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Liberalization of financial transactions in the Community with particular reference to Belgium, Denmark and the Netherlands

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Introduction

The Commission of the European Communities has already set the pace for a complete liberalization of markets for goods and services by 1992. Integration of financial markets has always been seen as a necessary complementary measure to reduce transaction costs and facilitate creation of an integrated European market for goods.

However, in the past integration of financial markets has proven extraordinarily difficult because finance is not only a useful service for trade, but underlies and influences closely the business cycle, price stability, growth and income distribution. This paper attempts to identify the likely effects of financial integration on these major variables.

According to the communication from the Commission to the Council of 23 May 1986, financial integration is expected to proceed in two phases:

(i) the first phase aims at liberalizing those transactions linked to the proper functioning of the common market (free circulation of goods, services and persons as well as free establishment) and to the creation of an integrated Community capital market (operations in securities);

(ii) the second phase aims at creating by 1992 a unified financial system in the Community through the removal of all the remaining restrictions and controls. The intention is to liberalize *erga omnes*.

This step-wise integration could raise certain difficulties. They will, however, not be discussed because they do not affect in a major way the three countries of this paper's specific concern. This paper focuses therefore on final integration and neglects transitory effects or problems. This seems well justified by the advanced degree of liberalization already achieved by the three small northern countries.

The liberalization objective of the Commission recognizes that the difficulties and final gains of liberalization are likely to be dissimilar for each country, depending on country size, the initial macroeconomic configuration, sophistication of its financial sector and on the degree and extent of regulations to be dismantled.

This paper does not attempt a complete treatment of these issues. Being focused on the three small, northern countries of the Community this paper limits the analysis of liberalization to the context pertinent to these countries. This context can be summarized as follows. All three countries are highly developed small countries and very dependent on foreign trade. Germany is the main trading partner for each of these three countries and hence the evolution of domestic prices relative to German prices is of particular importance. At present all three countries are forming a DM-zone, whilst at the same time trying to maintain or even improve a liberal system of international financial flows: the Netherlands are very close to an unrestricted system of foreign transactions; Denmark has significantly liberalized in recent years and Belgium does not impose any restrictions other than operating a two-tier exchange market.

This paper is organized in two parts. The first part deals with general issues of financial liberalization. The second part is more empirical and investigates the experience of Belgium, Denmark and the Netherlands. In Section 1 of the first part the effects of liberalization on resource allocation and income distribution are investigated. It is usually considered that the major potential advantage of liberalization lies in the domain of more efficient resource allocation. However, we shall argue that the most sizeable potential gain is a dynamic one: the effects of liberalization on savings and investment.

In Section 2 of the first part we turn to issues of macroeconomic policy and control. This is the area where liberalization is feared to cause problems, or welfare losses, such as the loss over domestic monetary policy control. Within the European Monetary System (EMS) it is sometimes feared that free capital movements and a fixed exchange rate allow foreign countries to dictate domestic interest rates, the domestic inflation rate and therefore the Phillips-curve trade-off. While largely true, the full truth is both more complex and more interesting. [1]

In this section we also examine, in passing, the issue of safeguard clauses for foreign exchange crises and how best to cope with such crisis situations.

The second part comprises four sections: one for each of the three countries studied and one for a comparison of the empirical lessons. Finally the conclusions of this study are summarized.

[1] Our discussion will be limited to the issues faced by small countries. Those of large countries and those of the EMS as a whole are discussed in the reports on France, Italy, the United Kingdom and the EMS.

General issues of financial liberalization

1. The effects of liberalization on resource allocation and income distribution

1.1. Liberalization of what?

In the communication cited in the introduction, a priority is already established among different international financial transactions: first, trade finance and second, capital market transactions.

Free movement of goods in the Community is realized when costs in any location differ only by unavoidable transport costs. Costs of trade finance could distort competition between exporters and local producers in either direction. Full commodity market integration requires therefore the elimination of implicit taxes or subsidies contained in trade financing. However, trade finance covers only one aspect. Capital costs in protected national markets can be significantly above those in world markets. When this is recognized, authorities tend to subsidize capital costs of particular producers distorting thereby not only resource allocation internationally but also domestically.[1]

Creation of an integrated financial market in the Community very much expands the dimension of liberalization. While trade finance is largely complementary, i.e. a necessary input for trade, capital market integration is both complementary to and a substitute for trade. Foreign direct investment is a generator of mainly intra-industry trade and thus complementary,[2] but it also can be a substitute when production abroad replaces exports. Frequently trade barriers (transport costs, tariffs, etc.), generate such substitution. The absence of significant trade barriers in the EEC suggests that foreign direct investment is predominantly trade-creating.

Market integration which should contribute to factor-income equalization according to the Heckscher-Ohlin-Samuelson theory, is undoubtedly assisted by capital market integration. Indeed, factor-income equalization can either be achieved through free trade or, alternatively, through free capital movements (the Mundell theory). Hence, free trade and free capital movements reinforce each other in bringing about factor-income equalization. As we shall see, the implications are not to be applauded by every economic agent, but the welfare of the Community is bound to increase. It is thus necessary to evaluate the allocation and distribution effects.

In the absence of exchange risks, free capital movements will generate convergent lending rates for identical maturities and risk classes. Similarly, deposit rates will tend to be equalized and hence spreads of borrowing-lending rates will tend to be equalized. Thus, throughout the Community, savers are confronted with identical conditions, and so are investors. Hence a major factor of market disintegration would tend to disappear, namely the fact that differentiated capital costs distort the competition for savings.

However, one sector which might suffer in some countries from capital market integration is the financial sector. Financial integration provides new opportunities and the most dynamic firms will be able to benefit. But integration will also mean increased competition and lower margins. In many cases this is to be welcomed because in highly protected financial markets returns are much more a reflection of monopolistic privileges awarded by governmental regulations than a reflection of innovation, risk-taking and rents for scarce entrepreneurial talent.

Whilst it is timely to shave the golden glitter of protected financial sectors, identical spreads do not imply identical costs and hence profit conditions, given the fiscal and regulatory differences among member countries. The market has been facing such difficulties for some time: increasing securitization easily allows borrowings and savings to be placed abroad, although banks participating in the international market are not subjected in their home countries to a uniform fiscal and regulatory environment.

In consideration of the extreme difficulty of uniformizing regulation, some discrimination has to be accepted; the same is true for industrial firms. A workable compromise has been supported by LECE:[3] harmonization should be pushed as far as possible but in areas where harmonization is not feasible each country would accept that foreign subsidiaries obey regulation in their home country. The monetary authorities of the country where headquarters are implanted would be responsible for Community-wide operations. Whenever financial techniques are imported which are ruled out by domestic regulations, thus putting domestic banks at a competitive disadvantage, authorities would be obliged to relax regulations. Such a treatment would be reserved for

[1] Compared to other distortions in the EEC, differentials in trade finance are likely to be of second-order importance, although this is not the case for capital costs in general. Real rates of interest do significantly differ among countries of the EEC.

[2] See Helpman and Krugman (1985).

[3] Ligue européenne de coopération economique (LECE): Vers un espace financier européen, Brussels, 11 and 12 December 1986.

financial firms with their headquarters in Europe, for purely practical reasons. This would at the same time give European firms on the European market an advantage comparable in spirit, but not dimension, to the customs union privilege. Over time, the Commission should, of course, endeavour to progress with regulatory harmonization.

The fiscal treatment of international capital flows is of particular importance, comparable to the question whether VAT on internationally traded goods should be collected at the point of origin or at the point of destination. To the extent that taxes on capital income (interest and capital gains) are retained at source, problems arise. Whilst tax collection would be relatively easy, interest rates would not be equalized (rates net of income tax will however be equalized) and hence banks would compete on unfair grounds. Moreover, taxes would be collected where savings are invested and not where income is earned.

Alternatively, capital income of non-residents could be tax exempt in the country where funds are invested and taxed at home. Interest rates would be equalized, savings would be taxed where income is earned, but tax evasion would be made easier (the Belgium-Luxembourg syndrome).

The most sensible solution would be a uniform tax for the Community, rendering capital flows for tax reasons uninteresting. Even better would be to set the uniform rate at zero to eliminate the traditional double taxation of savings (through taxation of income earned and subsequent taxation of income earned on income saved). Europe's present growth record is dismal by historical trends and could benefit from an additional boost to savings and a corresponding decline in investment costs which would result from the elimination of capital income taxes.

It can also be expected that the development of European financial markets would greatly benefit from such a measure for three reasons. First, non-taxation of capital income would eliminate existing distortions (as would uniform taxation). Second, non-taxation would improve the relative price of future goods in terms of present goods and this would stimulate savings and thereby the net size of the financial market. Third, Euromarkets have always benefited from their offshore character and thus from tax evasion. Whilst Euromarkets have other advantages as well, the removal of the tax advantage over domestic markets would render domestic markets more competitive. It seems therefore advisable to study the fiscal dimension of capital market liberalization in more detail as this question obviously transcends the scope of this paper.

The approach of the Commission to support liberalization without prior fiscal and regulatory harmonization has considerable pragmatic merit. Indeed, it can be hoped that once liberalization increases competition in national markets harmonization will be a forced result. As long as some countries maintain regulations and a tax structure putting its financial industry at a competitive disavantage they will lose business — unless regulations are relaxed. Empirically there is however no strong support for this conclusion: in some countries deregulation followed liberalization as in the United Kingdom;[1] in other countries, such as Germany, free capital movements have resulted in only a very timid and slow process of deregulation.

Will a European financial market with complete liberalization and regulatory harmonization be characterized by an even regional distribution? At least three arguments suggest that this is unlikely to be the case and much more likely is an evolution toward one (London) or a small number (London, Frankfurt, Paris, etc.) of monetary centres. First, economies of scale characterize financial products and the financial industry. With technological advance in communications the scale argument tends to become stronger rather than weaker in the future. Second, the industry is strongly conditioned by hystereses, that is trust is an essential input which can only be developed over time. Existing centres therefore have a competitive advantage over potential centres. Third, the quality and size of a national currency market provides support to the development of a national financial centre.

According to the first two arguments London might well emerge as the monetary centre of Europe. One could even imagine that transactions in French francs or Deutschmarks are carried out more efficiently in London than in Paris or Frankfurt.[2] But the fact that retail and wholesale banking cannot be totally separated, that central banks' supervisory and lender- of last-resort role is restricted to the national market, and that bourses will retain a largely national basis, suggests that attractive and large-sized currencies will provide an offsetting advantage to their national monetary centres.

1.2. The static effects of perfect capital mobility on resource allocation

In a world with no externalities (such as market failures or differences in available technologies amongst countries), no distortions (such as inopportune government interferences), complete hedging facilities and costless financial trans-

[1] See M.J. Artis, 'Exchange controls and the EMS' (this volume).

[2] This phenomenon is already observable for a variety of financial transactions in bonds, shares, swaps, option trading, etc.

actions, capital flows are determined by the differences between the domestic and foreign private marginal returns on capital, by differences in national time preferences and liquidity preferences. According to this theoretical benchmark, perfect capital mobility across nations equalizes private and social returns on capital abroad and at home, and maximizes the world global welfare.

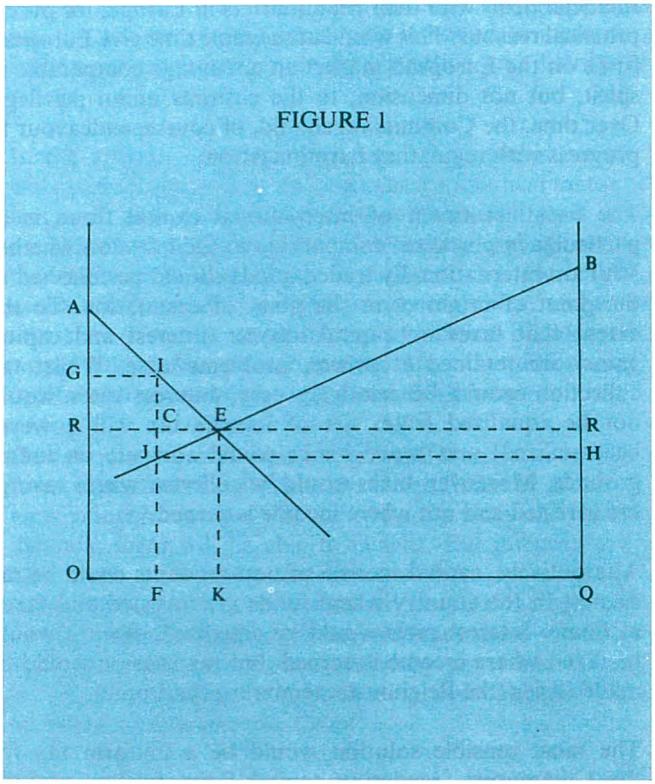
Financial resources flow from countries where capital is abundant and marginal returns relatively low to countries where capital is scarce. In the net lending country, capital holders obtain higher revenue from their foreign investment while total wage income is reduced because of the production decline. But the wage bill contraction is less than the rise in revenue from lending abroad such that the country as a whole has increased its real gross national revenue.

In the net borrowing countries, the inflow of funds triggers an increase in the national real capital stock. For a given labour force this reduces the income from investment obtained by domestic capital holders to the benefit of foreign investors and, for the major part of it, to the benefit of wage earners. At equilibrium, marginal returns on capital are equalized worldwide and the world global production has increased accordingly.

Figure 1 illustrates this static resource allocation effect in a simplified two-country case. The horizontal axis represents the global capital stock. Capital endowments are respectively OF for country A and FQ for country B. Before capital flows are liberalized both countries operate in isolation with country A's return on capital equal to G higher than country B's return equal to H. Country A's production is measured by the area QAIF while QBJF represents B's production. Labour's share in country A is the triangle AIG while GIFO is the return on capital. In country B the labour bill is measured by BHJ and capital income by HQFJ.

With capital market integration the system moves to point E where the marginal productivity lines intersect. Country A's production rises to OAEK with a labour income of AER and a capital income of REKO, of which CEKF is transferred to capital owners in country B. Similarly, country B's production is reduced to QBEK, divided between labour income (BER) and domestic capital income (REKQ). The production of the whole system has increased by the triangle IEJ of which IEC is a net production gain accruing to country A end JEC is a net revenue increase for country B. It should be noted that the net global production gain as well as its distribution amongst countries is highly dependent upon the slope of each country's marginal product curve and thus, at least to a certain extent, upon each country's technology.

FIGURE 1



In the second part of this paper it is shown that during the last 10 years Denmark and Belgium were able to sustain sizeable current account deficits. The effects can therefore be compared with those of country A: GNP in Belgium and Denmark was higher than otherwise, labour benefited and domestic capital obtained lower returns.

1.3. Some intertemporal considerations

In Figure 1, capital mobility is welfare-improving for both countries because marginal returns on capital are different in the absence of capital movements. The welfare gain is obtained from increased efficiency of static resource allocation. But even if returns were identical in the absence of capital mobility there could exist unexploited trading opportunities. One such case arises if countries have different aggregate time preferences. A country with a lower preference for the present could shift its consumption into the future through current account surpluses, while countries with less patience could shift their consumption patterns towards the present through debt accumulation. As in the static case, both countries gain.[1]

[1] See Kouri (1982).

In Figure 1, the value of the marginal product value of capital (mpc) schedule changes, of course, over time. Technological progress, improved terms of trade, lower wages, and growth of the labour force all shift the mpc-schedule upwards. Thus, if A's schedule shifts more than B's, then country A will attract an increasing share of B's capital.

Which countries can be expected to be net capital importers in long-run equilibrium? With similar savings propensities those countries generating the highest returns through their efficiency and innovation. The competitive pressure generated by capital market integration will however be such that past performance is of little help in forecasting the future.

1.4. Liquidity preferences

In the 1960s, Deprez, Kindleberger and Salant (1966) attracted considerable attention with their argument that a large share of European portfolio investment in the United States found its way back to Europe in the form of US direct investments. According to these authors, European investors preferred liquid, low-risk assets whereas US investors, using more sophisticated management techniques, preferred higher-yielding assets with less liquidity and more risk. Whilst these conclusions have been criticized, this argument is an illustration of mutually beneficial trade requiring no net capital movements. Thus, independently of current account imbalances, capital flows may be welfare-improving for both partners.

Recent financial innovations serve mostly to reduce risk, increase liquidity, and to approach as much as possible specific demands by important subgroups of market participants. They serve therefore much more gross than net flows, as also documented by statistics on gross and net capital flows.

Similarly, better satisfaction of varied and complex liquidity preferences thanks to financial integration is welfare-enhancing. However, the present argument does not directly affect resource allocation or intertemporal transfers of consumption, and does not therefore affect directly countries' net wealth. Only their liquidity structure is affected because only gross capital flows are concerned. But the indirect effects on growth can be positive: if, say, Italian savers have a preference for liquid and safe assets, whilst Dutch savers (or their institutions) prefer longer and riskier maturities, then Italy will lend short-term to the Netherlands which will invest long-term abroad, possibly in Italy. Maturity transformation, combined with different risk attitudes and investment capacities, is likely to stimulate growth.

1.5. Market distortions

A major distortion in countries with capital controls is of course the existence of these controls. But second-best theory should make us cautious to recommend elimination of these distortions in a world where many market imperfections exist.

In terms of the analysis represented by Figure 1 it is clear that both countries will gain from free capital movements as long as full employment is maintained, i.e., as long as labour markets work well and flexibly enough. For example, when B invests in A, the marginal product of labour in B falls and so must real wages. If they are rigid, country B could suffer a welfare loss: the higher capital return may be insufficient to compensate for the reduction in production caused by unemployment. In the long run it is unlikely that market rigidities pose an insurmountable difficulty but the short run is characterized by a plethora of rigidities and therefore by frequent divergences of social from private costs. The short run distribution of gains is hard to assess and would require a case by base analysis.

Another imperfection in the form of an externality is the following. Additional investment at home augments the marginal product of labour. A capital-exporting country obtains higher capital returns than one that locks in domestic savings, but does not obtain the associated labour income generated abroad. Hence, from a national viewpoint the social return on foreign investment is lower than the private return. By restricting capital exports through a tax and creating thereby pressure on foreign returns to increase the country can augment its social returns. Thus, sufficiently large countries with the power to influence world market interest rates may gain through restricting capital outflows.

This argument is similar to the optimum tariff argument and shares the shortcomings of the latter. Implementation of such an optimal tax is extremely problematic because it only maximizes national welfare and hurts trading partners. When they retaliate chances are that both will wind up worse off than in the initial situation.

No European country has the required size to have an influence on world market interest rates, but an integrated European market might have the required size. Small countries with respect to the rest of the world but large within the EEC may become price-makers in European financial markets while the EEC itself has a sufficiently large financing capacity to affect world interest rates. Financial integration would then give a relative advantage to the financially largest and most sophisticated member countries by promoting them from price-taker to price-maker through the support of all member countries. Power provides one

advantage: to command respect and to enable the Community to react or threaten to react to policies enacted by other powerful nations. Of course, such policies or threats require not only an integrated market but also appropriate monetary policies in the EEC.[1]

A major international externality is being produced by exchange rate misalignments (Dornbusch, 1976). If the misalignment persists over a significantly long period of time, it will induce a redistribution of productive capital (Steinherr, 1986). In practical terms, when the exchange rate of a capital-abundant country appreciates in real terms above its equilibrium level, its capital marginal product curve shifts up inducing thereby a reduction — or even a reversal — of its capital exports and an increase in equilibrium interest rates. Since the European Monetary System minimizes misalignments between participating currencies, externalities of this kind should not cause major concern inside the Community. But the experience with the dollar over the last 10 years suggests that global capital liberalization might lead to massive and quite volatile capital misallocations between the EEC and the USA. It might therefore prove useful to investigate the possibility of taxes imposed on Community external capital transactions either on a permanent basis (like the external tariffs for goods) or on a safeguard basis.[2]

In the main the discussion so far assumed price-clearing in capital markets. In recent years a substantial literature has developed rationalizing observed imperfections such as credit rationing. For a comprehensive survey of the literature see Stiglitz (1987). The main reason for credit rationing is imperfect information of lenders about the quality of the borrowers. In the face of excess demand for loans an increase in interest rates may eliminate credit demands by safe borrowers and increase demand by riskier borrowers (adverse selection) leading to a decline in bank profits. This problem can be illustrated with the following example. Suppose there are two types of borrowers; each has a project cost of x, entirely loan-financed. Revenues are R_i with probality P_i and zero with probability $(1-P_i)$. If there is a collateral $c < 1+r$ per ECU loaned (otherwise the bank faces no risk) expected returns V_i to firm i are

$$V_i = P_i[R_i-(1+r)B]-cB(1-P_i),\ i=1,2$$

If both firms borrow at the rate r because the bank lacks the information to identify low and high-risk borrowers but $P_1 > P_2$ then even if $P_1R_1 = P_2R_2$ we have $V_1 < V_2$. That is, even if the two projects have the same expected revenues, the riskier project yields a higher return because the probability of repaying the loan is smaller and $c < 1+r$ insures that this advantage is not fully compensated by the higher probability of losing the collateral.

The low-risk firm will not apply for a loan anymore when r exceeds the value r^* at which $V_1 = 0$. Thus, for $r \leqslant r^*$ both firms apply whilst for $r > r^*$ only the high-risk firm applies. For r slightly above r^* the jump in risk is not compensated by the increase in interest rates and therefore banks would do better not to increase r above r^* even in face of excess demand.

A number of useful insights can be derived from this example:

(i) Profit-maximization by banks may not generate Pareto-optimal equilibria. Hence, institutional changes leading to a reduction in credit rationing can improve aggregate social welfare.

(ii) Imperfect information can be reduced by investing in long-term bank-client relationships. This explains why market newcomers find it more difficult to obtain credit than established firms. This reinforces barriers to entry and protects vested interests. A new entrant to the market of country A may therefore find it costly or impossible to obtain desired credit amounts because he is unknown to local banks whereas banks in his home country find it difficult to assess risks in a foreign market. If home country banks were allowed to set up branches abroad, the combination of knowledge of the client and knowledge of market A would reduce the financial disadvantage of the newcomer to country A.

(iii) Access to capital markets in different countries offers opportunities to reduce costs and credit rationing. Any individual borrower faces rationing in any one market. Access to several markets reduces overall rationing. Furthermore, real interests are not equal in all markets. If in country A the real interest rate is set at $r < r^*$ both type of firms in our example are rationed; if $r > r^*$ low risk firms will drop their project. Hence, if in another Community country B a lower value of r^* prevails the low-risk firm can obtain funds there and invest profitably. On the other hand, high-risk promoters of country B will seek funds in country A.

(iv) Essentially the same arguments also apply to equity markets. For both equity and loans foreign market access offers additional advantages in a world of incomplete markets and imperfect information. One advantage for firms engaged in foreign trade is risk hedging. This argument is therefore particularly relevant for firms in the EEC with high trade intensities. A quotation

[1] For a discussion of the game-theoretic aspects of coordinated European monetary policies in an integrated European financial market, see Steinherr (1984).

[2] Along these lines see Basevi (1985).

on a foreign stock exchange improves the image of the firm, provides useful information to investors and lenders in that country (thereby reducing the lack of information), provides additional flexibility (at an additional cost), and hedges net worth. Suppose a firm in country A sells part of its productions to country B. If the currency of country B depreciates with respect to currency A whilst prices cannot be increased by the rate of depreciation, profits expressed in currency A fall whilst profits expressed in currency B fall by less or may even rise. Hence net worth is at least partially protected by a foreign quotation.

(v) Suppose that the money supply is reduced in country A. The impact on interest rates could be negligible if banks ration loans and all the impact will be felt by a credit squeeze. Access to credit markets of other countries not pursuing tighter monetary policies would help in avoiding a full repercussion on economic activity in country A.

1.6. Effects on income distribution

The effects on income distribution can be regrouped under three headings: functional income distribution (wage v. capital income); sectoral income distribution, and intertemporal income distribution (consumption v. savings).

Figure 1 depicts the effects on functional income distribution. Capital returns fall in the receiving country (country A) and rise in the capital-exporting country (country B). Inversely, labour income increases in the receiving country and falls in the capital-exporting country. It is therefore easily understood why labour unions usually welcome foreign investments, but not domestic investments abroad although aggregate welfare is increased. In this example, the distribution of savings has no importance: they will be invested in both countries such as to maintain equal marginal returns.

The case depicted in Figure 1 makes abstraction of financial intermediation and of other market imperfections. Financial intermediation only is useful in a world beset by friction, lack of information, transaction costs, etc. Even worse, the financial industry itself is protected by regulations and therefore rarely competitive. Free capital mobility is providing new opportunities but is likely to diminish spreads between borrowing and lending rates. This is empirically illustrated in the second part of this paper. Hence — apart from financial institutions able to take advantage of increased opportunities, able to cut off the fat represented by unnecessary demonstration expenditures and excessive retail facilities, or willing to be absorbed to benefit from increasing returns to scale — the banking industry in highly protected countries is bound to suffer.

In contrast, all other activities will gain from a wider choice of financial products (product diversification), of more competitive pricing and of more sophisticated financial services.

Among borrowers the advantages are of course not uniformly distributed. In general, capital-intensive activities will benefit more that others; foreign trade will benefit more than domestic trade; companies too small to borrow on Euromarkets, therefore constrained to the domestic market, will benefit more than multinationals. Big domestic projects will find finance more easily; market niches will be more likely serviced, and so on.

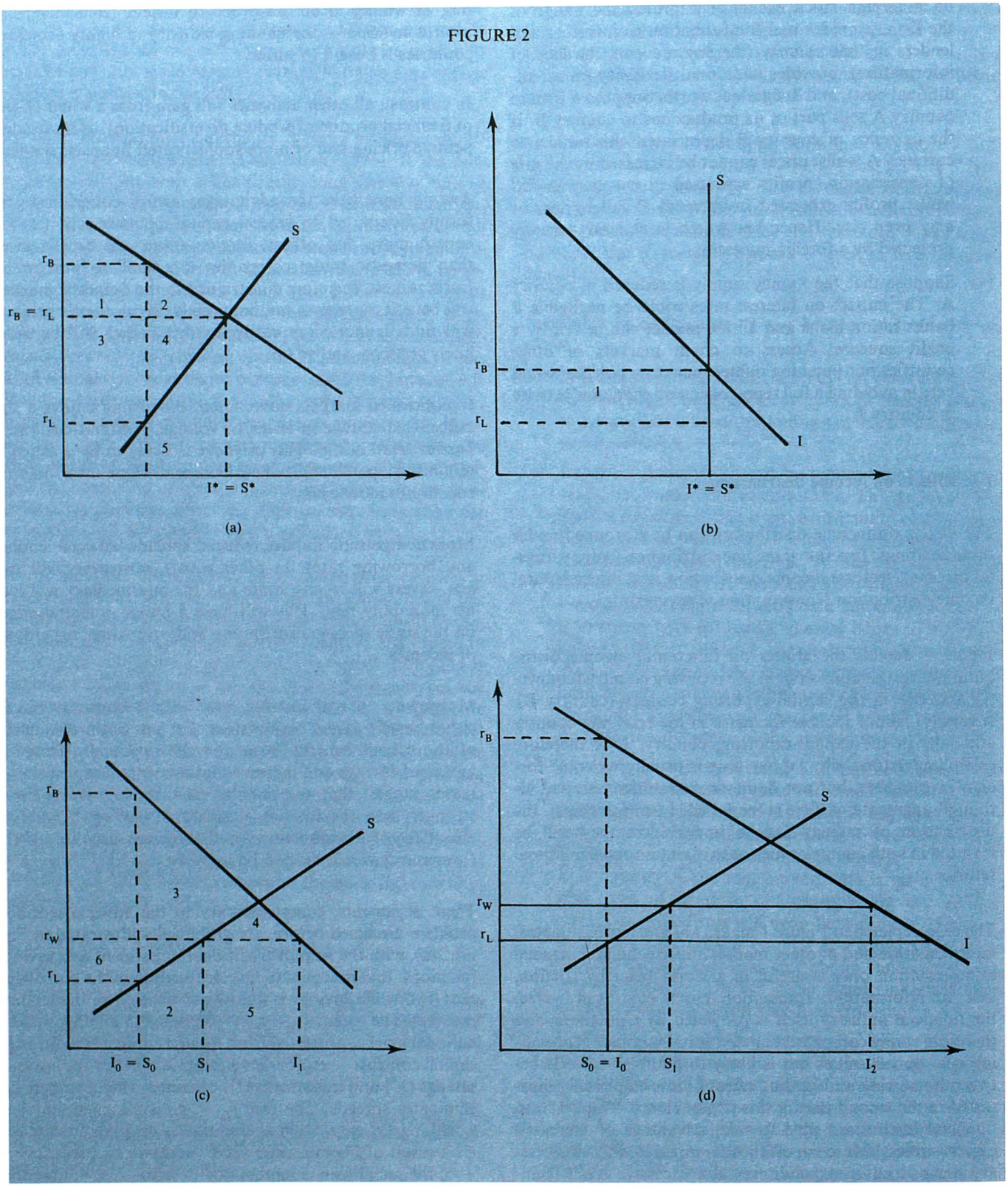
In controlled markets government borrowing enjoys a significant advantage in terms of volume, risk and customer-banker relationship. This privilege is likely to be drastically diminished in a liberalized environment where investors find substitutes more easily.

More competition implies reduced spreads between lending and borrowing rates. In other words, borrowers will pay less, savers will receive more and the intermediary will lose his monopoly rent. This will have a major potential effect on the static income distribution and, over time, on growth of incomes.

Movements in real interest rates with a constant spread either benefit savers or investors, but not both. Reduction of the spread benefits both and the expected effects are increased savings and increased investments. Empirical estimates suggest that the interest elasticity of investment is stronger than the interest elasticity of savings. Therefore the effect of liberalization on the current account of the Community would tend to be negative.

These arguments, complementary to the adverse selection problem discussed before, are graphically illustrated in Figure 2(a), with the help of traditional investment and savings functions. Investment is an inverse function of the borrowing rate (r_B), while savings is a positive function of the lending rate (r_L). The spread ($r_B - r_L$) — obtained in an oligopolistic national market protected from foreign competition through capital controls — establishes equilibrium below the levels of savings (S^*) and investment (I^*) obtained when competition eliminates spreads. The rate $r_B = r_L$ is assumed equal to world market rates: this assumption is dropped in case (c). As a result of liberalization GNP increases by areas 2 + 4 + 5; the social gain is represented by areas 2 + 4; investors

FIGURE 2


S
r_B
$r_B = r_L$
1
2
3
4
r_L
5
I
$I^* = S^*$
(a)
S
r_B
1
r_L
I
$I^* = S^*$
(b)
r_B
S
3
4
r_W
1
6
r_L
2
5
I
$I_0 = S_0$
S_1
I_1
(c)
r_B
S
r_W
r_L
I
$S_0 = I_0$
S_1
I_2
(d)

gain 1 + 2; savers gain 3 + 4; and banks lose their monopoly rent 1 + 3.

In Figure 2(b) a special case is represented, the case where savings are completely interest-inelastic. In this case competition would not lead to higher savings and investments.[1] GNP would remain unchanged and the social gain would be limited to distribution effects: savers would gain area 1 from bankers. A similar conclusion is obtained for the case where investment is considered completely interest-inelastic. A third case of interest arises, if capital outflows are permitted but capital inflows are controlled so that domestic banking can enjoy monopoly spreads. The loss in Figure 2(a) would be reduced, as depicted in Figure 2(c). The equilibrium $I_o = S_o$ is obtained in the absence of capital flows. If outflows are allowed, savings will increase to the level S_1, determined by the world interest rate (r_w) and the quantity $S_1 - S_o$ is invested abroad. Domestic savers increase their income by the area 1 + 2 + 6 and their welfare by the surplus equal to area 1 + 6; banks' monopoly rent would fall to $r_B - r_w$.

With total liberalization of capital transactions, domestic investment jumps to I_1, and the country becomes a net importer of capital equal to the current account deficit $I_1 - S_1$. This is precisely what is often feared by policy-makers: liberalization will create current account deficits. But, in fact, this is the best that could happen to this country. GNP will now increase by the area 1 + 2 + 3 + 4 + 5, of which area 5 represents interest payments on the foreign debt.

Figure 2(d) depicts the case where capital inflows are liberalized but not capital outflows: this corresponds to the legal distortion in some Community countries. For the restriction on capital outflows to make sense it needs to be assumed that domestic lending rates are below external lending rates.

Because $r_w > r_L$ foreigners will not invest in this country's fixed interest securities. Investment is therefore constrained to level I_o by available domestic savings S_o and savings will be rationed at borrowing rate r_B. If foreigners can freely acquire equity or invest directly then investment will increase to I_2 and foreigners will own the distance $I_o - I_2$. With free competition in capital markets savings would increase to S_1 and foreigners would only own $S_1 - I_2$. This example illustrates the possibility that domestic investment is either constrained by savings if direct foreign investment is controlled, or if not partial controls give rise to excessive foreign indebtedness.

In the second part of this paper it is shown that spreads in countries with capital controls are a multiple of spreads in countries with liberal capital transactions. Just to gain orders of magnitude the following example may be useful. With Cobb-Douglas technology, the elasticity of the desired capital stock with respect to cost of capital is above unity.[2] Hence, the impact of lower spreads on investment can be quite sizeable, even more so in periods of high unemployment.

In this discussion, we have neglected the economic use of bank profits. At one extreme, if bank profits are reinvested in banking then liberalization would tend to slow investment in banking and stimulate investment in other sectors. But, in addition to this redistribution effect, there is an overall gain because higher savings increase the aggregate amount of funds for investment.

In controlled markets, all savers may obtain lower than world market returns. But, generally, small savers are penalized most and they can expect to gain most from liberalization.

2.1. Macroeconomic policy in small EMS countries and free capital movements

2.1. The small country context

The advanced small EMS countries are highly dependent on foreign trade and therefore on stable and foreseeable price relationships. This constrains their domestic policies already very sternly: if they allow domestic prices to increase faster than those of their major EMS partners then domestic products will be replaced by foreign products both at home and abroad; a current account deficit develops and if no clear signals are given about the correction of the competitive loss, the market will expect a realignment. No financial support will be able to avoid a devaluation; the only solution consists in either domestic means to curb prices or in a devaluation.

[1] But investment would increase after liberalization if world market interest rates are lower than r_B.

[2] With the Cobb-Douglas production function $Y = K^a L^{1-a}$ marginal conditions are

(1) $w = (1-a)Y/L$ and $r = aY/K$

where w and r are real wages and real capital costs respectively. In full employment or in a situation where any productivity gains are reclaimed by higher real wages, employment is constant. From

(2) $\hat{Y} = (1-a)\hat{L} + b\,a\hat{K}$

where $\hat{}$ denotes growth rates, it is seen that $\hat{Y} = a\hat{K}$ and from (1):

(3) $\hat{Y} = \frac{a}{1-a}\hat{r}$.

If the real cost of capital falls from 5 % to 4 %, $\hat{r} = -20$ % and, with $a = 0{,}2$, $\hat{Y} = 5$ %, $\hat{K} = 25$ %.

Therefore any policy, fiscal or monetary, which affects prices is bound to fail in a small country aiming at maintaining EMS exchange rates, and this verdict is independent of the degree of capital controls.

A second feature of small countries is that whatever they do matters less than the same actions carried out by a large country. In the EMS the determination of individual monetary growth targets need to be resolved in one way or another. Either a large country acts as a leader and all others follow; or all countries take decisions jointly; or they combine joint decision-making with automatic rules; e.g. the McKinnon proposal (1984). The important point here is that as far as small countries are concerned it does not matter. Individually, these countries are not affecting much the overall outcome and therefore what they do is of no great importance for the EMS as a group. A major problem among large countries, namely how to coordinate through rules or through a decision-making process is not an issue for small members (Steinherr, 1984).

Because of their high foreign-trade dependency, small countries would find it difficult and costly to maintain extensive capital controls. Finance is often a by-product of trade, as argued before. But this is not the only constraint. In a very open economy as compared to a nearly closed economy, equilibrium is more often and more dramatically disturbed by foreign shocks. To smooth domestic production and consumption over time, these shocks require financing. Otherwise the real economy of a small country would become extremely unstable. Financing shocks in the current account does not necessarily require private capital flows, as monetary authorities can use exchange reserves and government can borrow on external markets to protect exchange reserves. In order to allow private agents to achieve a level of welfare close to the one attainable with free capital movements, government is, in fact, constrained to mimicking the private market. Therefore capital controls, implying costs discussed before, are justified only if government can avoid or correct strong market externalities.

In practice, the authorities find it very difficult to monitor current account finance timely and through appropriate actions. Government would have to accept risks which are usually borne by the market, and the international market will be more reluctant to absorb exclusively government debt, represented by a limited menu of financial products, rather than a more diversified portfolio of public and private papers.

We observe therefore that all advanced small EMS countries have liberalized foreign capital transactions. Moreover, they tend to follow a hard-currency monetary policy by pegging their currencies to the Deutschmark. The weight of Germany in international trade can be seen as the major reason for this choice.

2.2. Fiscal and monetary policies

In principle, for small countries all has been said by Mundell (1963) and Fleming (1962). Even the shortcomings of the Mundell-Fleming models (fixed prices, absence of expectations, no stock constraints on government debt) are not of great consequence for the issues here.

Any country operating with free capital movements experiences constraints on its conduct of fiscal and monetary policies. For a large country these constraints are however less severe. Whilst its prices and interest rates cannot diverge from parity conditions in equilibrium, it can influence equilibrium prices. For example, if money supply in the United States doubles, the world money supply increases significantly and therefore US interest rates and world interest rates decline.

As to fiscal policy, small countries tend to satisfy a larger share of domestic demand through imports and aggregate demand management operates therefore with a smaller multiplier. This is partly compensated by the fact that fiscal expansion in a large country tends to increase interest rates, leading to crowding-out. This effect is absent in a small country with free capital movements. Therefore, the worst case for the efficiency of fiscal policy in a small country arises with capital controls: a large import leakage is then combined with crowding-out through a rise in interest rates.

Free capital flows affect fiscal policy still in another way. Recently, economists have focused on the issue of debt-neutrality, i.e., the question whether it matters to finance a deficit with higher taxes or with government bonds. If it doesn't then debt is called Ricardo neutral, and the implication of interest here is that a bond-financed increase in government expenditure has the same effect on real variables as a tax-financed increase. In both cases the balanced-budget-multiplier is obtained. This is particularly important for small open economies where the balanced-budget-multiplier is $s/(s + m)$, that is, significantly smaller than unity. Now, debt neutrality requires absence of tax illusion *and* perfect capital markets allowing the private sector to undo the government's action. For example, if government increases taxes to repay its debt, and a perfect substitute for government debt exists, then private agents can replace government bonds with the perfect substitute. Moreover, the tax to be paid is equal to the present value of future tax liabilities which would have been required for services and repayment of the government debt. Thus, if interest rates

are unchanged — as would be the case for a small country and free capital movements — tax liabilities and wealth composition are unchanged and the shift from debt to taxes would have no real effect. Thus, liberalization has potentially the effect to create Ricardo neutrality and hence to reduce the value of the expenditure multiplier.

Thus, with capital controls the small, open economy operates with a small multiplier because there is crowding-out via interest rates; with free capital flows the multiplier seems to be very large because interest rates remain unaffected but this Mundellian argument neglects the Ricardian neutrality effect.

Monetary policy in small countries with fixed exchange rates within the EMS and free capital mobility is seriously limited as demonstrated by the Mundellian analysis. Whilst monetary policy is ineffective as a demand policy tool it remains a useful tool for managing foreign exchange reserves of the central bank. This may be of little social utility compared to the cost of maintaining central bank operations and compared to ambitions of central bank governors — but these are the facts of life.[1]

In summary, the loss of monetary control in small, open economies is reinforced by free capital mobility but not caused by capital mobility. Arbitrage in goods markets is already sufficient to destroy the monetary independence of these countries. However, not all is lost, as fiscal policy, whilst not very powerful for demand-tuning in a very open economy due to import leakages, gains in efficiency from capital mobility. Indeed, foreigners assist in financing deficits, thereby stabilizing interest rates and minimizing crowding-out.

2.3. Safeguard clauses

The arguments in favour of free capital movements are generally accepted in advanced, small, open economies. However, it is sometimes felt that in exceptional circumstances, such as exchange market crises, it would be beneficial to equip monetary authorities with tools to limit speculative capital flows.

The foundations of this argument are debatable. In a flexible exchange rate context, overshooting phenomena may well warrant some means of intervention. But in the EMS any balance of payments crisis is generated by fundamentals which then need to be addressed. Recent experience in Denmark, discussed in the second part of this paper, is of interest here. Capital transactions have been liberalized since 1982 when the country had a major current account deficit. Through a reduction in the fiscal deficit and moderation in monetary growth targets, the authorities succeeded in reversing expectations, in stabilizing the effective exchange rate and in reducing the current account deficit. Liberalization of capital transactions made these corrections easier rather than more difficult.

One could, of course, imagine situations where the market acts 'irrationally' from the point of view of the authorities, for example, as a result of political elections; or, if authorities have privileged information (as they often claim and rarely have) so that the market's and the authorities' interpretations of the sustainability of the exchange rate diverge.

Whilst probably exaggerated, it might reassure monetary authorities to keep safeguard clauses in reserve and, indeed, a more pressing need could arise for large EMS countries. If small countries insist on safeguards, the most efficient solution might be a generalized two-tier exchange market. Taxation is at any rate superior to administrative restrictions. A uniform tax rate renders all transactions below a certain level of profitability uninteresting whereas quantitative restrictions may allow low-profit operations and prohibit high-profit operations.

A two-tier exchange market is like a variable uniform tax on capital imports combined with a subsidy of the same rate on capital exports, if the financial rate depreciates with respect to the commercial rate. If the financial rate appreciates with respect to the commercial rate, then capital imports are taxed and capital exports are subsidized. See Fleming (1974), Decaluwe and Steinherr (1974).

The Belgian experience suggests that the two-tier system works quite well, in spite of the imperfect separation of the two market segments. It should be remembered here that all capital controls are imperfect much as a compliment to the human innovatory capacity. The advantages of the two-tier market can be summarized as follows. First, automaticity: no administrative decision is needed to take any actions. In the absence of tension, the premium of the financial rate will be close to zero and the market behaves like an integrated market. If tensions develop, the financial rate reacts immediately and variably according to the extent of tension. Second, low administrative costs and no discrimination other than between capital and trade transactions. Third, speculative attacks cannot upset trade. Fourth, the brunt of market expectations would be borne by the exchange rate (for capital transactions) and by interest rates. Without the

[1] A minor argument in favour of temporary capital controls was advanced by Johnson (1967). This argument is also mentioned in Claassen and Wyplosz (1985).

movement in the exchange rate, the whole weight would fall on interest rates. This advantage is clearly demonstrated by the Belgian experience discussed in the second part of this paper.

Although a two-tier exchange market might be the least inefficient form of capital control, it would not be efficient to maintain a two-tier market if safeguards are needed infrequently: the administrative cost is to be borne whether there are spreads between the two markets or not. In addition, once a two-tier market exists the Commission or any other body responsible for coordination, such as the Monetary Committee, would have little or no control over the use of capital controls. Individual countries may then rely on the two-tier market in setting their policies. By contrast, with *ad hoc* controls approval would be required and the extent and durability of these controls would be subject to coordinated decision-making.

For these reasons it would seem preferable to use on an *ad hoc* basis quantitative controls or better taxes on exchange operations.

Exchange controls would, of course, be *erga omnes*. However, this would pose a problem for the treatment of the ECU. After all, national currency is part of the ECU and the ECU is a European currency which is expected to become a parallel currency. But the ECU could only be considered as a parallel currency if there are no differential treatments of national currency and of the ECU. It would therefore be natural to except the ECU from temporary capital controls. Liberalization with occasional use of safeguard clauses would then also gain a little specific European dimension.

To fix ideas, consider the case where exchange of national currency (currency A) into foreign currency without an underlying trade transaction is prohibited (or taxed) to protect exchange reserves. If the ECU is excepted currency shifts and capital outflows would then still be possible, but no other EMS member's currency would be directly concerned by this flight into the ECU.

This increase in demand for ECU deposits in country A is not being matched by an increased demand for ECU loans in country A. Therefore there is a net capital outflow in ECU which requires central bank financing either directly in ECU or other reserve currencies, with a concomitant fall in the national money supply. In exchange for excepting the ECU from safeguard controls country A should be able to receive financial support in ECU. This would be similar to the present situation but with some attractive features added. First, support is to be provided by a common pool (the Fecom) and not on a bilateral basis because there would be no specific bilateral problem. Second, country A needs ECU and therefore ECU support is better justified than under present circumstances. Third, the usability problem of the ECU would disappear. If Fecom provides ECU loans of very short run and short-run maturities, an additional advantage would be gained: autonomous official ECU creation. The justification for this step is quite solid: it would only follow the increase in private demand. Of course, if it were desirable to reduce the money supply in country A, ECU assistance would have to be sterilized.

The advantages of such a scheme would be multiple:

(i) The ECU would be considered a liquid currency never constrained by safeguard clauses. Thus, also in tranquil periods the ECU would enjoy an advantage over other currencies;

(ii) any exchange crisis of a particular currency would be confined to that currency *and* would increase ECU assets;

(iii) the exception of the ECU from safeguard exchange controls would introduce a European element into an otherwise perfectly cosmopolitan approach;

(iv) once a resident of country A acquires an ECU he is of course free to exchange it into any other currency because the ECU is freely convertible. Nevertheless it can be expected that a large share of conversions of currency A remain in ECU to avoid twofold transaction costs and because the ECU is *a priori* as attractive as any other Community currency. In the past, weakness of currency A produced flows into currency B (the Deutschmark) and expectations of a devaluation of currency A and a revaluation of currency B. The Deutschmark has been the obvious candidate because several other EMS countries operated exchange controls. After liberalization speculative outflows are likely not to be concentrated on the Deutschmark anymore and thereby the ECU would gain in attractiveness;

(v) the loss of foreign exchange caused by ECU acquisitions could be offset by Fecom assistance — and not as currently is the case — by bilateral assistance.

Capital market integration in Belgium, Denmark and the Netherlands

A traditional counter-argument to international financial integration is that it deprives countries, and more specifically small countries, from any autonomous monetary policy control. Financial conditions and their stability are feared to be influenced more by foreign monetary authorities and private agents than by domestic authorities. The following sections analyse the experience of Belgium, Denmark and the Nether-

lands, and try to determine how, considering their respective evolution since the emergence of the EMS in 1979, these countries have managed their internal and external equilibrium.

The three countries present some strong structural similarities. They are all highly dependent on foreign trade as their imports represent more than 60 % of their GDP and the Federal Republic of Germany, the member country of the EMS with the strongest currency, is the largest trading partner for each of them.

This dependency on the Federal Republic of Germany has been differently managed by these three countries. Belgium found it difficult to peg its currency to the Deutschmark, sometimes at a high cost in terms of competitiveness and financial pressure.

The Netherlands has kept its currency close to the Deutschmark for a long time, even before the EMS. The financial cost of this policy choice has been quite limited, somewhat helped by natural gas which allowed the Dutch economy to maintain a positive current account balance during most of the 1970s and the 1980s, and to stay comfortably rated by the world financial market. Of course, natural gas is not the main explanatory factor. Much more important has been the readiness of Dutch authorities to accept the implications of their foreign exchange policy in setting their fiscal and monetary policies.

Denmark has only recently changed its overall external policy. With the hope to preserve domestic policy autonomy, Danish authorities controlled quite rigorously outgoing and ingoing capital flows for decades. Despite strict financial barriers, the continuous current account deficit and the increasing difficulty to control across-the-border financial transactions without hurting the highly trade-dependent economy resulted in a slow but uninterrupted depreciation of the krone. In 1983, Danish authorities swiftly reversed their stance adopting a strong currency option and liberalizing international capital flows.

1. Belgium

1.1. The dual exchange rate system of the Belgian franc

The BLEU dual exchange rate system exists since 1955. By maintaining a fixed exchange rate for current account transactions and a floating rate for capital account transactions, monetary authorities rendered possible the compliance with the general return to full convertibility while taking advantage of both fixed and flexible exchange rate systems.

Exchange market regulations are based on the distinction between current and capital account transactions. All current account transactions, apart from some invisibles (like tourism) and private transfers, are channelled through the official market where the National Bank of Belgium (NBB) intervenes. Regarding capital transactions a distinction is made between inflows and outflows. The acquisition of foreign financial assets by BLEU residents has always been assigned to the financial exchange market where the NBB does not — at least officially — intervene. Capital inflows, on the other hand, have been allowed to transit through the official market before May 1971 and after May 1983.

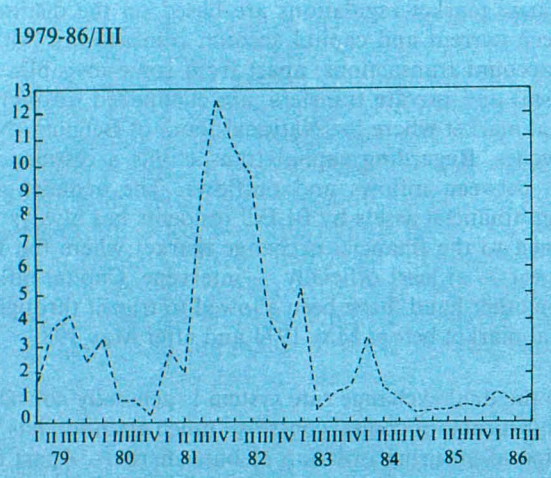
Since the dual exchange rate system is generally considered as a substitute for capital controls,[1] much attention has been devoted to ensuring isolation of both markets. Apart from illegal transfers, the existence of official and financial markets has always left room for arbitrage operations.[2] Without changing the legislation, the Belgian monetary authorities loosen or tighten regulations according to the pressure put on the franc in the financial market. For example, during the second half of 1981 — when anticipations of a devaluation of the franc provoked a record divergence between financial and official rates (see Graph 1) — the NBB set a number of punctual rules to strengthen the separation of both markets. Measures included the limitation of banks' balances in foreign currencies, and the reduction of the authorized time lag between current account transactions and repatriation of the proceeds. By contrast the NBB took an opposite stance after 1984, at a time when the divergence between the two exchange rates had declined to less than half a percentage point: a larger variety of payments has been allowed to transit through either of the two markets at the transactor's will.

1.2. The performance of the BLEU dual exchange market

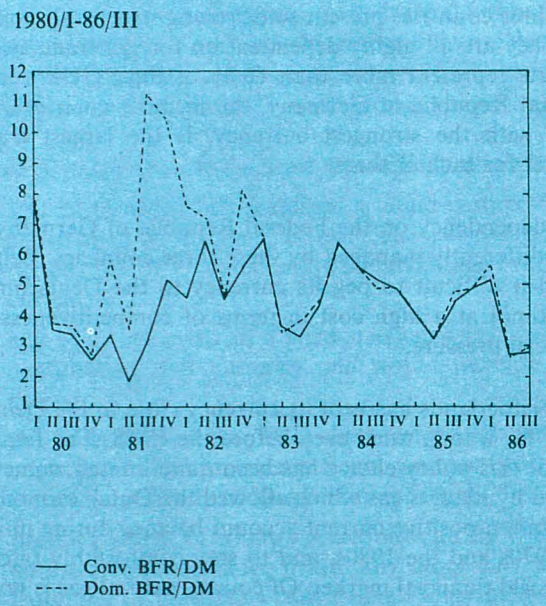
Reding (1985) evaluated the performance of the BLEU exchange market by comparing the fit of the covered interest rate parity using the financial exchange rate on the one hand, and the official exchange rate on the other hand: should the interest rate parity condition perform as well on the official market as on the financial market, it could be concluded that the dual market did not in any way provide

[1] Fleming (1974), Decaluwe and Steinherr (1976).
[2] Decaluwe and Steinherr (1974) provide empirical evidence.

GRAPH 1: **Belgium: The financial exchange rate discount on the official exchange rate**



GRAPH 2: **Interest rate differential: Belgium — Germany**



insulation from foreign disturbances or enhance control over domestic interest rates'.[1]

Using various estimation procedures, Reding concludes that the covered interest rate parity relation holds across currencies (notably the US dollar and the Deutschmark) but not across markets (official and financial). Whilst the financial exchange and interest rates adjusted fairly well in order to maintain the parity with the foreign interest rates, the two-tier exchange system has allowed the NBB to maintain during the turbulent period of 1981-82 the domestic interest rate far below what it would have been in an environment with fixed exchange rates and a unique exchange market.

This is illustrated in Graph 2 which traces two interest rate differentials. One is the differential between domestic Belgian and German 3-month deposit rates; the other is the differential between convertible Belgian and German 3-month deposit rates.[2] The gap between these two differentials is a measure of the required additional increase in domestic interest rates in the absence of a dual exchange market. In December 1980, the interest rate differential with respect to Germany would have jumped to more than 11 %, instead of the 5 % actually realized. During calm periods (from mid-1983 onwards) convertible and financial interest rates are virtually identical, as are official and financial exchange rates. Thus, one practical advantage of the dual exchange system is that during turbulent periods, domestic interest rates rise less than otherwise, because the spot financial exchange rate adapts sufficiently to equate covered returns without a major rise in interest rates.

It thus appears that the two-tier market fulfills quite well its advocated insulation role during exchange market unrest — i.e. when parity changes are anticipated. During these periods, market separation has been sufficiently efficient to prevent complete arbitrage between them and to allow the NBB to keep some control on both the official exchange and domestic interest rates. Symmetrically, during tranquil periods, the NBB loosens the regulation scheme thus permitting a better osmosis between the two compartments of the exchange market.

One should however not consider the evidence presented above as absolute reference. A careful analysis of the BLEU

[1] Reding (1985), p. 12.

[2] Convertible Belgian franc deposits are deposits by non-residents convertible at the official rate. Interest rates reflect therefore that part of the devaluation risk already incorporated in the discount of the financial rate.

balance of payments during the crisis period of 1981-82 shows that the NBB interventions in the official foreign exchange market have been supported by the Belgian Government's massive recourse to borrowing in foreign currencies.

Whether the two-tier exchange rate system shielded, at least partially, the domestic economy from disturbances in the foreign exchange market seems little questionable. Another concern is whether the legal freedom of across-the-border capital transactions has led to an effective capital integration of the BLEU with the rest of the world.

1.3. Capital integration and banking activity

The international role of Belgian banks is much more important than what could be expected according to domestic market size. Graph 3 shows the share of foreign liabilities and domestic liabilities in foreign currencies in the consolidated balance sheet of the Belgian banking system compared with the German and British banking systems. Considering the historical background of London as a financial centre, the international dimension of the Belgian banking system is quite remarkable and certainly not unrelated to the absence of direct capital controls. In recent years, a little more than half of banking activity in Belgium has been developed with non-residents. Taking into account the liabilities in foreign currencies with respect to residents, over 60 % of the liabilities of Belgian banks are related to foreign transactions.

Belgian financial institutions are obviously keen to develop their role as intermediaries. This raises some awkward policy questions as a systematically large net position would suggest that banks offer an efficient channel for net capital outflows and inversely in the case where liabilities to non-residents outweigh foreign assets.

During turbulent periods the NBB severely constrains bank positions in foreign currencies — generally with respect to non-residents — and it is clear that banks try to match, over the long run, their foreign assets and liabilities. It is therefore not easy to determine whether and to what extent financial institutions' foreign activities are significantly isolated from domestic intermediation. Nevertheless, recent experience based on the evolution of bank positions with respect to their foreign correspondents suggests that, without considering short-run adjustments during turbulent periods, the Belgian private banking system has systematically provided the domestic economy with foreign funds. Table 1 indicates the net external investment position of Belgian commercial banks since 1970. From a relatively modest net debtor position during the early 1970s, banks have massively borrowed funds abroad to reach a net negative foreign position of more than BFR 1 100 000 million in 1986 (comprising both domestic and foreign currencies).

1.4. Real capital flows

The integration of commercial banks in the international financial market is not sufficient to guarantee the integration of the whole economy. As argued before, perfect capital mobility goes well beyond strictly defined financial integration and allows savings and investment decisions to be completely dichotomized. In an environment with complete capital mobility domestic investment is not constrained by domestic savings as capital flows to countries where it obtains the highest reward.

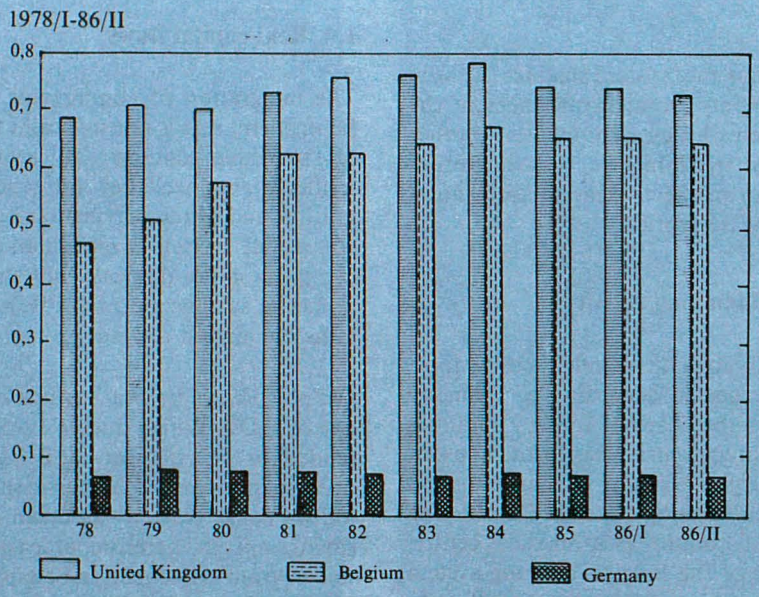
Graph 4 shows Belgian savings and investment as a percentage of GDP. Whilst during 1975-84 savings and investment tended to be collinear in Belgium, the level of domestic investment exceeded domestic savings for an eight-year period, in some years by as much as 4 % of GDP. Domestic savings appear therefore, at least over the medium term, not to constrain investment in Belgium. During 1976-85 financial inflows allowed Belgium to maintain a higher level of domestic investment than would have been possible without capital mobility.

1.5. Capital mobility and the balance of payments

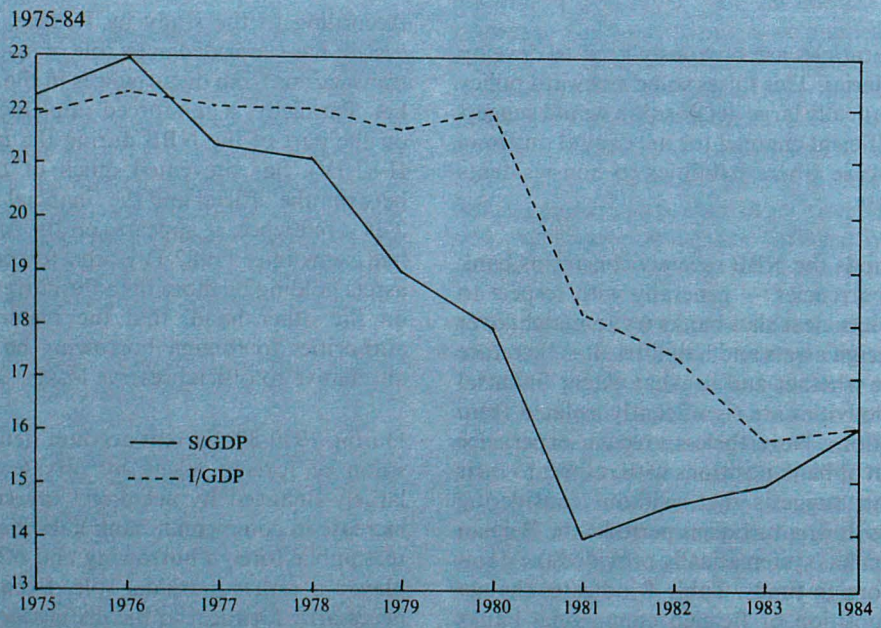
According to the study by Reding, the two-tier exchange system has succeeded in its role of insulating current account transactions from disturbances in the foreign exchange market. Parallelly, a reinforced implementation of regulations on the part of the NBB during the turbulent period (1981/II-82/IV), has prevented much of the potential arbitrage between the official and the financial markets. Taking Table 2 as a reference, it appears, on the one hand, that the NBB had sometimes (1982/IV) been forced to reduce its foreign assets holding by more than the current account deficit, and, on the other hand, that the massive recourse of public authorities to foreign borrowing has been an appreciated alternative to official reserve losses.

During 1979-80, current account deficits and the net acquisition of foreign assets by private non-banks have been largely financed by net direct investment inflows and the increase in commercial bank liabilities to non-residents. Direct public foreign borrowing and official intervention have played a rather marginal role. Even if this division is not necessarily identical to the distinction between autonomous and accommodating capital flows, the absence of direct capital controls did not produce unsolvable balance of pay-

GRAPH 3: **Foreign liabilities and domestic liabilities in foreign currencies as a percentage of the banking system's balance sheet in Belgium, Germany and the United Kingdom**



GRAPH 4: **Savings and investment in Belgium**



ments problems during the period preceding the 1981-82 crisis.

Whilst the current account deficit jumped to a cumulated record high of BFR 315 000 million in 1981 and 1982, its financing has changed in an essential way as Belgian authorities faced the financial market's lack of trust in the franc. After channelling funds from abroad during the preceding period, banks augmented massively their net foreign assets since the beginning of 1981 (see Table 2b).

This dramatic reversal may certainly be explained by the fact that private non-banks augmented dramatically their assets in foreign currencies deposited with banks, which led the latter to raise their holdings of foreign assets above the level they would have reached autonomously. The relatively limited change in non-banks' foreign assets during the speculative months of 1981 is thus seen as the consequence of anticipations.

The necessity to support the franc led Belgian public authorities to increase their direct recourse to foreign capital. Starting from early 1981, they borrowed in one single semester more than during the two previous years. *Ex post*, capital inflows through public operations financed more than half of the current account deficit in 1981, and overfinanced it in 1982, preserving thereby official reserves from an unsustainable contraction.

Table 1

Belgium: Net external investment position of commercial banks

(In billion BFR; at end of period)

	1970	1975	1980	1981	1982	1983	1984	1985	1986/1
Foreign assets	246	703	1 913	2 690	3 085	3 684	4 517	4 665	4 488
of which in BFR	33,4	67	118	135	158	184	221	239	253
Foreign liabilities	287	796	2 300	3 196	3 677	4 462	5 449	5 687	5 604
of which in BFR	50	162	354	349	361	368	459	531	570
Net investment position	−41	−93	−387	−506	−592	−778	−932	−1022	−1 116

Source: Bulletin of the NBB.

Table 2a

Belgium: Balance of payments 1981-82

(quarterly, in billion BFR)

	1981				1982			
	I	II	III	IV	I	II	III	IV
Current account	−36	−60	−49	−54	−51	−54	3	−15
Fgn. direct invest. (net)	11	34	−4	10	2	35	5	29
Public foreign borrow.	32	27	16	33	43	40	32	2
NFA non-banks[1]	20	16	−9	−8	−19	−40	−10	−6
NFA com. banks[1]	−34	−12	6	5	14	−2	30	−78
NFA NBB[2]	−47	4	−40	−13	−11	−20	60	−67
Com. credit	−12	−22	−5	−27	21	2	−13	10

[1] (−) = increase.
[2] (+) = increase.

Source: NBB, monthly and annual reports.

Table 2b

Belgium: Balance of payments (1978/I – 86/I)

	1978	1979	1980	1981	1982	1983	1984	1985	1986/I
1. Current account	−23	−92	−164	−198	−116	−39	−1,5	13	16
2. Fgn. direct invest. (net)	29	−3	41	49	67	47	4,5	43	−2
3. Public foreign borrow.	13	4,3	26	107	129	29	83	18	40
4. NFA non-banks[1]	−50	−31	25	−17	−82	−75	−107	−105	−40
5. NFA com. banks[3]	22	87	85	−11	−35	15	70	28	−20
6. NFA NBB[2]	−16	32	27	−96	−38	−22	67	−8	1
%(1) + (3) −(6)	6	−56	−111	5	51	12	14	39	55

[1] (−) = increase.
[2] (+) = increase. This entry does not comprise discounted commercial credits.
[3] Errors and omissions have been included in banks' capital flows.

The 1982 financing scheme is similar. The devaluation in February did not stop the speculative position against the franc with stayed under pressure until the June realignment amongst EMS currencies. Massive direct investment inflows and foreign public borrowing associated with an improvement of the private non-banks financing capacity, allowed the latter to reduce their foreign borrowing and, simultaneously, to raise their holdings of liquid foreign assets. Again, banks channelled — during the fourth quarter — flows abroad to cover domestic deposits in foreign currencies and autonomous spot positions despite the renewed public borrowing in foreign currencies.

The proceeds of the public authorities' borrowing in foreign currencies are exchanged with the NBB which utilizes them to intervene in the foreign exchange market, realizing thereby a sterilized intervention. The excess of public net foreign borrowing plus the net use of the NBB's international liquidity in relation to the current account deficit indicates that exchange market segmentation has never been complete and that several capital operations — such as leads and lags and financial transactions by non-residents in convertible francs — have been channelled through the official market. But, considering its amplitude, it also suggests that the NBB intervened non-marginally in the free financial exchange market.

It remains, nevertheless, that by assigning most of the private capital flows to the financial market, the two-tier exchange market appears, *ex post*, to have helped Belgian authorities to circumvent the tensions at a manageable level.

1.6. Conclusion

The BLEU has ceased to impose direct capital controls since the general return to convertibility in Europe in 1958.[1] Instead, monetary authorities set up a two-tier foreign exchange market whose advocated purpose was — and still is — to shield real flows from disruptive financial disequilibria. The separation between the official and financial markets is rather loose during quiet periods but is strengthened when the franc comes under heavy pressure.

Although both the domestic and the Euro-franc markets are modest in size, the absence of stringent capital barriers has permitted banks in Belgium and Luxembourg to massively develop their foreign currency and across-the-border operations which now represent the major part of their activity. This intermediary role of the banks benefited the domestic economy as financial institutions have continuously, over the last 15 years, channelled funds from abroad.

Statistics cannot offer a definite answer as to whether the immersion of Belgian banks into the world financial market suppressed all fund shortages in the domestic economy.

[1] One of the last marginal restrictions to capital flows has been recently lifted (in May 1987), which suppresses any discrimination 'en matière d'émission publique ou de demande de cotation à une bourse belge de titres créés par des personnes, sociétés ou institutions relevant d'un autre État membre de la CEE'.

Investment does not seem however to be constrained by the availability of domestic savings, which may indicate that most of the profitable investment opportunities are financed either domestically or internationally. Profitability remains, of course, constrained by world market interest rates.

Belgian monetary policy has been driven over the last 10 or more years by the external constraint, that is by the attempt to maintain the franc parity with the Deutschmark. However, the policy objective of pegging the Belgian franc to the Deutschmark has been incompatible with the increase in wage costs relative to Germany. Until wage-indexation was scaled down to support the devaluation in 1982, growth of labour costs in Belgium diminished competitivity of Belgium's trading sector and led to several exchange market crises. The last episode is the 1981-82 period sanctioned by a devaluation of about 10 %. During this turbulent period the NBB reinforced the separation of the dual exchange system and prevented most of the potential arbitrage between the two markets. Parallelly, public authorities massively tapped foreign banks and supplied the NBB with additional foreign exchange. Considering the volume of the funds leaving the BLEU during these two years and the implicit but delayed cost attached to the public borrowing in foreign currencies, the dual exchange system appears, *ex post*, to have helped in preventing a more expensive crisis.

2. Denmark

2.1. The removal of capital controls

After 1961, Denmark adopted the liberalization codes set by the OECD concerning payments associated with current account and certain capital account transactions. On the occasion of its accession to the EEC in 1973, Denmark became subject to the EEC's capital directives to which she complied partially according to the Executive Order on the Foreign Exchange Regulations of March 1981. Beyond these measures, Denmark maintained until recently extensive controls over foreign capital transactions.

Along with the growing recognition within the EEC that capital controls may have become largely inefficient and probably counter-productive in today's integrated world financial market, Danish authorities engaged in a broad liberalization process. The Foreign Exchange Regulation Order has been amended in 1982 and 1985, in order to free most of the private capital movements from quantitative barriers.[1]

In this section,[2] the main aspects of the liberalization process are reviewed according to the EEC classification code regarding categories of capital transactions.

List A:

Direct investment, loans and credits related to current account transactions:

This category has been basically liberalized already before the accession to the EEC. The amount of inward direct investment below which no formal permission from the Ministry of Industry is needed was increased from DKR 1 million to DKR 2 million per calendar year in 1982, and again to 10 million in 1985. On the other hand, the payment threshold for direct investment which residents can make abroad without specific permission — from the Nationalbank this time — has been raised from DKR 200 000 to DKR 500 000 in 1982, to DKR 2 million in 1983 and further increased to DKR 10 million in 1985. Direct investments requiring permission are normally approved in accordance with Denmark's obligations as a member of the EEC and of the OECD. Outgoing investment in purely financial institutions is however still subject to tight control.

List B:

Portfolio transactions (quoted securities):

A gradual liberalization of non-residents' purchase of exchange-listed kroner bonds was initiated in 1971 while sales of exchange-listed shares to non-residents were deregulated overnight on Denmark's entry into the EEC. A temporary ban on purchases of Danish government bonds was lifted in 1983. The only essential restriction still in application covers non-residents' purchase of Danish treasury bills which are regarded as money-market securities.

Following the transitional period, Danish residents were permitted, from the beginning of 1978, to buy exchange-listed bonds issued by international organizations of which Denmark was a member. On 1 May 1983 the rules were liberalized further, general access being granted to purchase foreign exchange-listed bonds with an original maturity exceeding two years. Since the beginning of 1984 Danish residents are allowed to buy foreign exchange-listed shares, as well as Danish bonds denominated in a foreign currency.

[1] Public capital operations are, for their part, managed discretionarily by the Danish public authorities.

[2] The exposition of the liberalization measures has benefited from J. Ovi (1985). In the meantime. Lists A and B were merged according to the Directive of 17 November 1986. See the *Official Journal of the European Communities* of 26 November 1986.

List C:

Portfolio transactions (unquoted securities):

Since 1983, non-residents have free access to all types of Danish shares while previously they could only buy exchange-listed securities.

After recommending banks to avoid involvement in financial constructions, aimed at tax evasion, the Danmarks Nationalbank has, since June 1985, accommodated specific applications from residents to acquire unlisted foreign securities including shares and certificates in foreign investment associations.

The issuing and placing of securities:

Since 1 January 1984 residents are allowed to issue Danish securities for subscription or sale abroad and have free access to Danish bonds denominated in a foreign currency.

Financial loans:

While companies[1] were previously granted only limited access to borrowing abroad — foreign loans, with a minimum maturity of five years, were restricted to finance fixed investment — the link to investments was dropped in May 1983, and the required minimum period was in 1985 reduced to one year.

Residents are still, as a general rule, not allowed to grant loans to borrowers abroad — except commercial credits. The Danmarks Nationalbank noticed however that this rule has had no particular effect, as interest rates have been higher in Denmark than abroad.[2]

More generally, the threshold for transactions for which permission is not required or which do not have to be reported for statistical purposes was increased from DKR 10 000 to DKR 25 000 in 1983 and again to DKR 40 000 in 1985. Parallelly, rules governing forward exchange transactions were largely liberalized in 1984.

[1] Activities of banks, stockbrokers and mortgage credit institutions are still severely controlled. In principle, banks are prohibited to maintain net indebtedness abroad and their net credit balance cannot exceed 15 % of equity subject to a maximum of DKR 2 million.

[2] The Danmarks Nationalbank, annual report, 1983, p. 54.

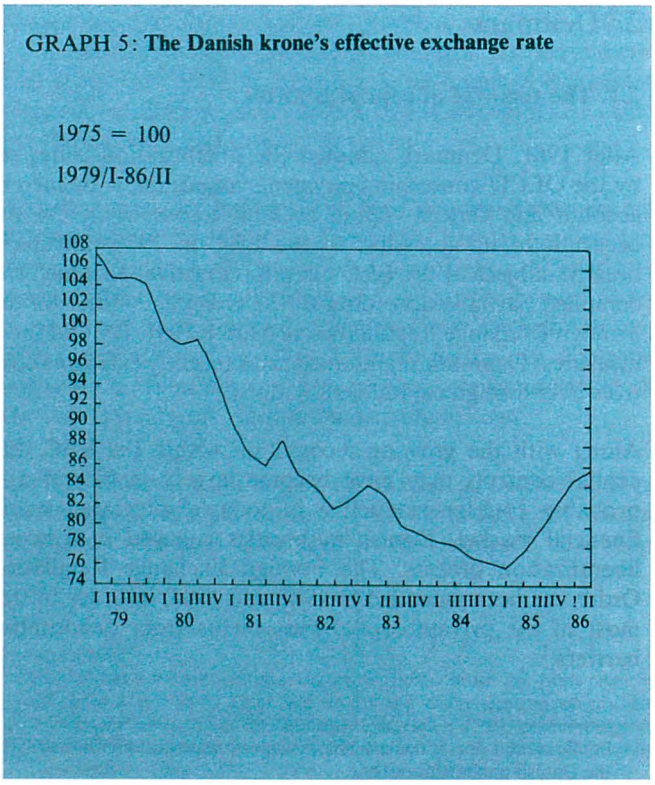
2.2. The financial environment of the liberalization

The recent Danish experience of financial liberalization offers an opportunity for testing some of the arguments raised against liberalization of across-the-border capital transactions. We shall restrain the following section to the balance of payments and exchange rate situation of Denmark at the time of liberalization, namely the period 1980-82.

In the first half of the 1970s the krone's nominal effective exchange rate appreciated steadily with respect to its industrialized partners but from the beginning of 1979 until September 1982, after a period of relative stability, it lost about 22 % of its value (Graph 5).

Even if this development owes much to the appreciation of the US dollar over this period, the krone's recurrent weakness during that period is also observable with respect to the Deutschmark, which is frequently used by Danish companies as borrowing currency. From January 1979 until the second half of 1982, the krone depreciated by 24 % with respect to the currency of Denmark's largest trading partner (Graph 6). Three readjustments of the krone's exchange rate

GRAPH 5: **The Danish krone's effective exchange rate**



against the other EMS currencies occurred during the same period.[1]

Even with relatively constraining capital controls, the interest rate differential with respect to the FR of Germany adjusted for expected depreciation, stayed largely positive, illustrating the low efficiency of existing controls for sheltering the domestic economy (Table 3). Adjusting for the market's expectations of the krone's depreciation against the Deutschmark,[2] the Danish domestic rate of interest presented constantly throughout the period a positive differential of 4 to 5 percentage points. In the light of several effective devaluations and the fear of future realignment, foreign lenders were apparently unwilling to increase their net assets in kroner while domestic companies were reluctant to finance the repayment of their old foreign debts by new foreign borrowing.

In connection with the government's policy of demand stimulation since the autumn of 1975, the current account deteriorated substantially and continuously over the period under review. The external balance deficit has been a recurrent problem for the Danish economy and it reveals a structural disequilibrium between domestic absorption and domestic supply rather than a competitivity problem. As appears in Graph 7, the situation owes much to the structurally high investment rate compared with domestic saving.

More than the current account deficit itself, its financing has significantly changed over the period 1980-82 compared with the previous years. Foreign borrowing by domestic companies — which includes intra-group loans — financed over 30 % of the current deficit in 1978-79 while non-residents' acquisition of domestic securities (mainly government bonds) provided ingoing financial flows. The massive recourse by the Danish Government to direct foreign borrowing overfinanced the deficit and allowed the Danmarks Nationalbank to increase its net foreign reserves.

The swift increase in the balance of payments deficit in 1980 was exclusively due to private financial transactions. After the two devaluations in 1979, business was not disposed — in spite of favourable interest differentials — to raise additional funds abroad. Accordingly, net incoming financial loans almost dried up in 1980 and completely reversed in 1981 and 1982. Parallelly, in February 1979, the Danish Government put a ban on the purchase by non-residents of government bonds that produced its maximal effect in the 1980-82 period. The circulation of government bonds abroad declined both through sales and redemptions, while foreign investors' interest in Danish bonds decreased. Residents, on the other hand, who had shown no special desire to purchase foreign bonds before, increased their net detention by DKR 1 200 million during the September-October 1982 crisis. Cumulated over the three-year time span, portfolio operations added to the external deficit. Consequently, and in order to prevent a major loss of international reserves, public foreign borrowing jumped dramatically — from DKR 5 705 million in 1979 to DKR 25 618 million in 1982 — although not sufficiently to preserve official foreign exchange reserves.

To sum up, the external financial position of the Danish economy was relatively negative at the time the decision to liberalize capital movements was taken. The traditional argument according to which, in a fixed exchange rate environment, only favourably positioned economies can liberalize across-the-border capital transactions without suffering an unsustainable loss of foreign official reserves, was far from being verified. The following section thus focuses on the balance of payments implications of liberalization.

2.3. The balance of payments reactions to the removal of capital controls

Towards the end of 1982, the Danish monetary authorities opted for a non-accommodating exchange rate policy which was supported by a tightening of fiscal and revenue policies. In connection with the deceleration of inflation, the current account deficit noticeably declined in absolute terms (Table 4) and even more in relative terms from 4 % of GDP in 1982 to 2,1 % in 1983. This improvement was, however, shortlived and the current account deficit in relation to GDP reached 4,4 % in 1985, the year of the second liberalization phase. Preliminary data for 1986 indicate a further worsening as the current account deficit reaches DKR 34 600 million, equivalent to approximately 5 % of GDP.

Whilst the removal of capital controls had almost no effect by itself on current account transactions,[3] it had far-reaching consequences for their financing. The ban on foreign sales of government bonds was lifted in May 1983 as non-residents gained free access to all types of Danish securities. The hard-currency stance adopted by monetary authorities in

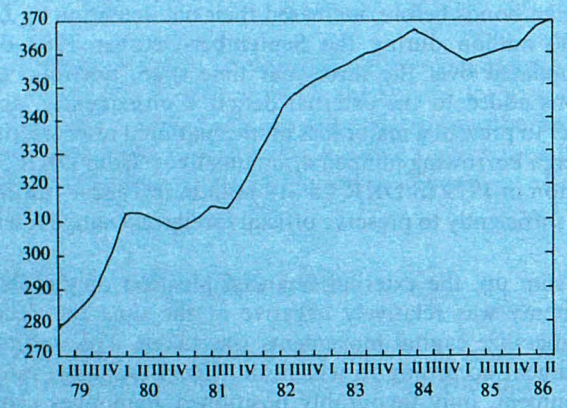
[1] The krone was devalued on 24 September 1979, 30 November 1979 and 22 February 1982. It was also devalued indirectly against the Deutschmark when the latter was revalued on 5 October 1981 and 14 June 1982.

[2] This adjustment is considered as a measure of the market's expectations of the depreciation of the krone against the Deutschmark. Expectations are assumed to depend on the difference between the inflation differential and the actual depreciation of the krone.

[3] This need not necessarily be the case if domestic investment is constrained by the availability of domestic funds.

GRAPH 6: **Index of the Deutschmark's value in Danish kroner**

1979/I-86/II



GRAPH 7: **Savings and investment in Denmark**

1975-84

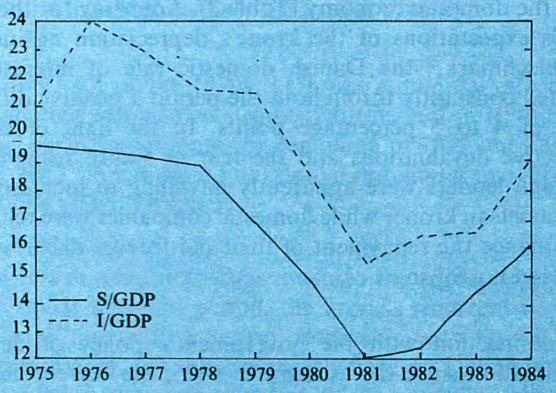


Table 3

The Danish krone's depreciation, bond yields and inflation differential (Denmark—Germany)[1]

	Interest differential	Inflation differential	Depreciation	Interest differential adjusted for		
				Inflation differential	Depreciation	Average
1979	8,85	7,70	4,57	1,15	4,29	2,72
1980	10,04	6,63	8,01	3,41	2,03	2,72
1981	8,27	5,35	1,63	2,92	6,64	4,78
1982	10,43	4,61	8,96	5,83	1,47	3,65
1983	6,93	3,49	4,28	3,44	2,66	3,05
1984	6,44	3,80	1,62	2,64	4,82	3,73
1985	4,87	2,47	− 1,05	2,40	5,92	4,16
1986/II	4,43	6,93	2,36	− 2,50	2,07	− 0,21

[1] This table is constructed from C.F. Jensen and J. Hald (1986).

Table 4

Denmark: Balance of payments (1978/I-86/I)

(in billion DKR)

	1978	1979	1980	1981	1982	1983	1984	1985	1986/I
Current account balance	−8 345	−16 065	−13 400	−12 270	−19 230	−12 775	−17 720	−27 960	NA
Fgn. direct invest. (net)	129	173	−145	−312	616	3	−2 354	−1 384	−782
Public foreign borrowing	7 885	5 705	10 025	8 880	25 618	17 417	−5 686	4 297	318
Portfolio inv.[1]	1 999	3 015	−457	511	−1 213	2 876	7 365	13 751	−11 111
Loans and other cap. flows[2]	3 820	7 671	1 952	−2 200	−8 253	−332	14 931	24 938	NA
Official reserves[4]	5 488	499	−2 025	−5 391	−2 462	7 189	−3 464	13 642	NA
Com. credit[3]	−236	−2 351	−1 042	−201	123	−3 225	−13 923	3 740	1 246

[1] (−) = outflows.
[2] (+) = increase.
[3] (−) = net from abroad.
[4] Incl. discrepancies.
Source: Nationalbank Review.

combination with continued high positive interest rate differential certainly gave a strong incentive to non-residents to take advantage of capital liberalization. Effectively, the portfolio balance moved rapidly into a surplus amounting to about DKR 24 000 million during 1983-85. Similarly, the successive easing of companies' financial borrowing abroad resulted in a complete reversal of capital movements from net outflows to increasing net inflows, amounting in 1985 to a flow of DKR 34 237 million into the domestic economy.

Because the reversal of private capital flows tended to finance a greater part of the current account deficit and despite increasing direct investment abroad, government had the opportunity to start redemptions of previous expensive borrowings, producing a net public financial outflow in 1984. Meanwhile, Danmarks Nationalbank more than restored its net foreign assets holdings after three years of continuous strain.

As to foreign loans and securities transactions, it appears that despite a negative starting situation, the easing of the former in connection with a firm exchange rate policy resulted in massive inward capital flows while the liberalization of the latter has not given rise to sizeable capital movements, except for the acquisition by non-residents of krone bonds.

Figures for 1986 are still partial. However, they suggest that, partly due to concern about the krone's exchange rate stability, sales and purchases of Danish government bonds by foreign investors have been almost equally balanced and that Danish companies have been paying back old foreign debts while raising new funds in domestic currency. Similarly to the 1980-81 period, with the private sector not filling the current account gap, the government had to import capital directly from abroad at an accelerated pace.

2.4. Interest rates and financial liberalization

The most spectacular change occurred in 1983 in the interbank money market where interest rates fell by approximately 8 percentage points during the second quarter, when the first liberalization measures came into force (Graph 8). Even if a slight increase occurred in the subsequent period, the declining trend resumed in early 1985, at the time of the second step towards financial liberalization, and money market rates reached a level as low as 8,66 % in February 1986.

Interest rates followed closely the reduction in inflation rates. The consumer price index decelerated from more than 12 % in 1980 to less than 4 % over the June 1985 to June 1986 period. This reduction outdid the pace of Germany's disinflation, which brought the inflation differential from 7,7 % in 1979 to 2,5 % in 1985. Since the krone has only slightly depreciated with respect to the Deutschmark over the last three years, the interest rate differential adjusted for inflation-depreciation has been maintained at a relatively high level. This explains, at least partly, that the capital liberalization measures have drained funds from abroad.

Symmetrically, the widening of the inflation gap since the beginning of 1986, associated with the firm-currency stance

developed by the Danish monetary authorities, has reduced the adjusted interest differential which, during the first semester, has become negative. Accordingly, and also for foreign exchange uncertainties, domestic companies have not been induced to refinance their borrowings abroad.

The evolution of bond rates is similar. Although they did not decline sharply over any limited period of time, the long-run trend has been continuously negative for the last five years, and the gap between 1982 — when bond rates peaked at more than 20 % — and the low 9,88 % recorded in March 1986 is quite impressive. The prospects for 1986 suggest that interest rates have adjusted upwards as the Danish current account sharply worsened and private capital flew out of the country.

Graph 9 shows that after erratic movements of the spread between domestic and Euro-rates following liberalization, spreads became negligible after liberalization.

2.5. Conclusion

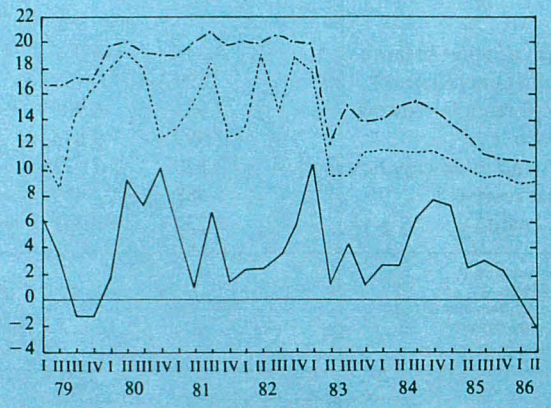
Although it is certainly not possible to attribute the evolution of financial markets and of the balance of payments to the sole removal of across-the-border capital controls, it is important to note that, while financial liberalization has been endeavoured in a non-favourable environment, it did not produce unsustainable capital outflows. On the contrary, monetary authorities dismantled exchange controls, adopted a 'hard-currency' stance, managed to curb the krone's depreciation rate with respect to the Deutschmark, and succeeded in redirecting private capital flows from a net outflow to a net inflow, and in reconstituting its foreign reserves.

The situation in 1986 may prove less idyllic but it presents many structural similarities with the pre-liberalization period: a deepening of the current account deficit and widening of the inflation differential. There is however no reason to believe that the financial liberalization has produced these difficulties or is even aggravating them. Indeed, the terms Denmark has been able to obtain for her recent borrowings in the Euromarket corroborate the view that the removal of capital barriers has not produced a negative impact on the financial market's perception of the Danish credit quality and the underlying economic fundamentals.[1]

[1] As an example, in early August Morgan Guaranty led a USD 1 000 million floating rate notes issue for Denmark which paid 1/8 below six-month Libid.

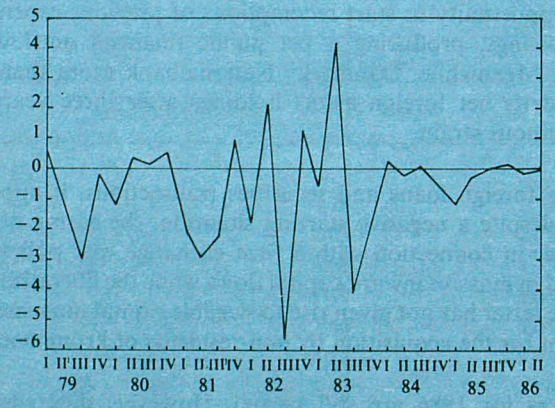
GRAPH 8: **Money market interest rates and bond yields in Denmark and Germany**

1979/I-86/II



GRAPH 9: **Denmark: Interest rate differential between 3-month domestic and Euro-krone rates**

1979/I-86/II



The Danish experience supports, however, a fact which became also apparent from the Belgian experience: if fundamentals (demand policies or wage pressure) generate current account deficits, the market expects realignments of the exchange rate. Either domestic interest rates reflect these expectations or when monetary authorities attempt to prevent a rise in domestic interest rates, private capital flows will be insufficient for financing the current account deficit. Governments are then induced to borrow directly abroad, instead of borrowing in the domestic market. In the process the money supply is being increased and the upward movement of interest rates is further delayed.

These experiences demonstrate the obvious: it is impossible to peg the exchange rate, peg the interest rate and to pursue autonomous demand and wage policies at the same time.

3. The Netherlands

3.1. The external monetary policy

Natural gas has brought the Netherlands to a special position in the Community not only for matters concerning energy but also for international adjustment problems. The direct impact of natural gas production on Dutch exports associated with the impact of the substitution process on imports has contributed, since the beginning of the 1970s, to maintain the current account balance in surplus except for the years 1978 through 1980.

The main target of the Dutch authorities has been to gear monetary policy towards the external constraint. Imports represent approximately 60 % of GDP and more than 20 % comes from Germany, the Netherland's largest trading partner. Since the beginning of the snake in 1972, monetary authorities have tried to maintain a stable exchange rate *vis-à-vis* the Deutschmark. This policy target has forced the Nederlandsche Bank (NB) to undertake unsterilized interventions in case of strong pressure on the guilder's exchange rate.

The guilder has always kept a strong position in the EMS. Apart from the weeks surrounding the 2 % realignment *vis-à-vis* the Deutschmark in September 1979 and March 1983, it showed only two periods of relative weakness — in the first half of 1981 and the beginning of 1982 (see Graph 10). Parallelly, the guilder's effective exchange rate has uninterruptedly appreciated and gained more than 15 % between 1979 and 1986.

Capital has been nearly free to flow inwards and outwards and the Dutch authorities have steadily reduced remaining barriers. Accordingly, rules concerning commercial banks' external position was eased in 1980 and the rules governing permission for capital imports by the private sector were significantly relaxed after July 1981.[1]

In the absence of strict capital controls, the NB has continuously maintained its control over interest rates in the money market either by acting on the official discount rate or by modifying the liquidity of the banking system through unsterilized interventions, reserve quotas and foreign exchange swaps with private commercial banks. Taking into account the exchange rate target, Dutch monetary policy has consisted in keeping domestic interest rates close to German interest rates. Graph 11 shows that the interest rate differential between the Netherlands and Germany has been modest from 1979-86 except during turbulent periods such as the months following the September 1979 devaluation when the differential jumped to more than 5 %. The other periods of exchange rate unrest are marked by a negative differential rapidly followed by a rise of the Dutch interest rate.

3.2. The Dutch balance of payments structure

The Dutch current account balance has been largely positive during 1978-86/I, except for the three first years. Accordingly, monetary authorities have been much more concerned about controlling capital inflows which were a potential source of domestic liquidity increase, of inflation and thereby a potential threat for the guilder's exchange rate stability.

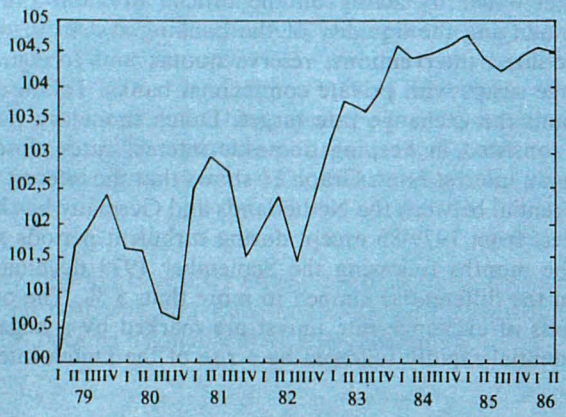
Table 5 shows the structure of current account financing. Partly due to the decline in capital productivity, direct investment abroad has represented an important share of outgoing funds, not matched by foreign direct investment in the Netherlands.

Contrary to what happened in Belgium and Denmark at times of widening current account deficits, foreign public borrowing has never been an instrument devoted to shielding official reserves. A very restrictive course of monetary policy during 1977-81 led private banks and non-banks to increase their foreign borrowing, taking advantage of relaxed controls and of the interest rate differential.

[1] As an illustration, the latter relaxation entails that the NB is prepared to grant permission on application for raising funds abroad by the private sector with a maturity of at least two years (previously 7 to 10 years) provided that the rate of interest has been fixed for those two years. The restrictions imposed on private foreign borrowing constituted one of the measures taken by the Dutch monetary authorities to control domestic liquidity over the period 1977-81.

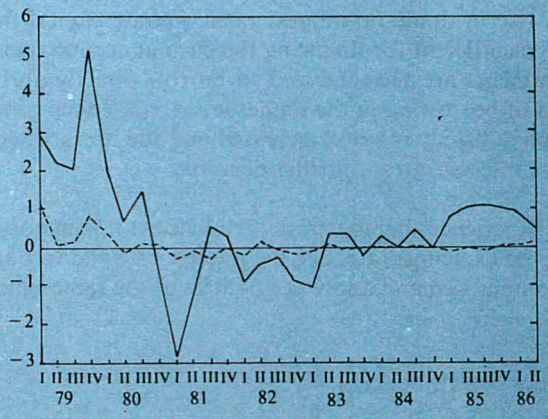
GRAPH 10: **Guilder value of the Deutschmark**

1973 = 100
1978/I-86/II



GRAPH 11: **Interest rate differential: Netherlands — Germany**

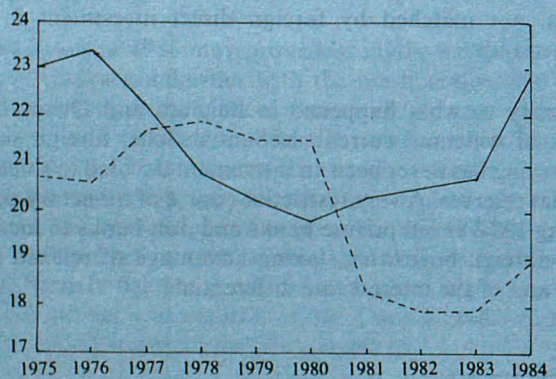
1979/I-86/II



--- Differential adjusted for forward premium
—— 3-month interbank rate differential

GRAPH 12: **Savings and investment in the Netherlands**

1975-84



—— S/GDP
---- I/GDP

GRAPH 13: **Interest rate differential: domestic — Euro-guilder (3 months)**

1979/I-86/II

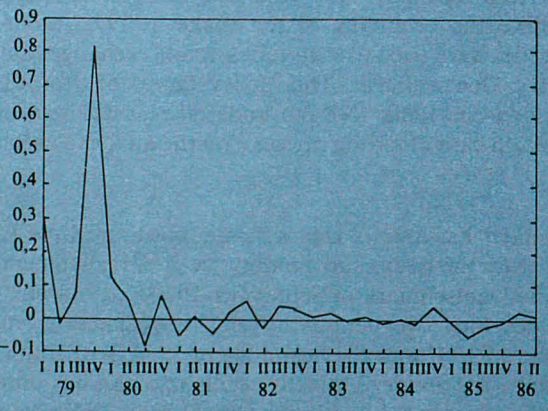


Table 5

Netherlands: Balance of payments 1978/I-86/I

(in billion HFL)

	1978	1979	1980	1981	1982	1983	1984	1985	1986/I
Current account	−2 686	−3 867	−4 900	7 764	11 638	12 007	16 611	18 814	3 375
Fgn. direct invest. (net)	−2 082	−1 756	−2 981	−4 859	−4 610	−3 801	−6 586	−9 120	−831
Public foreign borrowing	−59	−521	−180	−480	240	−189	−580	19	−461
NFA non-banks	274	1 390	1 569	−1 481	−5 716	−3 551	−7 869	−5 768	−2 489
NFA com. banks	2 588	3 898	9 049	−2 808	8 200	−5 080	−1 641	−1 864	989
NFA NB**	−1 975	−916	2 607	−1 814	4 752	−514	−65	2 086	588

(−) indicates outflows except for **

Source: De Nederlandsche Bank, quarterly statistics.

After the current account reversal in 1981, triggered by a sharp decline in the Dutch investment rate (see Graph 12), private domestic investors increased massively their foreign asset holdings through portfolio and direct investment operations forcing, at times of exchange rate unrest, the NB to intervene in the foreign exchange market.

3.3. Conclusion

Across-the-border capital flows are not directly constrained in the Netherlands. The Dutch authorities follow a strong currency policy by pegging their currency exchange rate to the Deutschmark. Their domestic monetary policy is geared towards this external constraint and the Nederlandsche Bank does not attempt to set interest rates at levels divergent from German rates.

The absence of capital controls combined with financial market efficiency should result in interest rate parity as well as in the complete dichotomy between saving and investment decisions. Graphs 12 and 13 are impressive illustrations. The former represents Dutch savings and investment as percentages of GDP. The absence of correlation between the two is striking and suggests that domestic investment has not been constrained by the availability of domestic funds — especially during the 1978-80 period — and that domestic savings have developed independently of domestic investment needs.

Graph 13 illustrates the interest rate parity between domestic and Euro-guilder rates. In the presence of capital barriers, full arbitrage cannot take place, and transaction costs as well as risk premiums for further potential controls maintain a differential which can be quite noticeable in crisis periods. This interest rate differential has been negligible for the guilder from 1979/I to 1986/I, except during the last quarter of 1979 when it reached 80 basis points, indicating the market's fear of additional restrictions on private borrowings abroad.

4. The three countries compared

It is possible to isolate four theoretical implications of international capital mobility which are empirically identifiable in the three economies reviewed:

(i) Perfect capital mobility renders domestic investment totally independent from domestic savings. With no barriers to flow of funds and efficient capital markets, savings are invested where they obtain the best rewards, independently of the residence of the ultimate lenders and borrowers. Accordingly, domestic investment, whether private or public, should not be constrained by the availability of domestic funds. Graphs 4, 7 and 12 illustrate the specific correlation of domestic saving

and investment in each country. During the period under review, Denmark exerted strict controls on capital flows which bound investment to domestic saving.

(ii) In the absence of capital barriers, domestic interest rates should not differ significantly from Euro-rates. Since Belgium operates a dual exchange market, domestic money market rates and financial Euro-BFR rates are identical. On the other hand, interest rates on convertible deposits differ noticeably from financial Euro-BFR rates during crisis periods, indicating the amplitude of the protection offered by the two-tier exchange system (see Graph 2). The Dutch situation corresponds closely to a situation of no capital controls (Graph 13). In Denmark, after erratic changes in 1983, the differential between Euro-krone and domestic rates has been dramatically reduced in 1984 and almost disappeared in late 1985 and 1986, after the second wave of liberalization (Graph 9).

(iii) By opening financial frontiers, capital integration offers the possibility for banking institutions to increase their potential markets. Taking into account comparative advantages, a small economy effectively open to international financial transactions can be expected to develop its external banking activities. Graph 14 shows the structure of the balance sheet of the banking system in five different countries. Banks in the United Kingdom hold more than 60 % of their assets on non-residents, whilst German banking activity is largely domestic. Both countries have nevertheless totally liberalized capital flows. Belgian banks have massively increased their external activities in the absence of legal barriers. The most important progression has been recorded by Danish banks whose foreign activities almost doubled from approximately 14 % in 1978 to more than 26 % in June 1986, most of the increase taking place after 1983.

(iv) Finally, due to the increased competition from foreign banks, financial integration should lead to a reduction in the spread between lending and deposit rates. It is again convenient to compare the situation in our three small countries with other economies. After financial deregulation in the USA, it is generally considered that US financial markets have attained an exceptional degree of competitiveness. On the other extreme, French financial institutions were until recently substantially protected from both internal and external competition. Graph 15 shows the spread between lending and deposit rates in five countries. Even if lending rates may not be totally comparable, theoretical expectations are confirmed by the data. The countries with free capital movements have the lowest spreads.

Indeed, spreads for Belgium and the Netherlands are close to US spreads and internal regulations, such as for example collective fixing of deposit rates, are likely to explain the excess over US spreads. The effects of liberalization on spreads are demonstrated by the Danish experience: from June 1982 to June 1986, the spread fell by 2 percentage points, attaining a level comparable to the Dutch spread. By contrast, spreads in France are much higher and certainly not compatible with competitive conditions.

The experience of Belgium, Denmark and the Netherlands certainly confirms the expected theoretical implications of free capital mobility. The three countries have nevertheless their own specificities which prevent any easy generalization. Natural gas has certainly given the Netherlands a financial advantage; it is doubtless that the two-tier exchange market shielded the Belgian domestic economy from financial disturbances; Denmark, on the other hand, has liberalized financial transactions in a crisis situation, both in terms of current account transactions and market expectations. It did not suffer, at least in the short run, from important capital outflows and financial instability; Denmark has been able to reduce its interest rate differentials with respect to Germany and to reconstitute its stock of foreign official reserves. However, what made liberalization possible, in spite of a difficult starting point, was the macroeconomic stabilization programme implemented simultaneously.

Conclusions

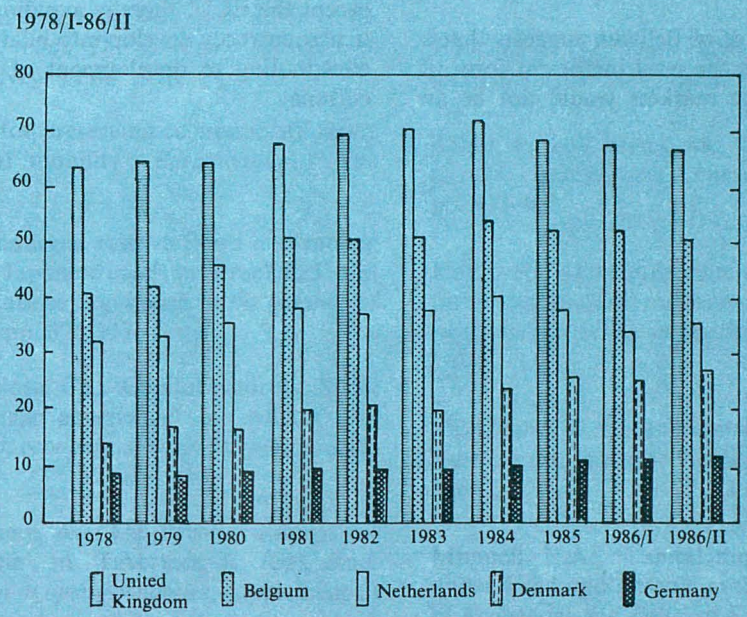
The review of the experience of three small EMS countries and theoretical considerations suggest several useful guidelines.

First, small EMS countries experience severe external constraints for domestic policy options. Liberalization of foreign capital transactions may marginally reinforce these constraints but do not bring about dramatic changes.

Second, whether capital transactions are stabilizing or destabilizing depends solely on underlying fundamentals. Small countries cannot deviate from EMS average performance or, if pegged to the Deutschmark, from Germany's price performance. This constrains domestic fiscal and monetary policy.

Third, whilst monetary policy loses much of its effectiveness, fiscal policy may even gain in efficiency from free capital mobility. Hence, an instrument for demand management remains available. By contrast, monetary policy is largely dictated by the remaining EMS countries or Germany.

GRAPH 14: **Foreign assets as a percentage of commercial banks' balance sheets**



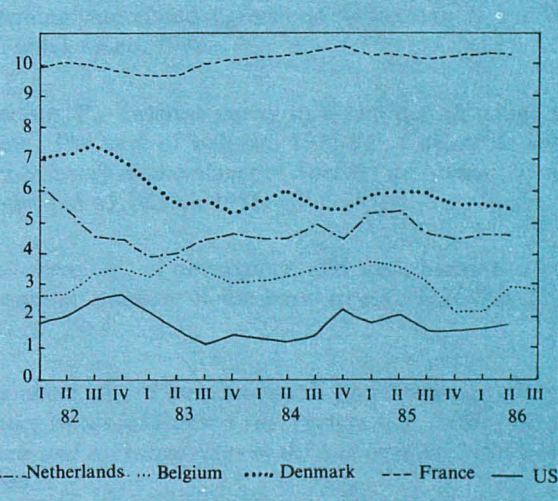
Fourth, the efficiency gains associated with liberalization can be quite substantial. Economies of scale, greater availability of specialized financial services, more stable rates and a greater opportunity set: all represent definite advantages. To this is to be added greater rationality in resource allocation.

Fifth, perhaps the greatest welfare gain will be generated by a reduction in spreads between lending and borrowing rates. In protected markets these spreads are a multiple of those in open markets. Savers and investors will both gain and income growth will accelerate.

Sixth, the distribution effects are generally favourable as the cake to be distributed grows in size. However, in particular cases either labour or capital owners lose but could always be compensated for that loss. Increased competition is also likely to have the socially desirable result of reducing monopoly rents of banks.

Seventh, the success of liberalization depends to a large extent on fiscal and regulatory uniformization. Recent regulatory agreements between the United States and the United Kingdom may help to inspire other member countries. From the fiscal side, national financial markets would reduce their competitive disadvantage *vis-à-vis* Euromarkets if capital

GRAPH 15: **Spread of lending over deposit rates**
$(1 + r_L)/(1 + r_D) - 1$



Source: IFS, lines 60 p and 60 i; for Belgium, Générale de Banque (crédits de caisse and large deposits, 3 months).

income was uniformly taxed or, even better, taxed at a zero rate.

Eighth, although the experience of Belgium suggests that a dual exchange market may be the least inefficient form of capital control, dual exchange markets would not be an appropriate institution for sporadic capital control under Community supervision. Any quantitative controls or foreign exchange taxes used for safeguard purposes may except the ECU, thereby avoiding that problems of a particular currency develop into bilateral strains and effectively contributing to development of the ECU into a parallel currency.

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Perspectives on financial liberalization in the newly integrating countries (NICs) of the European Community (EC)

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Introduction

This paper gathers some perspectives on financial liberalization in the three newly integrating countries of the European Community (EC). These are Greece, which joined in 1981, and Portugal and Spain, which followed in 1986.

While Spain is considerably larger and more industrialized than the other two countries, the three new members were seen as part of the 'newly industrializing countries' identified by the OECD in the early 1970s so that they are frequently referred to as European or Mediterranean NICs, along with Israel, Turkey, Yugoslavia, etc.

The three new EC member countries restored democratic institutions shortly after the oil crisis, after dictatorships of varying length and intensity. Now they are just embarking on a process of economic integration with the other nine member countries (EC 9) as well as among themselves.

As a consequence, it may be said that the three countries are also NICs in the sense of representing 'newly integrating countries' relative to a well-defined and substantially larger entity, the EC 9.

Grouping the three NICs together may be convenient for some purposes, but it should never be taken for granted, be it in describing their economic structure, in discussing the policy-making process or in attempting to characterize voting patterns on Community matters.

Greece and Portugal have a history of involvement with steps towards European free trade in manufactures in the 1950s and 1960s. Nevertheless the domestic effects of lower tariffs on industrial imports were rather limited in the face of both quantitative restrictions and domestic controls. With respect to Spain, even the lowering of tariffs was in its infancy when the political constraints on integration disappeared. A systematic comparison of the timing and sequencing of trade liberalization policies in these three countries, as well as in several other semi-industrialized economies in Latin America and Asia can be found in Michaely *et al.* (1986).

Conversely, the degree of financial development is highest in Spain. The financial underdevelopment of Greece is visible in the use of profits retention as the discretionary source of investment finance for firms, as argued by Dutta and Polemarchakis (1988). In Portugal, financial underdevelopment was exacerbated by the nationalization of banks in Portugal in 1975 which froze competition among financial intermediaries until private banks were allowed in 1985, as shown in Macedo (1987).

Aside from the effect of each country's calendar toward full integration with the EC 9, which ranges from 1991 for Greece to 1996 for Portugal, the central objective of a unified market in 1992 is to be taken into account. But even taking the target for the internal market to be common, the question remains of the best transition path for each one of the three NICs.

With respect to exchange rate arrangements, in particular, the absence of the United Kingdom from the exchange rate mechanism of the European Monetary System (EMS) seems to suggest the advantage for the NICs to explore new forms of association to the EMS, which will enhance the credibility of domestic macroeconomic management without excessive reliance on the policies of the Bundesbank.

Indeed, at present, the EMS is often seen as a Deutschmark area, and this identification would certainly be more misleading if the United Kingdom were to join the exchange rate agreement of the EMS. The same might be true if Spain were to join — even with an Italian-style wider band.

To experiment with some form of wider band or dual exchange rates, would certainly facilitate early Spanish membership in the system. This might not be enough to further dilute the identification of the EMS with the Deutschmark, but it would certainly enhance Spain's role within the NICs, perhaps including Italy. The experience of Italy from 1975 to 1985 is relevant because the opening was gradual and sustained, even though the inability in controlling the public sector borrowing requirement continues to make the perfect openness of the Italian capital market less credible than in other EMS member countries.

Preventing a sudden transition toward financial openness is certainly consistent with recent awareness of the drawbacks of excessive financial liberalization, as well as with the preference for a sequencing of financial liberalization after real liberalization. Nevertheless, this desirable caution could never be used as a defence of the existing financial structure in the NICs, especially the small ones.

This last observation underscores the importance of the structure of the financial markets at hand, but it should be emphasized that the description of such a structure is beyond the scope of this paper.

Instead of taking an institutional approach, the paper offers an analytical perspective on financial liberalization in the three NICs and then draws tentative policy implications.

The analysis is divided into two sections. Section I deals with some conceptual issues along the lines of Padoa-

Schioppa (1987) and Section 2 discusses the degree of capital mobility using real return differentials as computed by Frankel and MacArthur (1987).

Following the analysis, it is suggested in Section 3 that desirable financial liberalization and exchange rate unification among the 'old' EC 9 should not wait for the three NICs, as long as they are open to the new countries so that there is no durable exception to the objective of a cohesive Community. Such arrangements are sometimes called 'minilateral' to emphasize that they tend to be easier to achieve that the more ambitious multilateral negotiations.

The point here is that other minilateral solutions besides the one behind membership in the exchange rate mechanism of the EMS should be envisaged. Specific arrangements between the three NICs, or between Spain and Portugal, about ways to attain financial integration may thus be desirable.

1. The EC enlargement and capital market integration

1.1. Welfare effects of international capital mobility

There is now widespread agreement among economists and policy-makers that some form of financial development is the key to economic and social development.

The realization that financial repression maintains financial underdevelopment and hinders economic progress does not imply, however, that immediate financial liberalization is necessarily the most appropriate policy response.

Even the most enthusiastic defender of financial liberalization has become, in his own words, 'a little gun-shy' after the resounding failure of various experiments of all-out financial liberalization in the southern cone of Latin America.[1]

Particularly in light of these experiences, but also due to analytical results about the order of liberalization, financial liberalization without prior dismantling of trade barriers may not be advisable. Aside from the intuitive appeal of the message that relative prices must be transparent before worrying about their rate of change, the precedence of real over financial liberalization has been established analytically for different types of models.[2]

The idea of the early literature, which draws on the so-called transfer problem, is that, paradoxically, a capital inflow can hurt rather than help. If trade is distorted and foreign funds are used to buy imported capital-intensive goods for investment, the effect of a capital inflow will be negative on the economic welfare of the representative consumer in so far as the distortion will be amplified.

More generally, according to the basic theoretical equivalence between goods and factors in general equilibrium models, the classical assumption that factors are mobile across regions and sectors within each country but immobile between countries may seem peculiar. However, it has long been recognized that international trade in goods is just indirect trade in internationally immobile factors.

Then, if capital is internationally mobile, welfare would only increase unambiguously in the small open economy if all taxes were uniformly lowered, including both tariffs on goods and taxes on capital movements. Since international capital mobility raises the price-output response in the economy, if imports are capital-intensive, this greater response is bad: it raises the cost of tariff protection.[3]

The conclusion of this subsection, then, is that a feature of the transition towards an integrated European capital market is not only a lowering of taxes on the international movement of capital but also a substantial lowering of trade barriers by the NICs and also by the Community as a whole.

1.2. Macroeconomic effects of international capital mobility

The results summarized above are important for the microeconomics of financial liberalization but the current caution may have been rather the result of greater awareness about the macroeconomic preconditions for financial liberalization, especially after the 19 October 1987 stock market crash.

The importance of a stable macroeconomic environment was of course easy to underestimate during the prosperous 1960s, at least during the earlier part of the decade. After the turbulent 1970s and 1980s, though, some form of macro-

[1] McKinnon (1986), which is an assessment of the influential McKinnon (1973) book, where financial liberalization was more enthusiastically endorsed. See also Macedo (1986).

[2] See Edwards and Van Wijnbergen (1986), Rodrik (1984), Edwards (1984) and Macedo (1985). The relevance of the southern cone experiences for southern Europe is discussed by Calvo (1985). See also Branson (1984) on Greece, (1985) on Greece and Turkey and (1986) on Portugal.

[3] These very recent results are due to Neary (1987a and b), where several forms of trade restriction are compared with and without capital mobility. The welfare effects of tariffs are opposite to those of quotas when capital mobility is allowed for. The welfare cost of a quota is lowered rather than raised, because of the absence of the price effect. Similarly, the cost of a voluntary export restriction is lowered with capital mobility because the smaller price rise reduces the rents accruing to foreigners.

economic stabilization seems required for financial development to occur without generating bubbles and crashes. Shortly after a stock market crash such a lesson can be overtaught, just like it is undertaught before a banking crisis — the so-called 'disaster myopia' of financial markets.[1]

In turn, macroeconomic stabilization requires some form of control over the government budget deficit, a problem that has been pervasive in some of the member countries, including not only the three NICs but also Italy. Without controlling the primary deficit, even the gains on the rate of price inflation will be short-lived, and this lessens the credibility of macroeconomic stabilization.

The same can be said about the failure to solve the persistent unemployment which has been plaguing the EC 9, Spain and to a lesser extent Greece and Portugal. Without reforms at the microeconomic level, there is little hope of a sustained improvement in employment. Thus, macroeconomic success becomes tied to the ability to control the primary deficit and to bring about economic efficiency at the firm level, along the lines of the lowering of taxes on international transactions — or at least intra-EC transactions discussed in the previous subsection.

The conventional answer about the macroeconomic effects of greater capital mobility shows that monetary independence requires flexible exchange rates. Contrasting an entirely insulated domestic capital market with a fully integrated one, it is easy to see that, in the latter, monetary expansion will not be able to reduce interest rates and can only expand output if the exchange rate depreciates. If the exchange rate is fixed, on the contrary, an expansion of domestic credit leads to offsetting capital outflows: monetary policy is powerless.

This assumes that domestic and foreign assets are perfect substitutes, so that either imperfect substitutability or imperfect mobility may allow some control of the national central bank upon its monetary base, at least in the short run. There are several studies which estimated these offset coefficients, both in reduced form and in structural form. The earlier estimates for Germany, referring to the 1960s, were close to one, meaning that there was hardly any scope for an independent monetary policy by the Bundesbank.

Correcting the simultaneity bias lowered those estimates considerably. Nevertheless the interest-sensitivity of capital movements was measured to be quite high in Germany, implying that offset coefficients would indeed have been close to one if the Bundesbank had not pursued a systematic sterilization of reserve flows, as noted in the early empirical applications of the Mundell-Fleming model.[2]

Despite the appeal of this conventional result of the Mundell-Fleming model, recent directions in open-economy macroeconomics provide qualifications to the strong policy implication of loss of monetary independence. Simple examples have been provided of how price setting by firms, irreversible investments and expectations modify the analysis.[3]

Thus considerations of industrial organization and market structure, especially large entry costs and small national markets, may lessen the price discipline induced by opening the economy.

Similarly, viewing labour as an irreversible investment may induce waiting in the face of small improvements in business conditions induced, say, by favourable real exchange rate developments. If the insight is applied to the return of capital flight, then, the immediate payoff must overshadow the prospect of subsequent deterioration, thus requiring some frontloading which — because it involves higher fiscal incentives — may run counter to fiscal stabilization.

Finally, the role of expectations may be to extrapolate changes in monetary policy in ways that have a strong impact on asset prices. A small increase in money growth, extrapolated into cumulative increases, would lead to a strong immediate depreciation, to be then undone by a gradual appreciation.

Even without incorporating these new insights, whose policy relevance is quite clear, the conventional result must in any event be qualified when capital mobility is not perfect, exchange rates are not fully flexible and there exists some form of monetary cooperation.

This may well have been the situation in the EC area since the implementation of the European Monetary System, even though the trend toward dismantling capital controls accelerated in 1986.

[1] See Diaz (1986) for a classic analysis of the Chilean banking crisis and Macedo (1987) for an application to Portugal.

[2] The long-run success of this sterilization policy is highly questionable, according to Obstfeld's (1982) assessment of the evidence, the most relevant work in this connection may instead be the estimate of the offset coefficient of the Bank of Mexico by Cumby and Obstfeld (1983) and of the Bank of France by Claassen and Wyplosz (1982), both of which seem to suggest a higher degree of autonomy, because of imperfect substitutability as well as of imperfect mobility, due in the second instance to the existence of capital controls. The results are in Herring and Marston (1977).

[3] See Dornbusch (1987) for a description of the three examples discussed below in the text.

The degree of capital mobility is now higher among the major countries, especially with respect to Italy and France, with immediate implications for the NICs. Should they lower barriers as well, join the EMS exchange rate mechanism, cooperate more effectively, or some combination of these alternatives?

As mentioned, the policy implications drawn below point to 'minilateral' solutions among the NICs and some of the other member countries. In particular, the possible move toward the EMS would have to take into account the absence of the United Kingdom and hold views about the expected duration of Bundesbank leadership among the countries taking part in the exchange rate mechanism.

1.3. Long-run resource transfer versus capital market efficiency

The difference between the microeconomic and macroeconomic aspects of financial liberalization is further illustrated by the distinction between capital movements based on differences in endowments which lead to long run resource transfers and capital movements based on arbitrage opportunities which enforce capital market efficiency.

As emphasized by Krugman (1987), this distinction mirrors the distinction between inter- and intra-industry trade. This is important because the source of the gains from trade is different and the distributive consequences are also different. Inter-type capital movements tend to lower the rate of return to capital in less capital-intensive countries such as the NICs, whereas intra-type capital movements would enforce the equality of returns on comparable financial assets.

While the NICs are candidates for inter-type inflows, their situation in connection with intra-type movements is less clear. Indeed, Spain may even be less subject to capital controls than France or Italy. This hypothesis is confirmed by tests of interest rate parity which do not work for the French franc or the Italian lira but work for the Spanish peseta, largely due to one-way arbitrage.[1]

The importance of interest-rate sensitive remittances into Greece and Portugal may also lessen the ability of both governments to depart from interest-rate parity. It is therefore important to identify for each one of the three countries which way the exchange restrictions were binding.

Independently of these tests, it is known that the conduct of monetary policy in the three new EC members is much more passive than in the members of the EMS. The implied institutional changes should thus be included in the assessment of the costs and benefits from coordination within the EMS framework.

Simply put, for the central banks of Greece, Portugal or Spain to follow the Bundesbank rather than the Greek, Portuguese or Spanish Treasuries let alone their trade unions, may be an important change indeed.

Coming back to long-run resource flow, the consequences of the enlargement for the unification of the members capital markets can also be seen as part of the broader question of the flow of international capital into the Community, sometimes referred to as 'new international corporate arrangements'. For example, a Japanese company wishing to manufacture motor vehicles for the EC market needs to locate inside the EC to avoid the external tariff. An enlarged EC gives it more choice, and the cheap labour country may be the most attractive.[2]

2. Capital mobility and real interest-rate differentials in Greece, Spain and Portugal

2.1. Measures of capital mobility

The question of measuring capital mobility arises naturally from the strong policy implications of the degree of capital mobility. Under fixed exchange rates, once again, if capital is immobile, monetary policy works whereas, if capital is perfectly mobile, monetary policy is ineffective. Several attempts at measuring capital mobility under fixed exchange rates by focusing on the 'offset coefficients' from domestic credit expansion into capital outflows have been already mentioned.

Independently of the exchange rate regime, however, perfect capital mobility equalizes real rates of return among identical assets denominated in different currencies, and should be directly testable by looking at real interest differentials between countries. Given the world rate of interest, then, there should be no correlation between national savings and investment.

[1] This point is emphasized in Bliss and Macedo (1986). See also Vinals (1986).

[2] This effect takes the external tariff as given. See Bliss (1988) for a relaxation of this assumption in an enlargement context.

This is the macroeconomic implication of perfect capital mobility emphasized by Feldstein and Horioka (1980) and Feldstein (1983). If private saving falls, there should be no crowding out of private investment because the country can borrow abroad at the going interest rate. The same is true for the government saving through a budget surplus. Since the data suggest a high correlation between savings rates and investment rates, the paradoxical conclusion reached by these authors is that capital mobility is not in fact all that high between industrialized countries.

There are, again, econometric problems with the original results but, even when the endogeneity of national saving is corrected, the correlation remains and, in Obstfeld (1987), actually rises in the 1970s, suggesting that capital mobility declined. He also develops other measures of capital mobility, with equally poor results.

Along the same lines, several studies find higher correlations in the OECD area than in developing countries, contrary to the standard presumption, even though not the contention, of Harberger (1983) that capital mobility, both official and unofficial (i.e. capital flight) may in fact be higher between countries with different levels of financial development.

Dooley, Frankel and Mathieson (1986) test the Feldstein-Horioka proposition using data for 49 countries from 1960 to 1984 and correcting for the endogeneity of national savings. This is done with instrumental variables for the private and public savings rates in order to allow for a policy reaction of governments in the face of incipient current account imbalances, such that these will be reduced. Despite all of these refinements, they reach results that contradict the presumption that capital mobility is high. Indeed, as mentioned by Frankel and MacArthur (1987), the results also contradict the associated presumptions that capital mobility is higher for industrialized countries and that it has been rising since the 1950s and especially after 1973.

A rationalization of these findings, due to Dooley and Isard (1986), comes from the idea that governments are more tempted to renege on their debt to foreigners, the higher such debt is, so that there cannot be too high a level of capital mobility in a world of sovereign nations. While standard when applied to LDC debtors, this emphasis on the country or 'political' factors is not generally used for industrialized countries. It was certainly relevant for the three NICs some years ago, and may not be entirely out of place even now.

Tests of real interest parity are also in conflict with the standard presumption because they suggest that real interest rates are far from perfectly correlated among countries. This conclusion comes from the rejection of the unbiased nature of the forward rate as a predictor of the future spot rate. From the failure of uncovered interest parity follow differences in expected rates of return. The outcome is thus contrary to the standard presumption. Indeed, recent studies report that major industrialized countries move in the 1980s away from real interest parity relative to the experience of the 1970s. These results are also cited in Frankel and MacArthur (1987).

Taking due account of the difficulties associated with all of these tests, Frankel and MacArthur (1987) attempt to decompose the real interest differential into 'political' and 'currency' components, so as to assess where the failure of real interest parity comes from. If it comes from political factors, the notion that there are obstacles to the free movement of capital across nations is confirmed, whereas, if the failure comes from 'currency' factors, there will be other explanations for a fall in national savings to crowd out domestic investment via a rise in the real rate of interest. In particular, these authors point to the imperfect integration of goods markets.

Real return differentials can thus be attributed to 'political' or country factors, leading to departures from covered interest parity, as well as to currency factors, leading to a forward premium or discount over the inflation differential. We write then the real interest differential as the sum of the nominal interest differential and the real forward discount:[1]

$$r - r^* = (i - i^* - fd) + (fd - p - p^*)$$

where r (r^*) = real interest rate at home (abroad),

i (i^*) = nominal interest rate at home (abroad),

p (p^*) = price inflation at home (abroad),

fd = forward discount.

The real forward discount can in turn be expressed as the sum of the exchange risk premium and expected real depreciation:

$$fd - p - p^* = (fd - e) + (e + p^* - p)$$

where e = expected change in the nominal exchange rate.

By substituting this expression into the definition above, we see that the difference between the real interest differential and the real exchange rate depreciation encompasses both the political and the exchange risk premiums. Due to the lack of forward exchange rate data for Portugal, it

[1] This is related to the real forward premium described in Kouri and Macedo (1978), especially if the deflators are indexes of the purchasing powers of the two currencies.

is not possible to disentangle these two sources of risk. Nevertheless, the effect of trade barriers is presumably reflected in the real exchange rate, so that some of the micro-economic considerations mentioned in the first section can be addressed.

Given the widespread movements in real exchange rates that have characterized the current international monetary system, purchasing power parity cannot be said to be expected even when we are dealing with several years. A major reason for the failure of real interest parity may thus be the failure of goods market integration, as shown by expected movements in real exchange rates, rather than the political premium.

This is indeed one of the conclusions reached by Frankel and MacArthur (1987) in a study of three-month real-interest differentials in 24 countries from September 1982 to October 1986. The local interbank rate is measured relative to the Eurodollar interest rate and they are deflated by realized consumer price inflation during the *ex-post* three-month period.

The sample is divided into five categories of descending financial openness, of which the most open, the least open and the middle category — which we will call the semi-open — involve EC member countries. For our purposes, the classification confirms that there is a substantial difference between the two NICs included in the sample, Greece being the only 'closed' EC member country.

Thus, in the EC, Germany, the Netherlands, and the UK are open, and Belgium, Denmark, France, Ireland, Italy and Spain, are semi-open. Of the EC member countries, moreover, only Portugal is missing, the presumption being that it is closed, like Greece. In a way the Frankel and MacArthur (1987) groupings match financial development, with the effect of London as a world financial centre being reflected in the UK real interest differential and, on the other side, the two major hard currencies in the EMS.

Using the same methodology for the case of Portugal, Table 1 shows the mean and the coefficient of variation of the 3-month real interest differential between the Eurodollar rate and a standard rate in each one of the EC member countries, together with the three group averages involving the EC member countries in the sample.[1] Open countries tend to have a small and stable covered nominal interest differential and exchange risk premium but not necessarily a small and stable real interest differential or real exchange rate change against the US dollar.

The EMS countries show lower real interest rates than in the USA by about 2% and a real appreciation against the dollar of about 5%, offset by a 3% political and exchange rate risk premium.

Among the three NICs, Spain shows somewhat lower negative values, and a smaller positive difference, whereas Greece has a large negative differential with no real appreciation and Portugal a 4% negative differential and a 3% real appreciation, with a negative difference of 1%.

This seems to confirm that Spain is indeed the most integrated of the three NICs, whereas both Greece and Portugal seem to be in two different positions. Greece has a large differential but a lower coefficient of variation, whereas Portugal has a lower mean in absolute value but a much higher variance.

The comparison of the real interest differential with the various group averages suggests that the mean is indeed closest to the industrialized economies for Spain, where it is around $-1{,}5\%$ p.a. for the Atlantic group, $-1{,}8\%$ for all countries, and Spain is at its group mean of $-1{,}1\%$.

We also see that real depreciation was closest between the two Iberian countries, at about -3% p.a., whereas in Greece the value was 0,6% (relative to a group average of 3%). The average for all countries in the sample (excluding therefore Portugal) is -2%, whereas the open group reaches -3%, as mentioned.

[1] See Macedo (1983) on the available data on Portuguese forward rates and *Boletim Trimestral*, 1980 for an article by J.J. Toscano where the rate of crawl was used to compute a covered interest differential. In 1987, the Bank of Portugal began to report an *ex-post* covered interest differential between the escudo and major currencies, as well as their trade-weighted average: see *Boletim Trimestral* and *Boletim Mensal de Conjuntura*, 1987. However the calculations are explained in a forthcoming publication, so that it is difficult to compare the measure used here and the one presented by the central bank. One major difference stems from the fact that we use the 3-month interbank rate, which is free, rather than the (post-tax) deposit rate, which is administratively set. Another difference might be that we use changes in the escudo/dollar rate during the following three months. Using the common sample period, 1984/I to 1987/IV, we see that the mean of our measure is 10,8% whereas the mean of the Bank of Portugal's measure is 7,3%, both with standard deviations of about 20%. The coefficient of correlation between the two measures is only 46%. Note that the mean real differential using the same deflators changes sign from 2,2% to $-1{,}3\%$ and the correlation drops below 30%.

Here however, Greece shows a substantially greater volatility, with a coefficient of variation of 46, relative to 7 (in absolute value) for Portugal, Spain and the semi-open group and relative to 9 (in absolute value) for the open group.

2.2. Real forward discounts in Greece and Spain

Even though the unavailability of a forward exchange rate for the Portuguese currency prevents comparisons with Portugal, we can nevertheless compare the political and currency factors in explaining the real differentials against the dollar in Greece and Spain. The relevant results for the two NICs and the group averages are taken from Frankel and MacArthur (1987).

The covered interest differential was −3,1% p.a. in Spain (standard deviation is 3,6) and −9,7% p.a. in Greece (standard deviation is 6,3), whereas the Atlantic group average is 0,2% (standard deviation is 0,2) and the 'other European' group −1,3% (standard deviation is 2,8). The size of the political premium is much larger in Greece than in Spain, but the two NICs do show a substantial difference relative to the two DC group averages. In particular, the value for France is −2,1% (standard deviation is 2,9) and for Italy it is 2,1% (standard deviation is 3,6).

The real forward premium is 1,7% (standard deviation is 3) in the Atlantic group and zero (standard deviation is 4) in the 'other European' group but negative and more variable in both NICs. For Greece we have −0,3 and a standard deviation of 9,6 and for Spain −2,1 and a standard deviation of 5,5. Again, the value for France is 0,9% (standard deviation is 2,6) and for Italy it is −1,3% (standard deviation is 3,6).

The exchange risk premium is very similar in Spain and in the 'other European' group, namely a mean of 6% and a standard deviation of 23. In Greece it is a mean of 1% and a standard deviation of 27, whereas in the open Atlantic group it is 2% with a standard deviation of 25. Again, the value for France is 7% (standard deviation is 25) and for Italy it is 6% (standard deviation is 22).

These results confirm that currency factors are more relevant in Spain than in Greece, whereas political factors are stronger obstacles to capital mobility in Greece than in Spain.

While a more detailed analysis is certainly called for, these numbers are consistent with our prior remarks that Spain is becoming part of the European and international capital market in a way that has so far not been observed in Greece. Explanations might range from the different degree of industrialization to the nature of bank regulation in both countries.[1]

3. 'A minilateral' policy of financial liberalization for the NICs of the EC

Independently of the tests for capital mobility discussed in Section 2, it is important to note that the conduct of monetary policy in the three new EC members is much more passive than in the current members of the EMS or in the UK.

The implied institutional changes should thus be included in the assessment of the costs and benefits from coordination within the EMS framework. Simply put, for the central banks of Greece, Portugal or Spain to follow the Bundesbank rather than the Greek, Portuguese or Spanish Treasuries let alone their trade unions, may be an important change indeed.

The policy implication is that specific financial and exchange rate arrangements among the three NICs may be desirable, as long as they are open to other member countries along the lines of so-called 'minilateral' negotiations.

Aside from the effect of each country's calendar toward full integration with the EC 9, which ranges from 1991 for Greece to 1996 for Portugal, the objective of a unified market in 1992 is to be taken into account.

With respect to exchange rate arrangements, in particular, the absence of the United Kingdom from the exchange rate mechanism of the EMS seems to suggest the advantage for the NICs to explore forms of association which will enhance the credibility of domestic macroeconomic management without excessive reliance on the policies of the Bundesbank.

The idea is to experiment with some form of wider band as in Italy or dual exchange rates as in Belgium, so as to facilitate early membership in the system while preventing a greater financial openness than desirable, given the degree of real liberalization and financial development of the three NICs.

[1] Note the unfortunate consequence of a financial liberalization that leads to higher interest rates. Firms in the preferred sector find themselves in difficulty because they have to compete with firms from the curb market at higher rates. They may go bankrupt and will certainly try to lay off workers. Firms from the curb market are now facing lower rates and they increase borrowing for investment, which also allows them to shed labour. This phenomenon was also observed in Korea. Branson (1985), stresses the importance of the curb loan market in Greece.

This message is consistent with recent awareness of the drawbacks of excessive financial liberalization even by its most ardent defenders, such as in McKinnon (1986) as well as with the preference for a sequencing of financial liberalization after real liberalization, such as in Edwards (1985).

An illustration of the peculiar nature of capital mobility in the NICs is the strong effect on the three stock markets of the Wall Street crash of 19 October 1987 which was much higher than expected. This is precisely the effect of 'disaster myopia', and serves to remind us that the estimates of the degree of capital mobility reported above must be interpreted for calm rather than for turbulent periods.

This observation confirms the importance of the structure of the financial markets at hand. In the case study of Portugal, a story can be told about how the nationalization of banks and insurance companies in 1975 delayed financial decontrol and was responsible for an accumulation of bad debts among the 'old' banks.[1]

The relationship between capital mobility and the liberalization of financial services is characteristic of the new directions in open economy macroeconomics mentioned above, yet not always fully taken into account. The effect of greater capital mobility on the availability of financial services to residents of the NICs, or indeed of the lesser financially developed EC members, is again worthy of great attention but there does not seem to be any presumption that a national bank would do a better job that a foreign one.

Insurance, banking and the marketing of securities are around 7% of GDP in the Community and growing strongly, according to the Padoa-Schioppa report. Despite the mobility of capital across national borders, steps toward international harmonization in banking services or insurance are necessary not so much at the EC but rather at the world level.

Yet, even within the EC, the question of how the regulatory and executive powers should be organized in an integrated market remains unaddressed. This is another reason to encourage some 'minilateral' initiatives, especially with countries that are relatively underdeveloped financially.

Despite the harder credibility of an exchange arrangement that would not tie the central bank's hands, some experimentation with an informal peg to the ECU, perhaps with a wider band and a separate financial rate, may be appropriate for the countries where inflation is still substantially higher than the Community average or where the overhang of bad debts seems most serious for financial liberalization.

It should be noted that, even though it is outside the EMS, the pound sterling has not remained too far from the other major European currencies. This may be an indication that an 'as-if' joining of the EMS — sometimes called a shadow-EMS — on the part of Portugal and Greece may be appropriate, especially if the expectation that Spain is to join relatively soon becomes widespread.

4. Conclusion

It was argued in this paper that specific financial and exchange rate arrangements among the three NICs may be desirable, as long as they are open to other member countries along the lines of so-called 'minilateral' negotiations.

Once the relationship between capital mobility and the liberalization of financial services, characteristic of the new directions in open economy macroeconomics, is taken into account, the need for considerable innovation in Community practices with respect to harmonization, mutual recognition and coordinated supervision becomes apparent.

Otherwise, the effect of each country's calendar toward full integration with the EC 9, which ranges from 1991 for Greece to 1996 for Portugal, may be to delay the central objective of a unified market beyond 1992, at least for the NICs.

With respect to exchange rate arrangements, in particular, the absence of the United Kingdom from the exchange rate mechanism of the EMS seems to suggest the advantage for the NICs of exploring forms of association which will enhance the credibility of domestic macroeconomic management without excessive reliance on the policies of the Bundesbank.

These experiments might involve some form of wider band as in Italy or dual exchange rates as in Belgium, so as to facilitate early membership in the system while preventing a greater financial openness than desirable, given the degree of real liberalization and financial development of the three NICs.

In closing, it should be stressed that the implications of financial liberalization in the NICs for policy coordination in the enlarged EC are a major part of the research project described in Bliss and Macedo (1986), and, whilst of decisive policy relevance, are beyond the scope of this paper.

[1] Macedo (1987).

Table 1

Measures of capital mobility

(% p.a.)

	Real interest differential		Real exchange rate	
	mean	variation coefficient	mean	variation coefficient
EC 12				
B	−0,2	17,3	−6,9	3,4
DK	−4,1	1,0	−6,6	3,6
D (*)	−1,8	1,6	−5,2	4,9
GR (+)	−9,5	0,9	0,6	46,0
E	−1,1	4,8	−3,4	6,8
F	−1,3	2,1	−5,7	4,4
IRL	0,3	10,7	−3,3	7,5
I	0,5	7,5	−6,3	3,7
NL (*)	−1,8	1,8	−3,9	6,5
P	−3,6	3,2	−2,7	9,0
UK (*)	−0,3	12,9	1,2	23,3
Group averages				
Open (*)	−1,5	2,0	−2,6	9,2
Closed (+)	−5,8	1,6	3,1	12,3
Semi	−1,1	3,3	−5,1	4,5
All	−1,8	3,0	−1,9	14,3

NB: Variation coefficient is standard deviation divided by absolute value of mean.

Source: Adapted from Frankel and MacArthur (1987) except for Portugal (also excluded from averages).
Portugal data from Bank of Portugal (see footnote on p. 156).

Open: (*) as well as Canada, Switzerland.
Closed: (+) as well as Bahrain, Mexico and South Africa.
Semi: other EC 12 as well as Austria, Norway, Sweden.
All: above as well as Hong Kong, Malaysia, Singapore, Australia, Japan and New Zealand.

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Exchange controls and the EMS

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Introduction

This paper falls into two parts. The first is a comment on the general issues arising in connection with capital exchange controls and the proposals for their liberalization within the existing and potential membership of the European Monetary System. The second focuses on the specific experience of the United Kingdom which, in 1979, abolished completely a system of quite comprehensive exchange controls.

General issues

1. Rationales for exchange control

A number of different arguments for the deployment of exchange controls over capital movements can be found; we may distinguish, for example, at least the following possible rationales:[1]

(i) general 'second-best' arguments suggest that (unavoidable) rigidities in goods and labour markets are best matched by some institutionally created rigidities in foreign exchange markets;

(ii) the presence of controls confers monetary autonomy on the Central Bank of the country deploying them;

(iii) controls can act as a counter-speculative device to support the viability of adjustable peg exchange rate systems;

(iv) controls can be used to influence the distribution of ownership of domestic (and foreign) productive assets;

(v) controls may raise investment in the domestic economy and hence real growth.

These various arguments are spelt out further below and confronted with the arguments for the market solution; invariably it will be found that the latter either poses alternative means as superior to administrative exchange control for attaining the same objectives or makes a virtue out of denying that the objectives posed are good ones.

2. Creation and ownership of productive assets

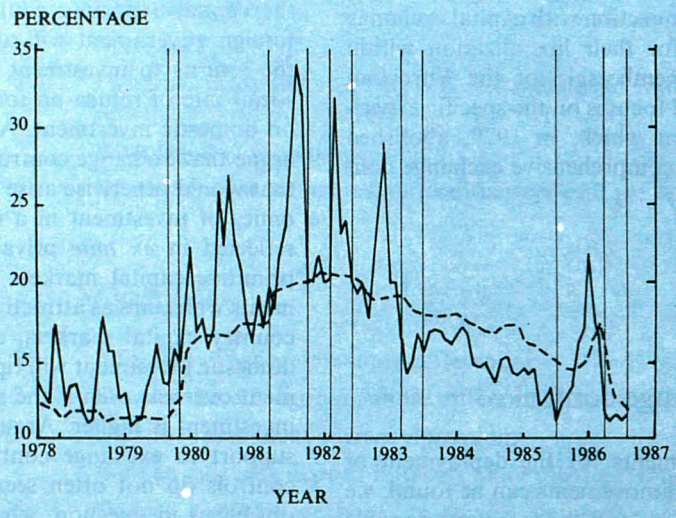
Exchange controls have been seen as helping to correct distortions which arise as the calculus of private rates of return yields systematically biased solutions compared to the calculus of social rates of return. The classic example here turns on the fact that private investors will rationally arbitrage after-tax rates of return; from the point of view of the capital exporting country, however, the fact that the foreign government will absorb tax revenues arising from the returns to investment in its economy implies that the social rate of return on foreign investment falls below that on domestic investment. A developing country might also argue that exchange controls will help correct the distortion that would otherwise arise as the exceptional external economies of investment in a developing economy will not be reflected in *ex ante* private returns. Moreover, relatively primitive capital markets may not offer investors instruments which are as attractive as those available in developed country capital markets, and the added liquidity cost of domestic investment will tip the balance in favour of investment overseas even if the social rate of return on domestic investment is higher. Arguments like these may lend some support to exchange controls; but administrative (direct) controls do not often seem the best way of securing the objectives in question, where fiscal arrangements and tax-and-subsidy policies appear to provide superior solutions. It is certainly questionable how far exchange controls will succeed in raising total investment in the protected economy for, if they are successful in creating a captive market, domestic private rates of return will be reduced and as a consequence inward capital flow will be diminished. A similar point is made in Hemmings (1981), in relation to portfolio investment and in Beenstock (1977) in relation to direct investment. In this event the controls might have to be appraised on the different grounds that they create a redistribution of asset ownership: a larger fraction of domestic assets will be owned by domestic residents and a smaller fraction of overseas assets will be owned by domestic residents than would otherwise be the case.

3. A counter-speculative role

Arguments of the kind spelt out above apply most obviously to the control of portfolio and direct investment; in the context of the EMS, however, most attention has understandably been directed at the effects of what might be described, for want of a better term, as 'monetary exchange controls': by this we mean to refer to the controls over the holding by residents of foreign-currency-denominated bank deposits and other short-term assets and controls over the lending by domestic residents and banks of domestic currency to foreign residents. These provisions are the key to the counter-speculative role of exchange control for they limit the amount of domestic currency which can be quickly sold in anticipation of devaluation.

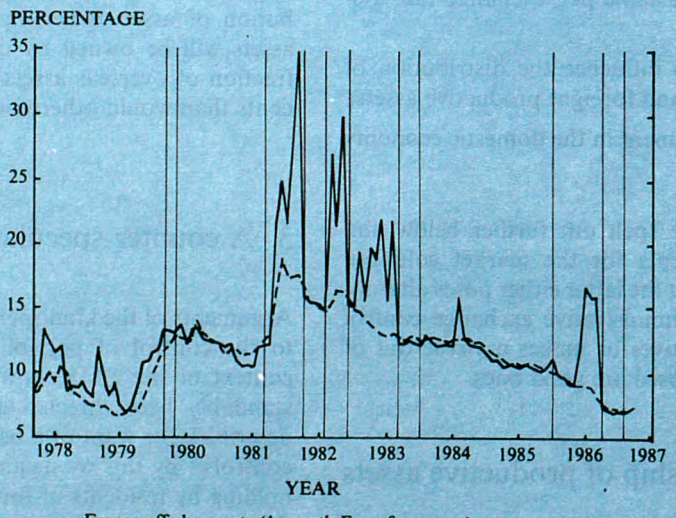
[1] See also Cairncross (1973).

GRAPH 1: **Italy: the off-shore/on-shore differential**



Note: The interest rate data are not fully maturity compatible
Source: Chase Manhattan: Bank of England

GRAPH 2: **France: the off-shore/on-shore differential**



Note: The interest rate data are not fully maturity compatible
Source: Chase Manhattan: Bank of England

Papers by Melitz (1985), Giavazzi and Pagano (1985), Giavazzi and Giovannini (1986), Claassen and Wyplosz (1982), and Wyplosz (1986), among others have illuminated the way in which such controls can be expected to work and actually function in practice in the EMS. In particular, the evidence on the behaviour of off-shore/on-shore interest rate differentials seems to show that the controls are highly effective, as these differentials rise sharply ahead of realignments when expectations of devaluation are widely held: Graphs 1 and 2 illustrate the Italian and French cases.[1] Given the history of the demise of the Bretton Woods system, in which a large role is generally attributed to the influence of speculative capital movements (see Artis and Ostry (1986)), it would indeed be surprising if exchange controls were not accorded a role in the success of the EMS. This role for exchange controls is given added emphasis by reason of the nature of the policy episode in which the EMS has been situated. By offering an option for 'under-indexed' crawling peg realignments, the EMS has afforded a compromise between rigid nominal exchange rate targets and inflation-accommodating real exchange rate targets. By choice, a counter-inflationary policy which is effective but not too rigorous can be exerted through niggardly and under-indexed realignment consistently with avoidance of the severe real exchange rate appreciations experienced by the UK and the US. It may be argued that avoidance of such misalignments is vital to the survival of an exchange rate arrangement within a customs union, on pain of undermining the customs union's trade liberalization achievements. If this is a correct description of the way in which the system can be used, speculation is an obvious problem. On the one hand, the policy-makers promise not to let (real rate) misalignments occur; on the other hand, they want to threaten wage and price setters with the defence of nominal parities. It is only too easy to see that speculation is invited by this posture and that, if allowed to occur, it can fatally undermine the policy-makers' ability to deliver the 'crawling peg — nominal rigidity compromise' which is the policy rationale of the EMS.[2] If so, there is a premium on considering whether speculation can be avoided by altering some other aspect of the EMS's present mode of functioning.

A timely EMS realignment effects a change of central rates within the existing bands so that market rates do not undergo a discrete change. At the same time the realignment renews the option (say) for a particular currency to (be expected to) depreciate against another. Timely realignments of this kind avoid presenting speculators with the prospect of 'one-way bets': they necessarily involve an amount of realignment which is small, relative to the band width, and the prospect that realignments will be of this timely type can thus be improved by increasing the band width and reducing the allowable amount of realignment. A combination of these two elements could therefore be envisaged as a modification of the present mode of functioning of the system in the event of the abolition of exchange controls.[3] It should not be forgotten, of course, that a coordination of policies will be helpful in reducing the need for realignments in the first place, but it would be quite fanciful to suppose that this can be relied upon to eliminate the need for realignments completely — especially as there is reason to think that the counter-inflation policy priority which commanded the agreement of EMS members in the system's formative years may be challenged by other concerns in the future.

4. The protection of monetary autonomy

Exchange controls confer monetary autonomy on those countries which deploy them, in two distinct ways. First, in an adjustable peg system, interest rates would otherwise be determined by those prevailing in the other countries in the system, or in the leading country, plus or minus the expected depreciation or appreciation permitted by the band width and the position of the currency within the band. With a very narrow band, interest rates are thus in effect determined directly by the leading country. The presence of effective controls breaks this interest parity link and permits some discretion for domestic interest rates to depart from the levels otherwise dictated by it. Second, in the absence of exchange controls, the type of control exercised by the Central Bank over its commercial banks is firmly disciplined by the presence, or potential presence, of off-shore banks. Any control which is onerous relative to the added cost of transacting off shore will result in a migration of business to the off-shore banks and make the control itself cosmetic in effect. Exchange controls break this link and provide greater room for discretion in the design and implementation of monetary controls and regulations.

Monetary autonomy of the first type may be recovered by widening the band: although the interest parity condition will still prevail with the wider band, increasing the band width will allow more of the effect of a change in interest

[1] See Giavazzi and Pagano (1985) for further discussion of the behaviour of these differentials.

[2] It might be objected that this description yields a view of the role of exchange controls which is altogether too benign and it must certainly be admitted that the discretion afforded by exchange control to pursue wise policies can be abused and thus lend support to unwise policies.

[3] The United Kingdom does not at present adhere to the exchange rate mechanism of the EMS. Some influential support for its participation advocates that this should occur on the basis of wider bands. See the Croham Report (1986).

rates in the leading country to be accepted in a change in the exchange rate and so require less of a parallel change in interest rates in the other country. The appearance of a slavish dependence can be so avoided.[1] Autonomy of the second type cannot be secured by increasing the width of the exchange rate band, but it is questionable how far such autonomy is desirable. At any rate, if deregulation and liberalization of domestic monetary systems is desired, no more powerful ally than the liberalization of exchange controls can be imagined.

5. An argument from 'second-best'

A general argument against the market solution and in favour of restriction of some kind may be said to flow from the 'second-best' principle of welfare economics. Specifically, if distortions remain in some set of markets, it does not follow that liberalizing others will lead to an overall improvement. The application of this principle to the regulation of trade and capital movements might be said to have governed the wisdom of the founders of Bretton Woods, for whom the creation of a stable system of exchange rates and freedom from controls on current account was coupled directly with the perceived gains from liberalization of trade and the continued restriction of capital movements. The erosion of controls over capital movements in the post world war period occurred in spite of, not because of, the acceptance of the principles of Bretton Woods. More recently, the analysis of exchange rate overshooting (e.g. Dornbusch, 1976) has provided a forceful analytical example, and the experience of first sterling and then the dollar has provided practical evidence that unregulated markets may produce untoward exchange rate behaviour. These examples are less than conclusive evidence in favour of exchange controls, however. In particular, some observers have drawn the conclusion that exchange rate behaviour can be rendered more stable without the need for exchange control, by writing rules for the conduct of policy in a world of exchange rate target zones (e.g. Williamson (1985); Edison, Miller and Williamson (1987)).

It must be said, moreover, that the case for the market solution is now understood to involve much more than welfare 'triangles' and to extend to considerations of x-efficiency and innovation in the operations of markets, here involving the entire capital and credit markets of Europe. As such, the potential gains from the generalized liberalization could be large, leading to a significantly improved allocation of resources and, through time, a higher rate of innovation and efficiency increase. It is impossible to comment in detail on the likely distribution of benefits from such a process, though it is probable that there will remain significant economies of scale in the provision of financial services. But whilst this would suggest that the provision of (though not the benefit derived from) such services might tend to be concentrated in a few centres, the persistence of distinctive national currencies provides an offsetting force:[2]

The most important positive propositions to emerge from this discussion are, perhaps, these:

1. Liberalization of exchange controls will compel liberalization of banking and monetary regulations.

2. It will also require a modification in the present functioning of the EMS, in order to avoid the speculative wreckage of the system and in order to avoid an intolerable loss of monetary autonomy.

3. One such modification would involve a temporary widening of the bands of exchange rate fluctuations until such time as the degree of policy convergence and coordination has developed to a point at which the bands can again be narrowed. Such a widening might be accompanied by a smaller permitted amount of central rate realignment.

The abolition of exchange control in the UK

1. Introduction

The United Kingdom has a long history of the use of exchange controls, starting with the 1914-18 war and resuming after a post-war interval of liberalization in 1924 since when exchange controls of some kind were continuously enforced until October 1979 when they were wholly removed. The removal of the controls at this time, prompted by a desire to reduce the appreciation of sterling and to provide a means of translating North Sea oil wealth into overseas earnings assets, can also be seen as part of a broad policy of widening the scope for the market solution.

[1] The liberation, it is fair to point out, may be purchased at the cost of somewhat higher average interest rates if the use of wider bands leads to more volatile exchange rate behaviour for which investors require a compensation.

[2] The logic of the market solution may in the long run, however, lead to the displacement of national currencies even for the conduct of substantial amounts of domestic business – a further erosion of monetary autonomy and sovereignty. Thus exchange control may be seen as a form of protection both for banking and for the national currency of denomination.

It might be hoped that the abolition of exchange controls in the United Kingdom would provide some clear lessons for the effects to be expected of abolition elsewhere; yet considering the magnitude of the step involved, there has been extraordinarily little analysis of the consequences of the abolition of the controls. There is in fact a major obstacle to the precise identification of the contribution of the abolition of the controls to the exchange rate, interest rates or to the development of balance of payments flows; this is represented by the coincidence in timing of the abolition of the controls with two other major shocks to the British economy — the second OPEC shock (itself accompanied by the transition of the UK from oil importing to oil exporting status) and the advent of the Thatcher government and a new regime of economic policy. But whilst the violation of the *ceteris paribus* conditions seems to rule out recourse to sophisticated modelling and readily explains the lack of well-quantified estimates, some effects are none the less clear enough. Above all, it seems clear that the removal of exchange control, in removing protection for domestic banking activity, forced the reform of monetary regulation to take place on a very liberal basis; whilst a move in this direction might have taken place in any event, the abolition of exchange controls provided a ruthless logic for it. It is also now possible to see that a development of currency substitution has taken place that would have been impossible in the continued presence of these controls and that the controls on outward portfolio investment and on the currency of financing of both portfolio and direct investment were substantially effective.

In what follows, the next section sets out the nature of the controls that were abolished in 1979. Following sections go on to discuss the evidence that abolition has supplied on the effects of these controls.

2. The controls in outline

The principal controls abolished in 1979 pertained, separately, to direct and portfolio investment, to the holding by residents of foreign currency deposits and to sterling lending, by UK residents and banks to non-residents.

In regard to direct investment, the controls provided for the restriction of all sterling-financed foreign investment (i.e. investment paid for with foreign exchange bought at the official rate) except where it could be shown to have advantages to the balance of payments; but direct investment financed by foreign borrowing or by foreign exchange bought from the investment currency market (see below) was freely allowed (at least, during the 1970s). In order to prevent leakage through the use of unremitted profits, the controls also normally required that at least two-thirds of after-tax profits should be repatriated.

In regard to portfolio investment, the controls provided that purchase by residents of foreign exchange for the purpose of investment overseas should only be made from the sale of existing foreign securities or from foreign currency borrowing. This created an investment currency market in which there was an implied premium over the official exchange rate (since non-residents were free to purchase securities at the official exchange rate, there would never be a discount). In addition, for a period up to the end of 1977, sales of securities were subject to a 'surrender' penalty, in that 25 % of the proceeds of sale had to be exchanged at the official rate.

Finally, the controls required that the holding by residents of foreign currency deposits should be limited to working balances, whilst sterling lending by banks and others overseas was similarly restricted to trade-related purposes.[1]

With the adoption by the United Kingdom of a floating exchange rate regime from 1972 onward, the original declared unifying rationale for the controls (to conserve foreign exchange) was lost and there is a dearth of official explanations for their continuation. Cairncross (1973) has remarked that the continuation of the controls may have been due, as much as anything else, to a perception that they might again be needed, for the old reasons, in the future and that to abolish them would effectively prevent their future use. This suggestion is given credence by the evident belief, at the inception of the new regime, that floating was a temporary expedient.

However this may be, the controls were finally removed in three stages in 1979. On 12 June it was announced, effective from the following day, that interest charges on foreign currency borrowing for portfolio investment could be financed at the official rate and the requirement of 115 % cover for such borrowing was removed; then, on 18 July it was announced that henceforth repayment of foreign currency borrowing outstanding for a year or more could be made with currency purchased at the official rate, whilst purchase of EEC securities was exempted from all the restrictions. At the same time, all the remaining restrictions on direct investment and the repayment of foreign currency borrowing incurred to finance it were removed. The rest of the restrictions (with the exception of some which were involved in the economic sanctions against Rhodesia, themselves removed in December) were lifted as from 24 October.

[1] All of the controls are described in detail in the Bank of England's (1977) manual.

With the removal of the restrictions and the reporting system associated with them, some of the information useful in assessing their effectiveness (in particular, that pertaining to the currency of finance of investment flows) was lost, a further hindrance to effective estimation of the impact of abolition.

Two attempts to quantify the effects of abolition are readily available: these are those by the Bank of England (1981) and by Chrystal (1985); their assessment is combined with later evidence in what follows.

3. Direct investment

The general opinion, before the abolition of the controls on direct investment, was that the regulatory regime of the 1970s was not intended to, and did not in fact, impinge significantly on the direct investment flows themselves (see, for example, Cairncross (1973); Tew (1978)), but upon the financing of these flows. Foreign currency borrowing to finance direct investment abroad had been freely allowed, and the effect of the control was described for this reason in the Bank of England's *Quarterly Bulletin* for December 1979 (p. 371) as primarily one of deferred access to official exchange (in the sense, presumably, that the profits on the investment, which would otherwise be repatriated at the official rate, could be used to repay the foreign currency loan incurred to finance it).

Certainly, it had always seemed doubtful to what extent the two-thirds rule for repatriation of foreign earnings was effective for the companies covered by the balance of payments statistics, where the figures showed that the proportion repatriated (though variable) was often closer to 40% than to $66^2/3$rds (see, for example, Tew (1978), p. 333); among other differences, the exchange control provisions extended only to companies where the voting control lay within the UK, whereas the balance of payments statistics embraces the earnings of companies in which the UK interest is in a minority. This explanation, whilst consistent with the nominal effectiveness of exchange control over direct investment suggests that the penetration of foreign investment activities by multinational companies will significantly dilute the overall impact of such restrictions.

As the outstanding foreign currency borrowing associated with portfolio investment was comparatively small, most of the refinancing which appeared to occur during the third and final quarters of 1979 could be attributed to the relaxation of the controls over direct investment: a comparison of net borrowing for overseas investment in these quarters with its average in the previous two years prompted the Bank of England to suggest an effect to the order of UKL 1 000 million in each quarter (*Quarterly Bulletin*, December 1979, p. 372; March 1980, pp. 13-14). This assessment, though, is somewhat bigger than the figures adduced in the Bank's subsequent analysis of the effects of abolition (Bank of England, 1981), would readily support. These figures (see Table 1) give the amount of direct investment and its financing in the period before the relaxation of controls in June and July, and in the third and fourth quarters of 1979, after which the foreign currency financing data are no longer available. These figures suggest a turn-round in identified foreign currency borrowing from UKL 260 million to a repayment of UKL 378 million, a total effect of UKL 638 million a quarter, total direct investment itself remaining more or less the same.

The direct investment data for subsequent and earlier years, together with their (end-of-year) stock counterparts are shown in Table 2. These reveal some important implied revisions to the earlier data used in Table 1; for example, the revised outflow figures corresponding to the quarterly averages shown in Table 1 and with the addition of the last period shown are, in UKL million: 1978Q1-1979Q2: 1 047; 1979Q3-1979Q4: 1 563; 1980Q1-1981Q2: 1 305; 1981Q3-1986Q2: 1 412. But it is not clear that these revisions significantly alter the provisional verdict of the earlier studies that the controls did little to affect outward direct investment in total.

Table 2 indicates an increase in inward as well as in outward direct investment after abolition, consistent with some effect of the controls in reducing domestic rates of return; and whilst the net outward flow has risen over the period it is clearly an erratic series, much influenced in the last two years shown by disinvestment by overseas oil companies. Tentatively removing the oil-related component flattens the upward trend in net investment almost completely.[1] Table 2 also reports stock data for direct investment held abroad by UK residents and those held by foreign residents in the UK.

The net asset position has clearly improved, but trends here are additionally complicated by valuation changes, including those due to exchange rate changes, and cannot be said to cast any light on the effect of removing exchange controls.

[1] The data only allow this to be done up to 1983 after which oil companies' investment, which was previously located in the category 'other UK residents' (which it might be assumed to dominate) can no longer be even approximately identified. Assuming that the investment shown for 'other UK residents', excluding oil companies after 1984, is representative of earlier figures, the net balance of direct investment, approximately excluding that of oil companies, beginning in 1975, emerges as, in UKL 1 000 million: 0,7; 1,5; 0,8; 1,6; 1,5; 1,3; 3,9; 1,4 and in 1983, 1,5.

What seems to emerge, then, is this: whereas the controls were not (in their latter years) intended to reduce overseas direct investment significantly, they were aimed at the financing of this investment. There is evidence that the controls had some effect in this sense, though their abolition also removed the data source needed to track this over a reasonable period of time. General considerations suggest that where there was an effect on outward investment it may have been purchased at the expense of some reduction in the incentive for inward investment to occur and this would further reduce the impact of the controls on the net flow and the net foreign exchange position. There is no strong evidence in the relevant figures for any net effect.

Table 1

Direct investment and refinancing

(million UKL; quarterly averages)

	1978Q1-1979Q2	1979Q3-1979Q4	1980Q1-1981Q2
Outward direct investment	707	643	724
Financed by: retained earnings	325	473	341
Identified foreign currency borrowing	260	−378	..
Unidentified finance	122	548	383

.. = not available.
Source: Bank of England (1981), p. 371.

Table 2

Direct investment 1975-85

(UKL 1 000 million)

	Flows			Stocks		
	Outward	Inward	Net outward	External assets of UK	UK liabilities to overseas residents	Net, UK
1975	1,3	1,5	0,2	18,6	12,1	6,5
1976	2,4	1,7	0,7	23,5	13,7	9,8
1977	2,4	2,5	−0,1	24,4	15,7	8,7
1978	3,5	2,0	1,5	28,1	17,9	10,2
1979	5,9	3,0	2,9	31,4	22,0	9,4
1980	4,9	4,4	0,5	33,3	26,4	7,9
1981	6,1	2,9	3,2	45,2	30,0	15,2
1982	4,3	3,0	1,3	53,3	31,8	21,5
1983	5,3	3,4	1,9	60,3	36,3	14,0
1984	6,0	0,4	5,6	81,5	38,0	43,5
1985	7,3	3,4	4,0	76,7	40,5	36,2

By convention these figures are shown with sign reversed in the balance of payments tables.
Source: CSO, *Balance of Payments Pink Book, 1986.*

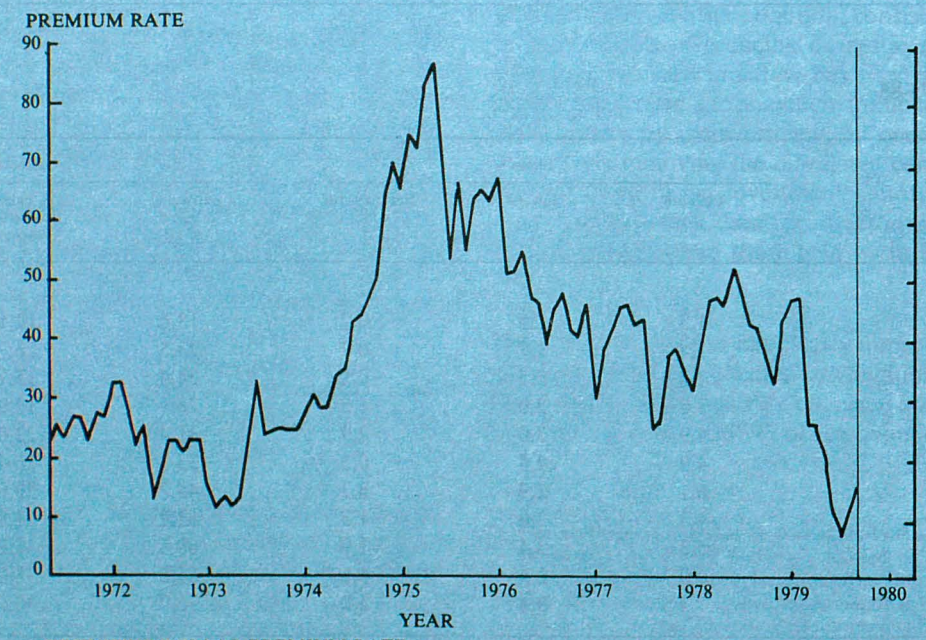
4. Portfolio investment

The effectiveness of the controls over portfolio investment was always evident in the height of the investment currency premium created by them. As Graph 3 shows, this premium was not infrequently in the range 30-50%, and on some occasions was even higher than this. Variations in the premium were frequently discussed in the pages of the Bank of England's *Quarterly Bulletin* and attributed to speculation on the exchange rate or on the stock markets in New York or London. The decline in the premium before abolition owed much to the circulation of rumours about the impending abolition of the controls.

Recourse to foreign currency borrowing to support portfolio investment was less significant than for direct investment: the Bank (1981) quoted an estimate of UKL 1 600 million to 1 700 million outstanding associated foreign currency borrowing at the end of 1978. Accordingly, refinancing of the existing stock of such borrowing was less significant (and in any case indistinguishable from the refinancing of borrowing connected with direct investment); but the removal of the controls clearly allowed outward investment to increase (see Table 3) and raised the net outflow sharply, despite some concurrent increase in inward investment.

Strict enforcement of the controls would have implied no outward portfolio investment net of foreign currency borrowing, and in 1975-78, the average gross outward flow was very small. Assuming that this is what would have been enforced by the continued presence of the controls, virtually the whole outward flow from 1980 on might be put down as the effect of abolishing the control — an amount in excess of UKL 45 000 million; granting that the controls deterred some inward investment, cumulating the increase in net outflow over the period might seem more appropriate — something to the order of UKL 30 000 million. A somewhat similar order of magnitude is suggested by crude calculations based on the increase in the share of overseas assets in financial institutions' portfolios, as portrayed in Table 4. Comparing the share in 1985 with either the average for 1975-78 or for 1978 alone suggests an increase to the order of 6-9 basis points, worth UKL 30 000 million to 40 000 million on 1985's total portfolio.

GRAPH 3: UK: the investment currency premium



EFFECTIVE DOLLAR PREMIUM RATE
Exchange controls abolished October 1979

Table 3

Portfolio investment 1975-85

(UKL 1 000 million)

	Flows			Stocks[1]		
	Outward	Inward	Net outward	External assets of UK	UK liabilities to overseas residents	Net, UK
1975	0,1	0,2	−0,1	6,9	6,1	0,8
1976	−0,1	1,0	−1,1	8,7	7,8	0,9
1977	—	1,9	−1,9	8,7	10,6	−1,9
1978	1,1	−1,0	2,1	10,3	9,7	0,6
1979	0,9	1,5	−0,6	12,3	10,4	1,9
1980	3,2	1,5	1,7	18,7	12,1	6,6
1981	4,3	0,3	4,0	25,4	12,7	12,7
1982	6,7	0,2	6,5	40,3	15,7	24,6
1983	6,5	1,9	4,6	60,0	19,3	40,7
1984	9,6	1,4	8,1	84,3	23,5	60,8
1985	18,2	7,1	11,2	100,6	32,1	68,5
1986[2]	12,0	2,3	9,7	. .	. .	. .

[1] End of year.
[2] First half-year.
. . not available.
By convention these figures are shown with sign reversed in the balance of payments tables.
Source: CSO, *Balance of Payments Pink Book, 1986.*

Table 4

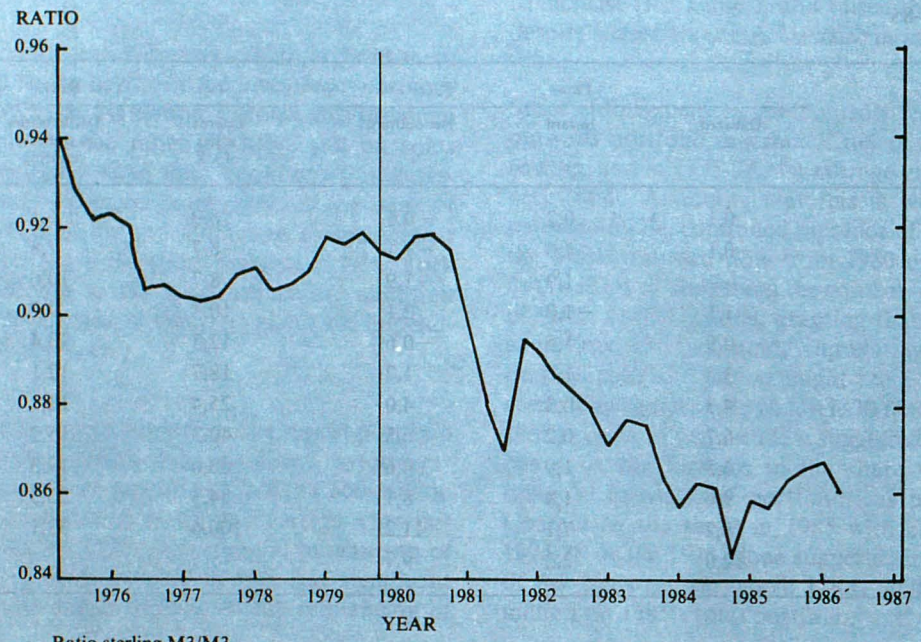
Financial assets and liabilities of other financial (non-bank) institutions: overseas components

(UKL 1 000 million and %)

	Overseas assets	Overseas liabilities	Net overseas	Gross financial wealth (total assets)	% Portfolio shares	
					Net overseas	Gross overseas
1975	7,0	1,4	5,6	77,3	7,3	9,1
1976	9,0	1,6	7,4	88,4	8,3	10,2
1977	8,6	1,8	6,8	117,1	5,8	7,3
1978	10,4	1,5	8,9	132,8	6,7	7,8
1979	11,0	2,2	8,9	150,1	5,9	7,3
1980	16,2	2,0	14,2	185,5	7,7	8,7
1981	22,5	2,3	20,2	210,3	9,6	10,7
1982	38,2	5,3	32,9	263,3	12,5	14,5
1983	54,9	7,6	47,3	326,7	14,5	17,7
1984	75,7	9,0	66,7	401,2	16,6	18,9
1985	77,3	9,9	67,5	472,9	14,3	16,4

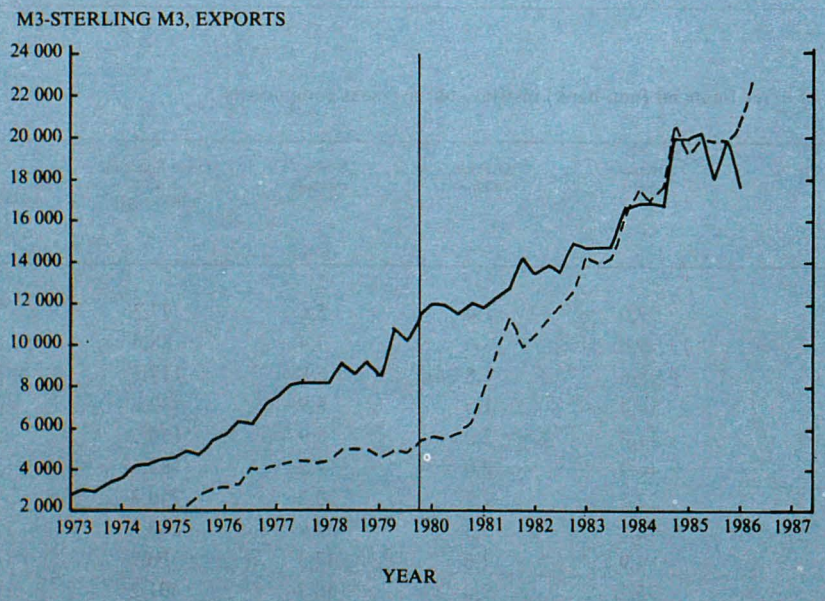
Source: CSO *Financial Statistics*, November 1986.

GRAPH 4: **Foreign currency deposit holdings and exchange control abolition**



Ratio sterling M3/M3
Exchange controls abolished October 1979

GRAPH 5: **Foreign currency deposits, trade and the removal of exchange controls**



---- M3-sterling M3
—— Exports
Exchange controls abolished October 1979

All such calculations are exceptionally crude and can only be treated as broadly indicative of what has been agreed in previous analyses (Bank of England, 1981; Chrystal, 1985), namely that there was a large effect on portfolio investment from the removal of the controls.

5. The monetary controls

The lifting of the monetary restrictions on bank lending in sterling to overseas residents and on the holding by residents of foreign-currency-denominated deposits has had some clear and sizeable effects. In addition, a particularly striking impact is noticeable from the removal of controls on the on-shore/off-shore differential and consequently on departures from covered interest parity. These in turn have implied significant changes in the scope and form of monetary policy.

The restriction of sterling lending overseas was an important component in the system of exchange control; such lending had broadly to be associated with UK trade. The statistics collected on bank lending give a straightforward picture of the consequences of removing this control: Table 5 shows bank lending in three categories — for identified long-term export credit, for other identified export credit and for 'other' purposes. Lending in the last category increases significantly after 1979, a good part of it going to the offices of unrelated banks abroad (which banks have also in this period increased their holdings of sterling deposits with UK banks as part of the growth in Eurocurrency business).

The lifting of the restriction on the holding of foreign currency bank deposits has been followed by a large increase in such deposits. M3, the broad monetary magnitude which includes foreign currency deposits, has grown faster than sterling M3 which excludes them. The ratio of sterling M3 to M3 has consequently fallen, as illustrated in Graph 4, from pre-abolition levels in the late 1970s of the order of 91% to 85-87% in the mid-1980s. This would not have been possible without the removal of the controls; Graph 5 illustrates the relationship of the difference M3-sterling M3 to trade (exports) before 1979, and the shift in this relationship in the post-abolition period.

The removal of the controls has had a dramatic effect on the on-shore/off-shore interest differential. In the presence of the controls, full arbitrage is inhibited and in consequence the on-shore/off-shore differential can exhibit significant departures from zero and significant variability. A predicted effect of removing the controls is that these distortions will be removed.[1] The calculations reported in Table 6 and the displays in Graphs 6A and 6B provide strong confirmation of this effect. Graph 6A shows the 3-month Euro-sterling rate and the 3-month local authority temporary loan rate and the differential between them, whilst Graph 6B displays the Euro-sterling rate against interbank rate. In Table 6 information is given on the mean, variance and range of each of these differentials before and after October 1979.

It is known that interest rates in Euro-markets closely reproduce covered interest parity (Johnston, 1979); the interest rate on Euro-X deposits may actually be set directly by adjusting the corresponding dollar rate for the cost of forward cover in the dollar/X market. This being so, deviations from covered interest parity between on-shore rates will primarily reflect the wedge between on-shore and Euro-rates and will tend to vanish as the wedge is removed. Since we have already found the abolition of exchange controls to be effective in this respect, it must be expected that deviations from covered interest parity between on-shore rates will tend to zero after abolition of exchange control. Once again, the graphical evidence (Graphs 7A and 7B) strongly confirms this. It will be seen that both the on-shore/off-shore differential and the covered interest differentials after abolition have non-zero means, however much reduced they are from pre-abolition levels. *Inter alia*, these are likely to be explicable in terms of observation error and systematic differences in perceived risk and transaction costs. In their study of this question, Frenkel and Levich (1977) argued that the presence of transaction costs meant that there was a band within which deviations from interest parity could fall consistently with perfect arbitrage and they argued that a large proportion of observed deviations from covered parity between US and UK interest rates actually fell within this band. McCormick (1979) subsequently showed, however, that Frenkel and Levich had estimated too wide a band and calculated that the proportion of observed deviations from parity of on-shore rates which fell within the band was less than 30%, not 96% as implied by Frenkel and Levich. (For off-shore rates, the recalculation sustained the contention that virtually all deviations fell within the neutral band.) These observations serve to strengthen the suggestion here that exchange controls did inhibit full arbitrage and that the

[1] Phylaktis and Wood (1986) have noted such findings in Johnston (1979) for Germany and in Otani and Tiwari (1981) for Japan in similar instances. The narrowing of the on-shore/off-shore differentials for France and Italy (as in Graphs 1 and 2 above) in times of 'calm' suggests that it is reasonable to think of their controls as akin to a variable tax, biting most vigorously when a realignment is expected, effecting little distortion at other times.

Table 5

Bank lending (in sterling) abroad

(UKL 1 000 million)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Identified long-term export credit	0,2	0,2	0,5	0,6	0,1	0,2	0,2	1,0	0,9	0,3	—
Other identified export credit	—	0,1	—	0,1	0,1	0,1	−0,1	−0,2	—	−0,1	−0,1
Other sterling lending	−0,1	0,4	0,1	0,1	−0,2	2,5	3,0	3,3	1,3	4,7	1,7

— = less than UKL 50 million; by convention these figures are shown with sign reversed in the balance of payments tables.
Source: CSO *Balance of Payments Pink Book*, 1986, Table 8.4.

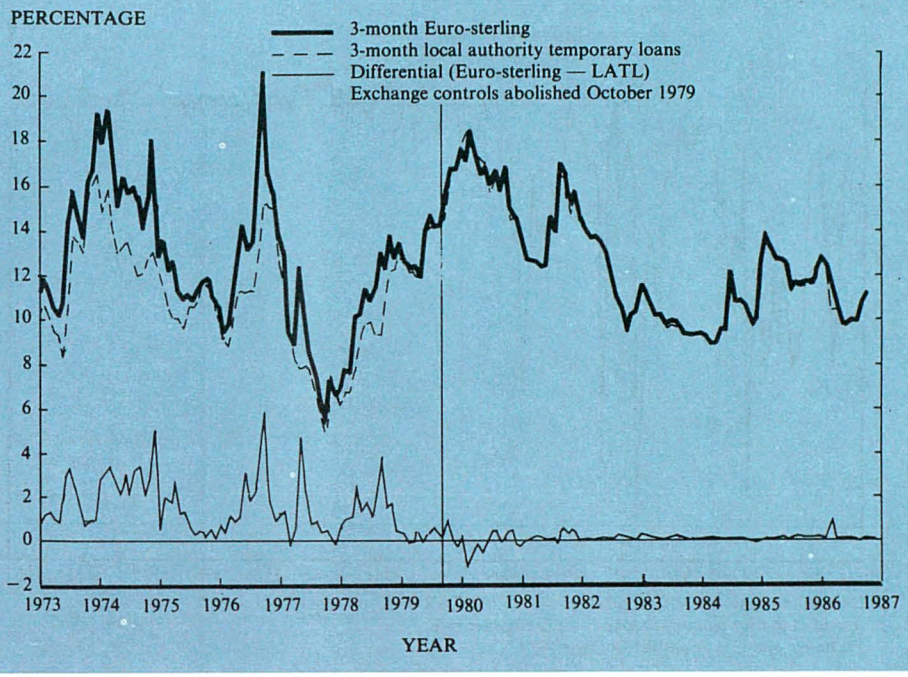
Table 6

On-shore/off-shore interest differentials per cent per annum

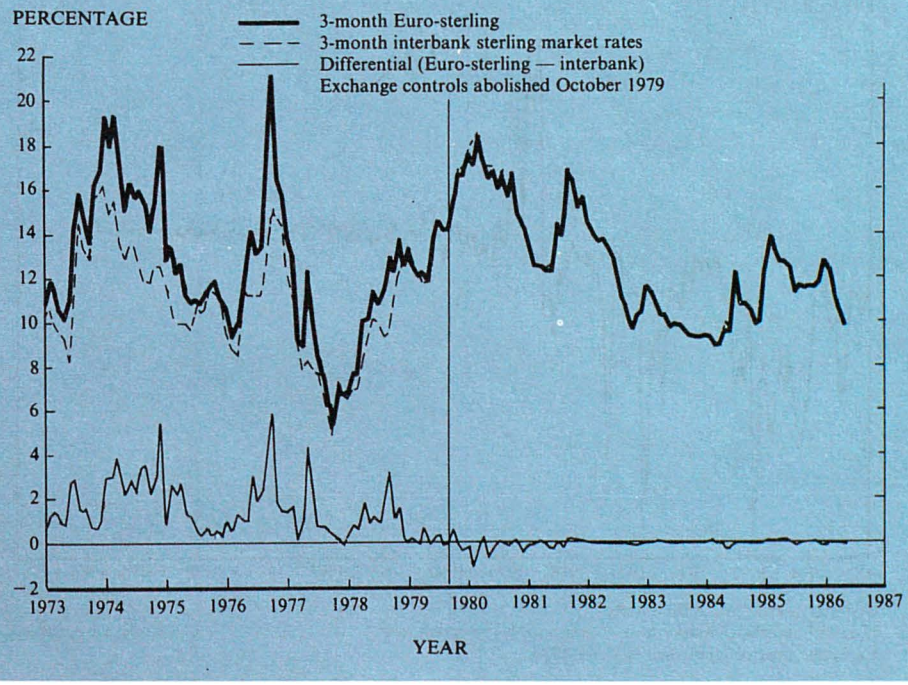
(end of month data)

	Euro-sterling *minus* local authority rate	Euro-sterling *minus* interbank rate
	Jan. 1973-Sept. 1979	
Mean	1,476	1,510
Variance	1,731	1,735
Range	−0,250 to 5,940	−0,160 to 6,000
	Oct. 1979-Oct. 1986	
Mean	0,075	0,040
Variance	0,069	0,045
Range	−1,280 to 0,940	−1,220 to 0,690

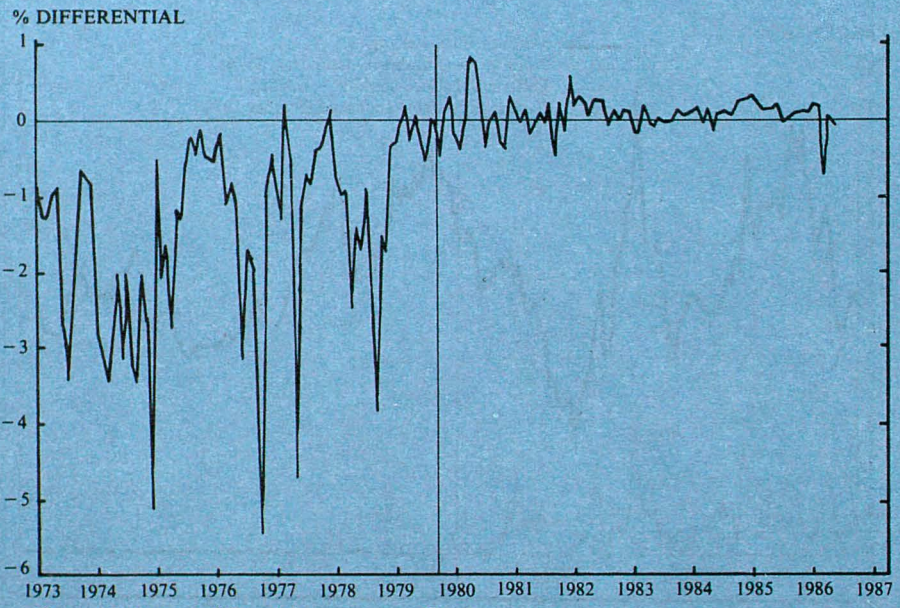
GRAPH 6A: **UK: the off-shore/on-shore differential**
(local authority loans)



GRAPH 6B: **UK: the off-shore/on-shore differential**
(interbank rate)

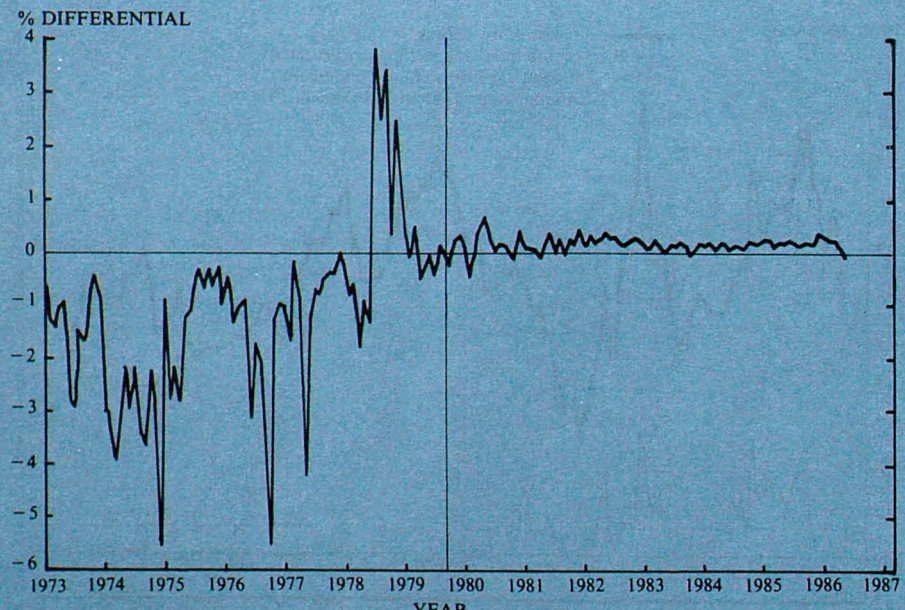


GRAPH 7A: **UK: departures from covered interest parity**
(3-month rates: (local autority loan rate/Euromarket rate)



Covered interest rate differentials
(Local authority temporary loans — Euromarket rate)
Exchange controls abolished October 1979

GRAPH 7B: **UK: departures from covered interest parity**
(3-month rate: (interbank rate/Euromarket rate)



Covered interest rate differentials
(3-month interbank market rate — 3-month Euromarket rate)
Exchange controls abolished October 1979

decline in observed deviations from parity ensuing upon their abolition does indicate a real change in this respect.[1]

6. Implications for monetary policy

The abolition of the monetary exchange controls in principle poses several problems for monetary control and in practice has disciplined the system of monetary regulation and control employed in the United Kingdom.

Three aspects of this may be singled out for discussion: the scope for intervention in the foreign exchange markets; the nature of monetary regulation; and, finally, the consequences of currency substitution.

Considered as part of a trend towards greater integration, and more efficient financial markets, abolition of exchange control can be considered to reduce the scope for sterilized intervention and for manoeuvres in the forward markets. As an example of the latter, a Bank of England tactic to exploit the forward markets to exert a bear squeeze on speculators may be mentioned. This tactic consisted of selling sterling forward, thus raising Euro-sterling but not on-shore rates of interest, discouraging spot sales and reducing the profit from selling sterling short. This manoeuvre cannot take place in the absence of exchange control, because the possibility of raising off-shore rates without also raising on-shore rates no longer exists.[2] Kearney and Macdonald (1986), more generally, have found some evidence that sterilized intervention was an effective instrument of policy in the 1970s for the UK, in contrast to Obstfeld's (1984) findings for Germany. Since the finding for the UK implies that capital mobility was less than perfect, they tentatively suggest that exchange control may have been responsible.

That the liberalization of exchange controls has had implications for the nature of monetary control and regulation is not in doubt. In a liberal regime, quantitative credit restrictions, or similar instruments, are subject to added leakage as frustrated business moves off-shore: this was forcefully illustrated in the British case (as noted in Artis and Lewis, 1981) when the Governor of the Bank of England requested the domestic banks in 1979 not to participate in or encourage the use of off-shore facilities to frustrate the impact of the then existing Special Supplementary Deposit Scheme (popularly known as the 'corset'). The corset control specified a steeply rising rate of call to zero-interest account at the Bank of England on interest-bearing deposits received by banks in excess of pre-specified allowable rates of growth. The banks reacted to this by rationing borrowers for credit and reducing their competition for deposits. In the presence of freely available off-shore banking facilities, frustrated borrowers could tap off-shore banking facilities, whilst lenders would find it profitable to divert deposits from on-shore to off-shore banks. The lifting of the exchange restrictions thus rendered the use of this control otiose and it was subsequently dropped in June 1980. Aside from its implications for the use of quantitative controls, or controls with a rationing effect, the lifting of exchange restrictions also implies that monetary regulations of the classical balance sheet ratio type may be redundant too. The ready availability of off-shore banking services, undertaken on the basis of complete freedom from imposed balance sheet ratios, implies that the scope for imposing such ratios on competing on-shore banks must be strictly limited. Ratios which are onerous will result in a migration of banking services to off-shore locations. In this light, the reform of the regulations governing the British banking system in 1981, which placed the system on a very liberal and essentially ratio-free basis was inevitable; though there would probably have been a movement in this direction in any case, the absence of exchange control was compelling.

In the long haul, these trends inevitably raise questions about the extent to which currency substitution will grow. The market solution draws its legitimacy from the efficiency gains of locating production in the lowest cost location; since banking services are highly mobile there is no guarantee that these services will not in future be purchased more efficiently from off-shore locations, perhaps involving non-sterling currencies as transactions media. Alternatively, as there are economies of scale in production, a UK location may prove efficient for global services performed for other economies. In either event, widespread currency substitution would have radical consequences for monetary policy, as has been spelt out in a number of recent papers by McKinnon.[3]

7. Consequences for asset prices

It is particularly difficult to draw inferences from the removal of exchange control for its consequences for the exchange rate and for interest rates. The coincidence of other major shocks at this time is especially awkward in this respect.

[1] Some recent work by Chrystal (1986), however, might provide a possible qualification. Using daily data on Euro-sterling and interbank rates, Chrystal finds evidence of a move to integration before the abolition of the controls, specifically in the period September 1978 — February 1979. What is unknown of course is whether this movement would have proved irreversible in the absence of a lifting of the controls or would, on the contrary, have been shown to be a temporary and accidental phase. On our view of the matter, the latter is the more likely.

[2] This is discussed in Llewellyn (1980).

[3] See, for example, McKinnon (1984).

The Bank of England's 1981 study cautiously concluded that the abolition of controls must have had some depreciating effect on the exchange rate, considered in itself, and may have had some effect in keeping interest rates down. The two effects are to some degree alternatives; if the controls succeeded in holding down the rate of return on British assets, investment in them would have been correspondingly less attractive for foreigners and the impact on the net demand for sterling and therefore the exchange rate consequently diminished.

It seems plausible in view of our discussion of the probable impact of abolition on balance of payments flows that the controls did contain the net demand for foreign currency: removing them should have depreciated the exchange rate. The evidence of the change in on-shore/off-shore interest differentials might be thought to indicate that domestic rates were reduced by the controls, since positive pre-abolition differentials in favour of off-shore rates fall or become negative after abolition. But the off-shore rate is in covered interest parity with the US domestic rate, and would only be itself unaffected by abolition, if abolition made no difference to the exchange rate and expectations of its future value. Raw data processing on a pre- and post-abolition basis has no chance of revealing effects on either the exchange rate or on interest rates; as is well known, the sterling exchange rate continued to appreciate strongly during 1980 and 1981 whilst nominal interest rates also rose during 1980. Chrystal (1985) has also looked at real interest rates, but arrived at no firm conclusion that abolition had definite effects on either nominal or real interest rates. There were strong coincidental forces making for an effect in the direction opposite to that which might have been associated with abolition *per se* both on the exchange rate and on interest rates.

8. Conclusions

Several conclusions can be drawn from the British experience in removing exchange controls. First, the removal of those controls does appear to have contributed towards eliminating deviations from covered interest parity and reveals their presence to have been more of a hindrance to financial integration than was perhaps fully realized at the time. The integration which abolition has accomplished has in turn posed a felt discipline on the type of monetary policy available; it creates a presumption of a strong decline in the effectiveness of sterilized intervention, a presumption against quantitative controls on credit (or controls producing this effect) and a presumption in favour of a very liberal regime of monetary regulation such as the UK now enjoys. Further into the future, the potential for currency substitution has still to be revealed. Second, various effects on the balance of payments flows can be discerned; in particular, a marked outflow of portfolio investment is to be found, and the balance of payments flows (on both sides of the balance sheet) bear witness to a greater degree of financial integration. Third, whilst there is a presumption from the apparent balance of payments effects that abolition produced a depreciation impact on the exchange rate and some presumption that interest rates may have been raised *ceteris paribus*, neither effect is evident from the data. At the time when the restrictions were lifted the UK balance of payments was also affected by other important shocks: the new monetary regime of the Thatcher government, the second oil price shock and the move from oil deficit to self-sufficiency in production. These factors serve to obscure any effects abolition may have had on asset prices and hinder quantitative assessment of the effects on balance of payments flows. They also qualify the value of the British experiment as a guide to the likely experience of other countries taking the same route; among the findings, those pertaining to the impetus to financial integration are perhaps the most robust to this qualification.

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Part Three — The proposals presented by the Commission to the Council for the creation of a European financial area

In November 1987 the Commission presented to the Council a set of proposals for the implementation of the final phase of its programme for liberalizing capital movements presented in May 1986.

They comprise:

(i) a proposal for a Directive for the complete liberalization of capital movements;

(ii) a proposal for a Directive amending the 1972 Directive on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity;

(iii) a proposal for a Regulation adjusting and combining the existing Community instruments for providing medium-term financial support for Member States' balances of payments.

The proposals were put forward in a Communication from the Commission to the Council indicating the main options adopted and drawing attention to three sets of complementary questions: harmonization of supervisory and prudential rules in the field of finance; tax aspects of the liberalization of capital movements; and the link with participation by all Community currencies in the EMS exchange-rate mechanism.

I — Communication from the Commission

Creation of a European financial area

Introduction

In April 1983, the Commission sent the Council a communication on financial integration.[1] This gave new impetus to Community discussions and was followed in May 1986 by a programme for the liberalization of capital movements,[2] which is a vital element in the creation of an integrated financial area. The first stage of that programme was put into effect by the Council in November 1986 when it adopted a Directive which entered into force on 1 March 1987 extending the list of liberalized transactions.

Several Member States have taken measures which go beyond their Community obligations; and the relaxation of exchange controls in France and Italy has made it possible to terminate the protective clauses under Article 108 of the Treaty from which they previously benefited.

The programme adopted in May 1986 stipulates that the Commission will study with the Monetary Committee and the Committee of Central Bank Governors the implications of financial integration for monetary cooperation and on the liberalization of financial services. It also stated that proposals for a Directive establishing the full liberalization of capital movements will be submitted to the Council in 1987.

A link was established between the strengthening of the EMS and the liberalization of capital movements during the discussions which followed the realignment of January 1987. At their informal meeting in Knokke in April 1987, the Ministers for Finance agreed that the measures under examination for strengthening the EMS should be adopted in September and that the Commission would present as soon as possible afterwards its proposals on the liberalization of capital movements.

The informal meeting of Ministers in Nyborg in September approved a package on the strengthening of the EMS and welcomed the Commission's intention to send its proposals for the implementation of the final stage of the liberalization of capital movements to the Council meeting of November.

The first part of this document outlines the main options on which those proposals are based.

The second part considers the following three complementary questions, which have been posed during the Commission's considerations on the implications of the full liberalization of capital movements and in the notes sent by the President of the Commission to the President of the Council for the informal meetings of the Finance Ministers:

(i) How should the programme to liberalize capital movements fit in with the programme to harmonize national supervisory structures, whose purpose is to facilitate the full freedom of financial services while ensuring the protection of savings and the conditions for fair competition between financial intermediaries?

(ii) With no restrictions, capital movements will be determined to a greater extent by fiscal considerations. What measures may be necessary to ensure that there is no misallocation of capital and to combat a possible increase in fiscal evasion?

(iii) Maintaining stable exchange rates is necessary both for achieving and preserving the large internal market. What relationship is there between financial integration and participation in the exchange rate mechanism of the EMS?

The Commission's view is that solutions to these questions must not be regarded as pre-conditions for the programme of liberalization of capital movements. An integrated financial market will not be achieved by simultaneously implementing all the necessary measures. On the contrary, it will be achieved by creating a dynamic movement towards integration and accepting some disequilibrium within an overall programme which is both coherent and binding. The liberalization of capital movements will itself provide the momentum for this process.

Legislative proposals for the final state of the liberalization of capital movements

The Commission's proposals are based on three texts:

(i) A proposal for a Directive for the full liberalization of capital movements;

(ii) A proposal for the amendment of the 1972 Directive on regulating international capital flows;

(iii) A proposal for a Regulation amending and combining the existing two Community instruments which are available to provide medium-term balance of payments assistance.

[1] COM(83) 207 final.
[2] COM(86) 292 final.

1. The Directive to implement the full liberalization of capital movements

The purpose of this Directive, which will be based on Article 69 of the Treaty, is to extend liberalization to all capital movements. This extension will cover mainly the following operations:

(i) investments in short-term securities;

(ii) current and deposit account operations;

(iii) financial loans and credits.

As the Directive will also stipulate that transfers made for the purposes of capital movements must be effected on the same exchange rate conditions as those for current payments, a dual exchange market could not be maintained or introduced except under a safeguard clause, provided for in the Treaty or in this Directive.

The obligation to liberalize will be worded in a general way. This will remove any ambiguities over its scope, which may remain even after the decisions of the Court of Justice on this subject. The obligation must be interpreted to imply:

(i) not only the elimination of restrictions on capital transfers but also on the underlying transactions;

(ii) the possibility for a resident in one Member State to have access to the financial system of another Member State and all the financial products that are available there; this resident therefore puts himself in the regulatory framework of the market in which he deals;

(iii) the elimination in domestic rules of discriminatory measures, for example fiscal discrimination, and restrictions imposed on certain types of investor, in so far as they are not strictly necessary for prudential reasons.

The new Directive will contain a safeguard clause which would permit the reintroduction of controls on short-term capital movements if they were seriously endangering a Member State's monetary or exchange rate policy.

Exercise of the safeguard clause would be subject to Community procedures. Either the Commission, after consulting the Monetary Committee and the Committee of Central Bank Governors, would authorize the implementation of protective measures; or in an emergency the Member State would do so itself, in which case it would inform the Commission and the Member States. The Commission may then decide whether the measures taken should be amended or suspended. In all cases the measures would be limited in time to a maximum of six months and could only affect transactions newly liberalized by the Directive.

A safeguard clause in the Directive itself is necessary, despite the fact that the Treaty provides safeguard clauses through Articles 73, 108 and 109, for the following reasons:

(i) Articles 108 and 109 require that the Member State has balance of payments difficulties, but there can be disruptive short-term capital movements without a balance of payments crisis. Article 73 refers to 'disturbances in the functioning of the capital market'. There are risks in encouraging a wide interpretation of this to cover monetary and exchange rate difficulties connected with short-term transactions.

(ii) As the measures would affect short-term and monetary transactions, the Committee of Central Bank Governors should be consulted; but the safeguard clauses of the Treaty do not provide for this.

(iii) It is desirable to have a short fixed time-limit.

Four Member States — Spain, Portugal, Greece and Ireland — are not in a position to proceed to the final stage of the liberalization of capital movements at the same pace for a variety of reasons such as: precarious balance of payments positions, high external indebtedness, less developed domestic financial systems, etc.

The new Directive will provide for a longer timetable over which these countries would remove controls on the transactions covered. This would not affect the special provisions which already apply in these countries on other transactions covered by previous legislation.

For Spain and Ireland it is proposed that the transitional period would terminate at the end of 1990; and for Portugal and Greece at the end of 1992.

2. Amendment of the 1972 Directive on regulating international capital flows

The purpose of amending this Directive is the following:

(i) To include a declaration of intent that the degree of liberalization of capital movements to and from third countries should be equivalent to those within the Community. This solution is preferable to the introduction into Community law of an obligation to liberalize *erga omnes*. Although this would probably be done in practice, such a legal commitment, which would be more difficult to reverse than to make, could compromise the Community as a whole or individual Member States in negotiations with third countries.

(ii) To give operational content to the notion that there should be a Community dimension, which is contained in the preamble to the existing text but not in the Articles. The proposal is that Member States would keep the Commission informed of measures taken *vis-à-vis* third countries, and that the Commission, after consulting with the Monetary Committee, would be able to make recommendations to the Member States.

(iii) To extend the range of instruments covered by the Directive and to make them the same as the instruments which would be necessary for the implementation of the safeguard clause in the new Directive implementing Article 67 of the Treaty.

It is desirable to include these aims in an amended version of the 1972 Directive rather than in the new Directive because they have to be based on different Articles of the Treaty.

3. Mechanisms providing medium-term balance of payments assistance

The purpose of the proposal, which takes the form of a regulation based on Articles 108 and 235, is to:

(i) establish a single instrument to provide medium-term financial support (MTFS) by combining the existing Community loan and medium-term financial assistance mechanisms;

(ii) make the Community loan the primary instrument for medium-term assistance;

(iii) extend the conditions under which medium-term assistance can be granted to cover needs associated with the liberalization of capital movements as well as general balance of payments difficulties.

It is desirable to fuse the two instruments for the following reasons:

(i) it will unify the conditions under which they can be granted, while preserving their different financing methods;

(ii) it reflects the current reality that the MTFS is not used.

The granting of the loan, or the opening of a credit line, would be made by a Council decision taken by a qualified majority on a proposal from the Commission after the Monetary Committee had been consulted. The decision would cover: the amount of the loan, its length, procedures (e.g. single or phased payment) and the economic policy conditions to be attached. The nature of the conditionality would depend on whether the loan was activated for purely balance of payments reasons or whether it was granted to assist the process of liberalization of capital movements.

The broadening of the mechanisms' scope and the order of precedence introduced between the two financing methods will mean that the upper limit on the outstanding amount of financing in the form of market borrowing should have to be raised to more than the present 8 000 million ECU.

Complementary questions

1. The protection of savers and depositors: The harmonization of supervisory and prudential rules

The liberalization of capital movements, combined with the full liberalization of financial services, will not only allow capital to move freely throughout the Community, but will also make it possible for banks, the many different categories of savings institutions and other financial intermediaries to offer and advertise their services to savers and depositors throughout the Community either through establishments in the Member States or across frontiers without establishments.

It is important that this liberalization should take place in a framework which ensures a satisfactory level of protection for savers and depositors, high standards of disclosure and information for investors and shareholders, equal conditions of competition in financial markets and the solvency and stability of banks and other financial institutions.

The Commission's approach to the question of investor and depositor protection distinguishes between two different situations. The first case is where a resident in one Member State addresses himself on his own initiative to a supplier of financial services in another Member State. The second case is where a supplier from one Member State wishes to market his services and solicit business from the residents of another Member State, either from an establishment in that other Member State or across frontiers under the freedom of services provisions of the Treaty.

In the first case the residents of any one Member State should be free to address themselves to the suppliers of financial services and products in any other Member State on the same terms and conditions as residents in that Member State. In doing so, the client or purchaser of financial

services is deemed to place himself under the regulatory framework of the Member State of the supplier and accordingly he cannot invoke the rules of his country of residence to protect himself. Banking and other savings institutions in all Member States of the Community are in general subject to strict regulation by the national authorities both as regards their solvency and liquidity and as regards the protection of investors and depositors.

To deal with the second case, the Commission has initiated a substantial programme of legislation to harmonize national rules for the prudential supervision of financial institutions and for the protection and information of investors. Many of these measures have already been adopted or are under discussion by the Council; the remaining proposals will be put forward by the Commission before the end of 1988. The objectives of the measures proposed are:

(a) the removal of the remaining obstacles (i.e. other than exchange controls) to the freedom of establishment and freedom of services;

(b) harmonizing prudential rules to ensure the solvency and financial stability of financial institutions;

(c) ensuring equivalent standards of investor, depositor and consumer information and protection.

The method of approach in the legislation as set out in the White Paper comprises three main elements:

(i) the harmonization of the essential elements of prudential rules and standards;

(ii) the mutual recognition of the way in which these standards are applied in the different Member States;

(iii) based on (i) and (ii), the principle of 'home country control', i.e. the principle that all the activities of banks (and other financial institutions) throughout the Community, whether carried out through a branch or by cross-frontier provision of services, will be supervised by the authorities of the Member States of the head office.

Although it is important that rapid progress should be made in the adoption of the harmonizing measures described above, their adoption should not be regarded as a precondition for the final phase of liberalization of capital movements. Many of the measures in question indeed relate to transactions which have already been liberalized. In the view of the Commission this programme provides a sufficient level of protection for savers and depositors; no further specific prudential measures are required for the completion of the liberalization of capital movements.

2. Taxation questions

The liberalization of capital movements highlights the following four issues in the field of direct taxation:

(i) harmonization of company taxation;

(ii) tax evasion;

(iii) discriminatory provisions in national tax systems that provide an incentive for private individuals to invest in national securities;

(iv) restrictions on investments by pension funds in Member States.

2.1. Harmonization of company taxation

The full benefits of the liberalization of capital movements will not be obtained if investment decisions are distorted by significant differences in company taxation between Member States. Such decisions include not only decisions by companies as to where to set up their head office and where to do business, but also decisions by shareholders and individual investors as to where to place their funds.

The Commission takes the view that these distortions should be substantially reduced by a closer approximation of the systems, the taxable base and tax rates of company taxation in the different Member States. Its approach to this issue will be set out fully in a White Paper on the taxation of enterprises to be issued before the end of this year. The Commission will take as the starting point the Directive for the harmonization of company taxation systems which it put forward in August 1975. This proposal will be complemented by a proposal to harmonize the tax base and some aspects of the 1975 proposals will be amended. In particular, the bracket of tax rates then proposed (45-55 %) is now too high in view of recent and prospective developments in Member States.

2.2. Tax evasion

The final stage of liberalization of capital movements carries with it a risk of increased tax evasion. This is because investors in all Member States will be able to have investment income paid into bank accounts held by them outside their country of residence and this will heighten the risk that this income will not be declared in their country of residence. The Commission takes the view that an increase in tax evasion would be a matter of serious concern both because of the loss of budgetary revenue and because of the damage to fiscal equity, and that practical measures should be taken to minimize this risk.

This risk is less in the case of income arising from dividends than from interest from bonds or bank deposits. In the former case, in a large majority of Member States a substantial part of the tax due from the shareholder is deducted at source (usually through a withholding tax) by the company. The proposals in the Commission's 1975 Directive for the harmonization of corporate taxation would ensure a common Community system for ensuring such a deduction.

The risk is greater in the case of interest income, because most industrial countries either impose no withholding tax at all on such income or exempt non-residents from its application.

Tax evasion already takes place, even where exchange controls have not been removed, and the extent of any increase in evasion, when these controls are removed, must be uncertain. If, as capital movements become completely liberalized throughout the Community, the threat of increased evasion proves substantial, two main types of remedy (which are not mutually exclusive) could be considered:

(i) a generalized withholding tax applied either to all residents and non-residents alike or at least to all Community residents;

(ii) an obligation on banks to disclose information about interest income, received by Community residents, to their tax authorities.

Either of these solutions would ensure that any interest income paid into a bank account within the Community would be taxed. The withholding tax would be administratively more simple. But it would probably have to be levied at a relatively low rate and the revenue would accrue to the country where the income arises. The obligation on banks to declare income would ensure that the taxpayers concerned paid the full tax due to their country of residence. But it could only be operated if banking secrecy requirements, applying in several Member States, were removed.

The problem of fiscal evasion presents Member States with a dilemma. The more effective any measures taken within the Community to combat such evasion, the greater the risk of capital movements to third countries. A fully effective solution can therefore only be achieved through international agreements either for the more general extension of a withholding tax on interest or for stronger cooperation between fiscal administrations. So far as a generalized withholding tax is concerned, the prospects for such an agreement seem remote at present. As regards stronger cooperation between tax authorities, prospects seem somewhat brighter, since a convention has now been negotiated in the Council of Europe and the OECD and will soon be open for signature.

Conclusions

The final phase of liberalization of capital movements entails a risk of increased fiscal evasion. There is no watertight solution to this problem, but everything possible must be done to minimize the risks.

Action to strengthen cooperation between fiscal administrations, e.g. in cases of suspected fraud, would be helpful and should in any case be set in hand. The other two main options are a withholding tax on all forms of interest payment to be paid at least by all Community residents and/or a general obligation on all banks to declare interest income to Community fiscal authorities.

The Council is invited to give its views on these solutions and on any other solutions which may be considered feasible.

2.3. Discriminatory provisions in national tax systems that provide an incentive for private individuals to invest in national securities

There has been an increasing tendency in Member States in recent years to introduce tax incentives for the purchase of domestic securities (shares and bonds). These measures could be regarded as discriminatory and might lead to distortions in capital movements and to a misallocation of capital investment. Such measures may take the form of a deduction from taxable income of sums invested in such securities, generally up to a specific ceiling, and/or of an exemption, likewise normally subject to a specific ceiling, for income arising from such securities. They are normally limited over time.

The Commission takes the view that such distortions should be eliminated. It is proposing to open discussions with the Member States concerned with the view to imposing a standstill and gradually removing any distortion or discrimination. In the latter case Member States would have the choice of discontinuing the tax concession or extending it to securities issued in other Member States.

2.4. Restrictions on investments by pension funds in Member States

Some Member States do not allow pension funds to invest in foreign securities, or restrict their scope for doing so, thereby impeding the free movement of capital.

The Commission is aware that some form of prudential supervision might be justified in the case of pension funds.

However, the restrictions are, in its view, excessive. It is planning to start discussions with the Member States concerned with a view to their gradual removal.

3. The relationship between liberalization of capital movements and the EMS

Full participation in the exchange rate mechanism of the EMS and liberalization of capital movements are complementary. On the one hand, liberalization can be undertaken because of the support given by the system to the stabilization of exchange rates. On the other hand, liberalization increases the need to fully coordinate policies and hence requires a strengthened system. Those countries which do not fully participate and which have not liberalized capital movements should complete the two processes in parallel.

Sterling presents a different case. The UK has fully liberalized capital movements but does not participate in the exchange rate mechanism. This has a number of disadvantages both for the UK, its closest partners, and for the Community as a whole:

(i) For the UK it has been recognized that the exchange rate is a valuable policy target and the authorities maintain a degree of stability *vis-à-vis* the Community currencies. The credibility of this policy would, however, be enhanced if it were formalized.

(ii) For its closest partners, Ireland especially, which has very close commercial and financial links with the UK, sterling's non-participation causes problems. The very large potential for capital flows between the two countries has made it more difficult for Ireland to move fully towards liberalization of capital movements.

(iii) For the Community as a whole, the overall purpose is to complete a large internal market. This goes beyond the establishment of a free trade area and a zone of unimpeded capital mobility and requires exchange rate stability throughout the European financial area. The creation of an integrated financial area implies a degree of joint management through a reasonable homogeneous regulatory and supervisory framework and close and structured coordination between monetary authorities.

II — Proposal for a Council Directive for the implementation of Article 67 of the EEC Treaty

Liberalization of capital movements

(Presented by the Commission)

The Council of the European Communities,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 69 thereof,

Having regard to the proposal from the Commission, which consulted the Monetary Committee for this purpose,

Having regard to the Opinion of the European Parliament,

Whereas Article 8A of the Treaty stipulates that the internal market shall comprise an area without internal frontiers in which the free movement of capital is ensured;

Whereas Member States should be able to take, within the framework of appropriate Community procedures, the requisite measures to regulate bank liquidity and, if necessary, to restrict temporarily short-term capital movements which, even where there is no appreciable divergence in economic fundamentals, seriously disrupt the conduct of their monetary and exchange-rate policies;

Whereas, in the interests of transparency, it is advisable to indicate the scope, in accordance with the Nomenclature laid down in this Directive, of the transitional measures adopted for the benefit of the Kingdom of Spain and the Portuguese Republic by the 1985 Act of Accession in the field of capital movements;

Whereas the Kingdom of Spain and the Portuguese Republic may, under the terms of Articles 61 to 66 and 222 to 232 respectively, of the 1985 Act of Accession, postpone the liberalization of certain capital movements in derogation from the obligations of the Directive of 11 May 1960; whereas Council Directive 86/566/EEC of 17 November 1986 also provides for transitional arrangements to be applied for the benefit of those two Member States in respect of their obligations to liberalize capital movements; whereas it is appropriate for those two Member States to be able to postpone the application of the new liberalization obligations resulting from this Directive for the same periods and for the same economic reasons;

Whereas the Hellenic Republic and Ireland are faced, albeit to differing degrees, with difficult balance-of-payments situations and high levels of external indebtedness; whereas the immediate and complete liberalization of capital movements by those two Member States would make it more difficult for them to continue to apply the measures they have taken to improve their external positions and to reinforce the capacity of their financial systems to adapt to the requirements of an integrated financial market in the Community; whereas it is appropriate, in accordance with Article 8C of the Treaty, to grant to those two Member States, in the light of their specific circumstances, further time in which to comply with the obligations arising from this Directive,

Has adopted this Directive:

Article 1

1. Without prejudice to the following provisions, Member States shall abolish restrictions on the movement of capital taking place between persons resident in Member States. The different categories of capital movement are set out in Annex I to this Directive.

2. Transfers in respect of capital movements shall be made on the same exchange-rate conditions as those ruling for payments relating to current transactions.

Article 2

Member States shall notify the Commission, the Monetary Committee and the Committee of Governors of the Central Banks, by the date of their entry into force at the latest, of measures to regulate bank liquidity which have a specific impact on capital operations carried out by credit institutions with non-residents and which involve regulation of the net external positions of such institutions or of the setting of compulsory reserve ratios on their external assets or liabilities.

Such measures shall be confined to what is necessary for the purposes of domestic monetary regulation.

Article 3

1. Where short-term capital movements of exceptional magnitude impose severe strains on foreign-exchange markets and lead to serious disturbances in the conduct of a Member State's monetary and exchange-rate policies, being reflected in particular in substantial variations in domestic liquidity, the Commission may, after consulting the Monetary Com-

mittee and the Committee of Governors of the Central Banks, authorize that Member State to take, in respect of the capital movements listed in Annex II to this Directive, protective measures, the conditions and details of which the Commission shall determine.

2. The Member State concerned may itself take the protective measures referred to above, on grounds of urgency, should these measures be necessary. The Commission and the other Member States shall be informed of such measures by the date of their entry into force at the latest. The Commission may, after consulting the Monetary Committee and the Committee of Governors of Central Banks, decide that the Member State concerned shall amend or abolish the measures.

3. The period of application of protective measures taken pursuant to this Article shall not exceed six months.

Article 4

The provisions of this Directive shall not prejudice the right of Member States to take all requisite measures to prevent infringements of their laws and regulations or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information.

Application of those measures and procedures may not have the effect of impeding the capital movements in question.

Article 5

For the Kingdom of Spain and the Portuguese Republic, the scope, in accordance with the Nomenclature of capital movements contained in Annex I to this Directive, of the provisions of the 1985 Act of Accession in the field of capital movements shall be as indicated in Annex III.

Article 6

1. The Member States shall take the measures necessary for them to comply with this Directive no later than ..... They shall forthwith inform the Commission thereof. They shall also make known, by the date of their entry into force at the latest, any new measure or any amendment made to the provisions governing the capital movements listed in Annex I to this Directive.

2. The Kingdom of Spain and the Portuguese Republic, without prejudice for these two Member States to Articles 61 to 66 and 222 to 232 of the 1985 Act of Accession, and the Hellenic Republic and Ireland may temporarily continue to apply restrictions on the capital movements listed in Annex IV to this Directive, subject to the conditions and time-limits laid down in that Annex.

Article 7

The Nomenclature of capital movements and the Explanatory Notes in Annex I, together with Annexes II, III and IV, form an integral part of this Directive.

Article 8

The Council Directive of 11 May 1960, as last amended by Council Directive 86/566/EEC of 17 November 1986, is hereby repealed.

Article 9

This Directive is addressed to the Member States.

Done at Brussels,

For the Council

The President

Annex I

Nomenclature of the capital movements referred to in Article 1 of the Directive

In this Nomenclature, capital movements are classified according to the economic nature of the assets and liabilities they concern, denominated either in national currency or in foreign exchange.

The capital movements listed in this Nomenclature are taken to cover:

(i) all the operations necessary for the purposes of capital movements: conclusion and performance of the transaction and related transfers. The transaction is generally between residents of different Member States although some capital movements are carried out by a single person for his own account (e.g. transfers of assets belonging to emigrants);

(ii) operations carried out by any natural or legal person,[1] including operations in respect of the assets or liabilities of Member States or of other public administrations and agencies, subject to the provisions of Article 68 (3) of the Treaty;

(iii) access for the economic operator to all the financial techniques available on the market approached for the purpose of carrying out the operation in question. For example, the concept of acquisition of securities and other financial instruments covers not only spot transactions but also all the dealing techniques available: forward transactions, transactions carrying an option or warrant, swaps against other assets, etc. Similarly, the concept of operations in current and deposit accounts with financial institutions includes not only the opening and placing of funds on accounts but also forward foreign-exchange transactions, irrespective of whether these are intended to cover an exchange risk or to take an open foreign-exchange position;

(iv) operations to liquidate or assign assets built up, repatriation of the proceeds of liquidation thereof[1] or immediate use of such proceeds within the limits of Community obligations;

(v) operations to repay credits or loans.

I — Direct investments[1]

1. Establishment and extension of branches or new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings.
2. Participation in new or existing undertakings with a view to establishing or maintaining lasting economic links.
3. Long-term loans with a view to establishing or maintaining lasting economic links.
4. Reinvestment of profits with a view to maintaining lasting economic links.

A — Direct investments on national territory by non-residents[1]

B — Direct investments abroad by residents[1]

II — Investments in real estate (not included under I)[1]

A — Investments in real estate on national territory by non-residents

B — Investments in real estate abroad by residents

III — Operations in securities normally dealt in on the capital market (not included under I, IV and V)

(a) Shares and other securities of a participating nature.[1]

(b) Bonds.[1]

A — Transactions in securities on the capital market

1. Acquisition by non-residents of domesic securities dealt in on a stock exchange.[1]
2. Acquisition by residents of foreign securities dealt in on a stock exchange.
3. Acquisition by non-residents of domestic securities not dealt in on a stock exchange.[1]
4. Acquisition by residents of foreign securities not dealt in on a stock exchange.

B — Admission of securities to the capital market[1]

(i) Introduction on a stock exchange.[1]

(ii) Issue and placing on a capital market.[1]

[1] See explanatory notes.

[1] See explanatory notes.

1. Admission of domestic securities to a foreign capital market.

2. Admission of foreign securities to the domestic capital market.

IV — Operations in units of collective investment undertakings[1]

(a) Units of undertakings for collective investment in securities normally dealt in on the capital market (shares, other equities and bonds).

(b) Units of undertakings for collective investment in securities or instruments normally dealt in on the money market.

(c) Units of undertakings for collective investment in other assets.

A — Transactions in units of collective investment undertakings

1. Acquisition by non-residents of units of national undertakings dealt in on a stock exchange.

2. Acquisition by residents of units of foreign undertakings dealt in on a stock exchange.

3. Acquisition by non-residents of units of national undertakings not dealt in on a stock exchange.

4. Acquisition by residents of units of foreign undertakings not dealt in on a stock exchange.

B — Admission of units of collective investment undertakings to the capital market

(i) Introduction on a stock exchange.

(ii) Issue and placing on a capital market.

1. Admission of units of national collective investment undertakings to a foreign capital market.

2. Admission of units of foreign collective investment undertakings to the domestic capital market.

[1] See explanatory notes.

V — Operations in securities and other instruments normally dealt in on the money market[1]

A — Transactions in securities and other instruments on the money market

1. Acquisition by non-residents of domestic money market securities and instruments.

2. Acquisition by residents of foreign money market securities and instruments.

B — Admission of securities and other instruments to the money market

(i) Introduction on a recognized money market.[1]

(ii) Issue and placing on a recognized money market.

1. Admission of domestic securities and instruments to a foreign money market.

2. Admission of foreign securities and instruments to the domestic money market.

VI — Operations in current and deposit accounts with financial institutions[1]

A — Operations carried out by non-residents with domestic financial institutions

B — Operations carried out by residents with foreign financial institutions

VII — Credits related to commercial transactions or to the provision of services in which a resident is participating[1]

1. Short-term (less than one year).

2. Medium-term (from one to five years).

3. Long-term (five years or more).

A — Credits granted by non-residents to residents

B — Credits granted by residents to non-residents

[1] See explanatory notes.

VIII — Financial loans and credits (not included under I, VII and XI)[1]

1. Short-term (less than one year).
2. Medium-term (from one to five years).
3. Long-term (five years or more).

A — Loans and credits granted by non-residents to residents

B — Loans and credits granted by residents to non-residents

IX — Sureties, other guarantees and rights of pledge

A — Granted by non-residents to residents

B — Granted by residents to non-residents

X — Transfers in performance of insurance contracts

A — Premiums and payments in respect of life assurance

1. Contracts concluded between domestic life assurance companies and non-residents.
2. Contracts concluded between foreign life assurance companies and residents.

B — Premiums and payments in respect of credit insurance

1. Contracts concluded between domestic credit insurance companies and non-residents.
2. Contracts concluded between foreign credit insurance companies and residents.

C — Other transfers of capital in respect of insurance contracts

[1] See explanatory notes.

XI — Personal capital movements

A — Loans

B — Gifts and endowments

C — Dowries

D — Inheritances and legacies

E — Settlement of debts by immigrants in their previous country of residence

F — Transfers of assets constituted by residents, in the event of emigration, at the time of their installation or during their period of stay abroad

G — Transfers, during their period of stay, of immigrants' savings to their previous country of residence

XII — Physical import and export of financial assets

A — Securities

B — Means of payment of every kind

XIII — Other capital movements

A — Death duties

B — Damages (where these can be considered as capital)

C — Refunds in the case of cancellation of contracts and refunds of uncalled-for payments (where these can be considered as capital)

D — Authors' royalties: patents, designs, trade marks and inventions (assignments and transfers arising out of such assignments)

E — Transfers of the moneys required for the provision of services (not included under VI)

F — Miscellaneous

Explanatory notes

For the purposes of this Nomenclature, the following expressions have the meanings assigned to them respectively:

Direct investments

Investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain lasting and direct links between the person providing the capital and the entrepreneur to whom or the undertaking to which the capital is made available in order to carry on an economic activity. This concept must therefore be understood in its widest sense.

The undertakings mentioned under I-1 of the Nomenclature include legally independent undertakings (wholly-owned subsidiaries) and branches.

As regards those undertakings mentioned under I-2 of the Nomenclature which have the status of companies limited by shares, there is participation in the nature of direct investment where the block of shares held by a natural person or another undertaking or any other holder enables the shareholder, either pursuant to the provisions of national laws relating to companies limited by shares or otherwise, to participate effectively in the management of the company or in its control.

Long-term loans of a participating nature, mentioned under I-3 of the Nomenclature, means loans for a period of more than five years which are made for the purpose of establishing or maintaining lasting economic links. The main examples which may be cited are loans granted by a company to its subsidiaries or to companies in which it has a share, and loans linked with a profit-sharing arrangement. Loans granted by financial institutions with a view to establishing or maintaining lasting economic links are also included under this heading.

Investments in real estate

Purchases of buildings and land and the construction of buildings by private persons for gain or personal use. This category also includes rights of usufruct, easements and building rights.

Introduction on a stock exchange or on a recognized money market

Access — in accordance with a specified procedure — for securities and other negotiable instruments to dealings, whether controlled officially or unofficially, on an officially recognized stock exchange or in an officially recognized segment of the money market.

Securities dealt in on a stock exchange (quoted or unquoted)

Securities the dealings in which are controlled by regulations, the prices for which are regularly published, either by official stock exchanges (quoted securities) or by other bodies attached to a stock exchange, e.g. committees of banks (unquoted securities).

Issue of securities and other negotiable instruments

Sale by way of an offer to the public.

Placing of securities and other negotiable instruments

The direct sale of securities by the issuer or by the consortium which the issuer has instructed to sell them, with no offer being made to the public.

Domestic or foreign securities and other instruments

Securities according to the country in which the issuer has his principal place of business. Acquisition by residents of domestic securities and other instruments issued on a foreign market ranks as the acquisition of foreign securities.

Shares and other securities of a participating nature

Including rights to subscribe to new issues of shares.

Bonds

Negotiable securities with a maturity of two years or more from issue for which the interest rate and the terms for the repayment of the principal and the payment of interest are determined at the time of issue.

Collective investment undertakings

Undertakings:

(i) the object of which is the collective investment in transferable securities or other assets of the capital they raise and which operate on the principle of risk-spreading, and

(ii) the units of which are, at the request of holders, under the legal, contractual or statutory conditions governing them, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a collective investment undertaking to ensure that the stock-exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.

Such undertakings may be constituted according to law either under the law of contract (as common funds managed by management companies) or trust law (as unit trusts) or under statute (as investment companies).

For the purposes of this Directive, 'common funds' shall also include unit trusts.

Securities and other instruments normally dealt in on the money market

Treasury bills and other negotiable bills, certificates of deposit, bankers' acceptances, commercial paper and other like instruments.

Credits related to commercial transactions or to the provision of services

Contractual trade credits (advances or payments by instalment in respect of work in progress or on order and extended payment terms, whether or not involving subscription to a commercial bill) and their financing by credits provided by credit institutions. This category also includes factoring operations.

Financial loans and credits

Financing of every kind granted by financial institutions, including financing related to commercial transactions or to the provision of services in which no resident is participating.

This category also includes mortgage loans, consumer credit and financial leasing, as well as back-up facilities and other note-issuance facilities.

Residents or non-residents

Natural and legal persons according to the definitions laid down in the exchange control regulations in force in each Member State.

Proceeds of liquidation (of investments, securities, etc.)

Proceeds of sale including any capital appreciation, amount of repayments, proceeds of execution of judgments, etc.

Natural or legal persons

As defined by the national rules.

Financial institutions

Banks, savings banks and institutions specializing in the provision of short-term, medium-term and long-term credit, and insurance companies, building societies, investment companies and other institutions of like character.

Credit institutions

Banks, savings banks and institutions specializing in the provision of short-term, medium-term and long-term credit.

Annex II

List of operations referred to in Article 3 of the Directive

Nature of operation	Heading
Operations in securities and other instruments normally dealt in on the money market	V
Operations in current and deposit accounts with financial institutions	VI
Operations in units of collective investment undertakings: undertakings for investment in securities or instruments normally dealt in on the money market	IV-A and B(c)
Financial loans and credits: short-term	VIII-A and B-1
Personal capital movements: loans	XI-A
Physical import and export of financial assets:	
— securities normally dealt in on the money market	
— means of payment	XII

Annex III

Referred to in Article 5 of the Directive

Scope of the provisions of the 1985 Act of Accession relating to capital movements, in accordance with the nomenclature of capital movements set out in Annex I to the Directive

Articles of the Act of Accession (dates of expiry of transitional provisions)	Nature of operation	Heading
	(a) Provisions concerning the Kingdom of Spain	
Art. 62 (31.12.1990)	Direct investments abroad by residents	I-B
Art. 63 (31.12.1990)	Investments in real estate abroad by residents	II-B
Art. 64 (31.12.1988)	Operations in securities normally dealt in on the capital market: acquisition by residents of foreign securities dealt in on a stock exchange, excluding bonds issued on a foreign market and denominated in national currency	III-A-2
	Operations in units of collective investment undertakings: acquisition by residents of units of collective investment undertakings dealt in on a stock exchange, excluding units of undertakings taking the form of common funds	IV-A-2
	(b) Provisions concerning the Portuguese Republic	
Art. 222 (31.12.1989)	Direct investments on national territory by non-residents	I-A
Art. 224 (31.12.1992)	Direct investments abroad by residents	I-B
Art. 225 & 226 (31.12.1990)	Investments in real estate on national territory by non-residents	II-A
Art. 227 (31.12.1992)	Investments in real estate abroad by residents	II-B
Art. 228 (31.12.1990)	Personal capital movements:	
	(i) for the purpose of applying the higher amounts specified in Article 228 (2):	
	— dowries	XI-C
	— inheritances and legacies	XI-D
	— transfers of assets built up by residents in case of emigration at the time of their installation or during their period of stay abroad	XI-F
	(ii) for the purpose of applying the lower amounts specified in Article 228 (2):	
	— gifts and endowments	XI-B
	— settlement of debts by immigrants in their previous country of residence	XI-E
	— transfers of immigrants' savings to their previous country of residence during their period of stay	XI-G
Art. 229 (31.12.1990)	Operations in securities normally dealt in on the capital market: acquisition by residents of foreign securities dealt in on a stock exchange, excluding bonds issued on a foreign market and denominated in national currency	III-A-2
	Operations in units of collective investment undertakings: acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange, excluding units of undertakings taking the form of common funds	IV-A-2

Annex IV

Referred to in Article 6 (2) of the Directive

I — The Kingdom of Spain and the Portuguese Republic may continue to apply or reintroduce, until 1 October 1989 and 31 December 1990 respectively, restrictions existing on the date of entry into force of this Directive on capital movements given in List I below:

List I

Nature of operation	Heading
Operations in units of collective investment undertakings:	
— Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange: undertakings subject to Directive 85/611/EEC[1] and taking the form of common funds	IV-A-2(a)
— Acquisition by residents of units of foreign collective investment undertakings not dealt in on a stock exchange: undertakings subject to Directive 85/611/EEC[1]	IV-A-4(a)

[1] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (Ucits) (OJ No L 375, 31.12.1985).

II — The Kingdom of Spain and the Portuguese Republic may continue to apply or reintroduce, until 31 December 1990 and 31 December 1992 respectively, restrictions existing on the date of entry into force of this Directive on capital movements given in List II below:

List II

Nature of operation	Heading
Operations in securities normally dealt in on the capital market:	
— Acquisition by residents of foreign securities dealt in on a stock exchange: bonds issued on a foreign market and denominated in national currency	III-A-2(b)
— Acquisition by residents (non-residents) of foreign (domestic) securities not dealt in on a stock exchange	III-A-3 and 4
— Admission of securities to the capital market where they are dealt in on, or in the process of introduction to, a stock exchange in a Member State	III-B-1 and 2
Operations in units of collective investment undertakings:	
— Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange: undertakings not subject to Directive 85/611/EEC[1] and taking the form of common funds	IV-A-2
— Acquisition by residents (non-residents) of units of foreign (domestic) collective investment undertakings not dealt in on a stock exchange: undertakings not subject to Directive 85/611/EEC[1] and the sole object of which is the acquisition of assets that have been liberalized	IV-A-3 and 4
— Admission to the capital market of units of collective investment undertakings: undertakings subject to Directive 85/611/EEC[1]	IV-B-1 and 2(a)
Credits related to commercial transactions or to the provision of services in which a resident is participating: long-term credits	VII-A and B-3

[1] See footnote to List I.

III — The Kingdom of Spain and Ireland, until 31 December 1990, and the Hellenic Republic and the Portuguese Republic, until 31 December 1992, may continue to apply or reintroduce restrictions existing at the date of entry into force of this Directive on capital movements given in List III below:

List III

Nature of operation	Heading
Operations in securities dealt in on the capital market: admission of securities to the capital market where they are not dealt in on, or in the process of introduction to, a stock exchange in a Member State	III-B-1 and 2
Operations in units of collective investment undertakings: admission to the capital market of units of collective investment undertakings undertakings not subject to Directive 85/611/EEC[1] and the sole object of which is the acquisition of assets that have been liberalized	IV-B-1 and 2
Financial loans and credits: medium-term and long-term	VIII-A, B-2 and 3

[1] See footnote to List I.

IV — The Kingdom of Spain and Ireland, until 31 December 1990, and the Hellenic Republic and the Portuguese Republic, until 31 December 1992, may defer liberalization of the capital movements given in List IV below:

List IV

Nature of operation	Heading
Operations in securities and other instruments normally dealt in on the money market	V
Operations in current and deposit accounts with financial institutions	VI
Operations in units of collective investment undertakings: undertakings for investment in securities or instruments normally dealt in on the money market	IV-A and B(c)
Financial loans and credits: short-term	VIII-A and B-1
Personal capital movements: loans	XI-A
Physical import and export of financial assets: — securities normally dealt in on the money market — means of payment	XII

III — Proposal for a Directive amending Directive 72/156/EEC on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity

(Presented by the Commission)

The Council of the European Communities,

Having regard to the Treaty establishing the European Community, and in particular Article 70(1) thereof,

Having regard to the proposal from the Commission, which consulted the Monetary Committee for this purpose,

Having regard to the opinion of the European Parliament,

Whereas by Directive .../EEC for the implementation of Article 67 of the Treaty, the Council established the free movement of capital between the residents of the Member States;

Whereas the Member States shall endeavour to attain the highest possible degree of liberalization in respect of movement of capital between the residents of the Community and those of third countries;

Whereas by Directive 72/156/EEC,[1] the Council established a set of instruments for regulating international capital flows and neutralizing their undesirable effects on domestic liquidity; whereas in view of the fact that the free movement of capital within the Community has been established, these instruments may be put into operation in order to regulate short-term capital movements between residents of the Member States of the Community only on the conditions and according to the safeguard procedures laid down in the Treaty and in Directive .../EEC; whereas Directive 72/156/EEC must be amended accordingly;

Whereas it must be possible for these instruments to be used on a recommendation from the Commission, in order to ensure coordinated action by the Member States, in the event of short-term capital flows to or from third countries leading to serious disturbances in their domestic monetary situation and in the stability of exchange rate relationships in the European Monetary System;

Whereas for the sake of clarity, it is advisable to present in a single text all the exacting terms of Directive 72/156/EEC, as amended by this Directive,

Has adopted this Directive:

Article 1

The exacting terms of Directive 72/156/EEC shall be replaced by the following:

'Article 1

1. In the arrangements which they apply to the conclusion or performance of transactions and to transfers in respect of capital movements with third countries, the Member States shall endeavour to attain the same degree of liberalization as in the case of operations taking place with residents of the other Member States of the Community.

2. The Member States shall inform the Commission of the restrictions which they impose on movements of capital to or from third countries at the date of entry into force of this Directive, and of any subsequent change to these provisions.

3. The Commission may make recommendations to Member States on this subject.

Article 2

The Member States shall take all necessary measures to ensure that the monetary authorities have available the following instruments and are able, where necessary, to put them into operation immediately without further enabling measures:

(a) for effective regulation of international capital flows:
   (i) rules governing the constitution of short-term assets or liabilities placed with non-residents and payment of interest on the short-term holdings of non-residents;
   (ii) regulation of short-term financial loans and credits granted to or contracted with non-residents;

(b) for the neutralization of those effects produced by international capital flows on domestic liquidity which are considered undesirable:
   (i) regulation of the net external position of credit institutions;

[1] OJ No L 91, 18.4.1972, p. 13.

(ii) fixing minimum reserve ratios, in particular for the holdings of non-residents.

Article 3

1. The Member States shall forthwith adopt the necessary measures to comply with this Directive. They shall forthwith inform the Commission thereof.

2. Each Member State shall, where necessary, and taking account of the interests of the other Member States, apply all or some of the instruments mentioned in Article 2.

When these instruments apply to movements of capital occurring between residents of the Member States of the Community, they may be put into operation only on the conditions and according to the procedures laid down in the provisions of the Treaty relating to the use of a safeguard clause or in the provisions of Articles 2 and 3 of Directive .../EEC for the implementation of Article 67 of the Treaty.

Without prejudice to these provisions, the Commission may recommend to the Member States that all or some of the instruments mentioned in Article 2 be put into operation, in the event of short-term capital flows to or from third countries leading to serious disturbances in the domestic monetary situation and in the stability of exchange rate relationships in the European Monetary System.

3. When the instruments mentioned in Article 2 are applied, the Commission shall ensure close coordination between the authorities of the Member States.

Article 4

In exercising the powers which are conferred upon it by this Directive, the Commission shall act in consultation with the Monetary Committee and the Committee of Governors of the Central Banks.

Article 5

This Directive is addressed to the Member States.'

Article 2

This Directive is addressed to the Member States.

Done at Brussels,

For the Council,

The President

IV — Proposal for a Council Regulation establishing a single facility providing medium-term financial support for Member States' balances of payments

(Presented by the Commission)

The Council of the European Communities,

Having regard to the Treaty establishing the European Economic Community, and in particular Articles 108 and 235 thereof,

Having regard to the proposal from the Commission, which consulted the Monetary Committee for this purpose,

Having regard to the Opinion of the European Parliament,

Whereas Article 108 of the Treaty provides for the granting of mutual assistance, to be decided by the Council on a proposal from the Commission, to a Member State in difficulties or seriously threatened with difficulties as regards its balance of payments; whereas the Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters confirmed the need for a Community facility for medium-term financial assistance of balances of payments;

Whereas it should be possible for the operation of lending to a Member State to take place soon enough in order to encourage that Member State to adopt, in good time, measures likely to prevent the occurrence of an acute balance-of-payments crisis;

Whereas a financing facility, in the form of a credit line or a loan commitment to a Member State undertaking to implement a capital liberalization programme despite a fragile balance-of-payments situation, should provide back-up for such a programme in orderly exchange-rate conditions;

Whereas each loan to a Member State must be linked to the adoption by that Member State of economic policy measures designed to re-establish or to ensure a sustainable balance-of-payments situation and adapted to the gravity of the balance-of-payments situation in that State and to the way in which it develops;

Whereas appropriate procedures and instruments should be provided for in advance to enable the Community and Member States to ensure that, if required, medium-term financial support is provided quickly, especially where circumstances call for immediate action;

Whereas, in order to finance the support granted, the Community needs to be able to use its creditworthiness to borrow resources that will be placed at the disposal of the Member States concerned in the form of loans; whereas operations of this kind are necessary for the achievement of the objectives of the Community as defined in the Treaty, especially the harmonious development of economic activities in the Community as a whole; whereas the Treaty makes no provision for the specific powers of action required for this purpose;

Whereas by Decision 71/143/EEC,[1] as amended by Decision 86/656/EEC,[2] the Council set up machinery for providing medium-term financial assistance that was initially valid for a period of four years from 1 January 1972; whereas this machinery has since been renewed and extended, on the last occasion for two years until 31 December 1988 by Decision 86/656/EEC; whereas this machinery provides for the Member States to grant medium-term loans, within certain limits, to one or more Member States experiencing balance-of-payments difficulties;

Whereas by Regulation (EEC) No 682/81,[3] as amended by Regulation (EEC) No 1131/85,[4] the Council set up a Community loan mechanism designed to support the balances of payments of the Member States; whereas this mechanism provides for the Community to contract loans, according to needs and within the limits set on outstanding borrowing, in order to on-lend the proceeds to one or more Member States experiencing balance-of-payments difficulties;

Whereas the Community loan mechanism has demonstrated its effectiveness; whereas its general design and the arrangements for implementing it still meet the needs of the Community; whereas, in view of the Community's borrowing capacity and of the conditions available to it for borrowing from financial institutions or on capital markets, the mechanism could constitute the main form of mutual assistance provided for under Article 108 of the Treaty; whereas it could also constitute, under certain conditions and in an appropriate form, an instrument to provide back-up for a programme of capital liberalization; whereas the ceiling on amounts outstanding under the mechanism should be adjusted accordingly;

Whereas, however, it is appropriate that the obligation on Member States to finance mutual assistance under the machinery for medium-term financial assistance stays in force until the final stage of the European Monetary System so as to ensure that system's cohesion and stability, irrespective of the conditions prevailing on international capital markets; whereas the present procedures for exempting a Member State from contributing or for mobilizing Member States' claims should, nevertheless, be simplified;

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[1] OJ L 73, 27.3.1971, p. 15.
[2] OJ L 382, 31.12.1986, p. 28.
[3] OJ L 73, 19.3.1981, p. 1.
[4] OJ L 118, 1.5.1985, p. 59.

Whereas it is appropriate to merge medium-term financial assistance and the Community loan mechanism into a single facility for medium-term financial support, while retaining their specific methods of financing,

Has adopted this Regulation:

Article 1

1. In accordance with the decision adopted by the Council pursuant to Article 3 or 4 and after consulting the Monetary Committee, the Commission shall be empowered to contract loans on the capital markets on behalf of the European Economic Community, with the aim of lending the proceeds to one or more Member States which are experiencing or seriously threatened with balance-of-payments difficulties or which have undertaken to implement a programme of capital liberalization despite a fragile balance-of-payments situation.

2. The outstanding amount of loans to be granted to Member States pursuant to paragraph 1 shall be limited to ... million ECU in principal.

Article 2

Where a Member State proposes to call upon sources of conditional financing outside the Community, it shall first consult the Commission and the other Member States in order to examine, among other things, the possibilities available under the Community facility for medium-term financial support. Such consultations shall be held within the Monetary Committee.

Article 3

1. On the initiative of the Commission acting pursuant to Article 108 of the Treaty or of the Member State experiencing balance-of-payments difficulties and seeking a Community loan, the Council, after examining the situation in that Member State and the adjustment programme that it has undertaken to implement, shall decide, as a rule during the same meeting:

(i) whether to grant the loan, and the amount of the loan;

(ii) the average duration of, and the techniques for disbursing the loan, which may be paid in one amount or in several instalments;

(iii) the economic policy conditions attaching to the loan, with a view to re-establishing a sustainable balance-of-payments situation.

2. If the amount available under the ceiling referred to in Article 1(2) is insufficient, or if the conditions available on international capital markets are unsatisfactory, Community loans to Member States experiencing balance-of-payments difficulties shall be financed in full or in part by the other Member States, whose contributions in principal may not exceed the ceilings specified in the Annex.

In such cases, the Council, in addition to taking the decisions referred to in paragraph 1, shall decide on the size of the Member States' contributions to the financing of the loan and on the financial conditions attaching to the credits they make available in that connection. The Council may exempt from contributing any Member State which maintains that difficulties exist or can be foreseen as regards its balance of payments.

Article 4

1. On the initiative of a Member State undertaking to implement a capital liberalization programme despite a fragile balance-of-payments situation, the Council, after examining the situation in that Member State and the back-up programme presented in support of its application, shall decide, as a rule during the same meeting:

(i) whether to grant a financing facility, in the form of a credit line or an undertaking to grant a loan, which may be activated at the request of the beneficiary Member State as and when the need arises and for a period that may not normally exceed one year;

(ii) the overall amount of resources allocated;

(iii) the back-up measures accompanying the liberalization of capital movements with a view to ensuring a sustainable balance-of-payments situation.

2. Loans drawn under the financing facility and granted pursuant to paragraph 1 shall, as a rule, have a term of one year renewable for a further one-year period.

3. In cases where restrictions on capital movements are introduced or re-introduced during the term of the loan, the latter may be consolidated only within the framework of a longer-term loan granted as mutual assistance pursuant to Article 108 of the Treaty.

Article 5

The Commission shall take the necessary measures to verify at regular intervals, in collaboration with the Monetary Committee, that the economic policy of the Member State in receipt of a Community loan accords with the adjustment

or back-up programme and with any other conditions laid down by the Council pursuant to Article 3 or 4. To this end, the Member State shall place all the necessary information at the disposal of the Commission. On the basis of the findings of such verification, the Commission and, where appropriate, the Member States holding claims under the facility shall release further instalments. The Council shall decide on any adjustment to be made to the initial economic policy conditions.

Article 6

1. Loans granted as medium-term financial support shall have a term of one year or more. They may be granted as consolidation of short-term monetary support made available by the central banks of the Member States.

2. At the request of the beneficiary Member State, such loans may carry the option of early repayment.

3. Normally, no Member State may draw on this facility to the extent of more than 50 % of the ceiling referred to in Article 1 (2).

Article 7

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and shall not involve the Community in the transformation of maturities or in any exchange or interest-rate risk.

When the borrowings are expressed, payable or repayable in the currency of a Member State, they may be concluded only after consultation with the competent authorities of that Member State.

Where a Member State receives a loan carrying an early repayment clause and decides to invoke this option, the Commission shall take the necessary steps after consulting the Monetary Committee.

2. At the request of the debtor Member State and where circumstances permit an improvement in the interest rate on the loans, the Commission may, after consulting the Monetary Committee, refinance all or part of its initial borrowings or restructure the corresponding financial conditions.

Refinancing or restructuring shall not have the effect of extending the average duration of the borrowings concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

3. The costs incurred by the Community in concluding and carrying out each operation shall be borne by the beneficiary Member State.

Article 8

1. If one or more Member States that are creditors under this facility experience difficulties as regards their balance-of-payments and/or a sudden decline in their foreign currency reserves, they may request mobilization of their claims. The Council, having due regard to the circumstances, shall decide to mobilize such claims, in particular in accordance with one of the following procedures, or a combination thereof:

(i) by refinancing from Community borrowings from financial institutions or on capital markets;

(ii) by a transfer of the claim to other creditor Member States;

(iii) by early repayment in full or in part by the debtor Member State or States.

2. Where refinancing takes place in accordance with paragraph 1, the debtor Member State shall agree that its debt, originally denominated in one currency, shall be replaced by a debt denominated in the currency used for the refinancing. Where applicable, the debtor Member State shall bear any additional cost resulting from an alteration in the interest rate and the costs incurred by the Community in concluding and carrying out the operation.

3. Any creditor Member State may arrange with one or more other Member States for the partial or total transfer of its claims. The Member States concerned shall notify the Commission and the other Member States of the transfer.

4. Any Member State that is a creditor in respect of a loan carrying an early repayment clause shall take the requisite steps where the debtor Member State decides to invoke this option. The Member States concerned shall notify the Commission and the other Member States of the operation.

Article 9

For the application of the ceilings referred to in Articles 1(2) and 3(2), the loan operations shall be recorded at the exchange rate of the day on which they are concluded. The repayment operations shall be recorded at the exchange rate of the day on which the corresponding loan was concluded.

Article 10

The Council shall adopt the decisions referred to in Articles 3, 4, 5 and 8, acting by qualified majority on a proposal from the Commission, made after consulting the Monetary Committee on the matter.

Article 11

The European Monetary Cooperation Fund shall make the necessary arrangements for the administration of the loans.

The funds shall be paid only to central banks and shall be used only for the purposes indicated in Article 1.

Article 12

No later than five years after the adoption of this Regulation, the Council shall examine, on the basis of a report from the Commission, after delivery of an opinion by the Monetary Committee and following consultation with the European Parliament, whether the facility established still meets, in its principle, its arrangements and its ceiling, the needs which led to its creation.

Article 13

1. Regulation (EEC) No 682/81 and Decision 71/143/EEC are hereby repealed.

2. Amounts not yet repaid under outstanding Community loan operations concluded pursuant to Regulation (EEC) No 682/81 before the date of entry into force of this Regulation shall count against the ceiling referred to in Article 1(2) at their initial value in ECUs.

3. References to the instruments repealed by virtue of paragraph 1 shall be deemed to be references to this Regulation.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Council,

The President

Annex

The ceilings for credits provided for in Article 3(2) shall be as follows:

Member State	Million ECU	% of total
Belgium	875	6,28
Denmark	407	2,92
Germany	2 715	19,50
Greece	235	1,69
Spain	1 132	8,13
France	2 715	19,50
Ireland	158	1,13
Italy	1 810	13,00
Luxembourg	31	0,22
Netherlands	905	6,50
Portugal	227	1,63
United Kingdom	2 715	19,50
Total	13 925	100,00

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