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INTRA-EEC CAPITAL MOVEMENTS AND DOMESTIC FINANCIAL MARKETS

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CAPITAL markets in the continental European countries have recently been the subject of much interest and study. Part of this interest concerns the role of capital-market integration and international capital mobility in the process of integration of the EEC countries. Continued progress toward EEC integration was uncertain during 1968-69 as basic problems involving exchange-rate adjustments, the common agricultural policy, and a membership broadened to include the United Kingdom forced a reevaluation of earlier expectations. Likewise, there occurred a partial, and perhaps temporary, retrenchment on earlier liberalizations of foreign investment and a postponement of new initiatives for freeing capital movements. On the other hand, the establishment of a system of intermember credits for foreign-exchange crises and the expressed intentions to adopt a plan for currency integration among EEC members by 1980 indicate that financial integration of some form may be gaining in priority among the members.

This paper attempts to provide some evidence of the extent to which intra-EEC capital mobility has tied the financial markets of the members into a more closely integrated complex. Measures of the intensity of intra-EEC capital movements relative to other financial flows are developed and examined for trend. In addition, intercountry differences and variations in interest rates are examined for indications of an effective integration process. It is patently clear that integrating forces going beyond the confines of the EEC, particularly the Eurocurrency and Eurobond markets, have played a substantial role in

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connecting more closely the EEC markets, even without an explicit connection with the Common Market integration program. This aspect is also briefly considered.

The paper is organized as follows. In Section 1 the presumed deficiencies of European financial markets and the benefits and costs of integrating them are briefly examined. In Section 2 the approach to financial integration taken by the EEC to date is outlined. Sections 3 and 4 then present some quantitative evidence as to the extent of the integration. In the former the relative intensity of intra-EEC capital movements is examined, and the latter is concerned with the harmonization of national interest-rate movements among the members.

1 ADVANTAGES AND COSTS OF FINANCIAL INTEGRATION

"UNDERDEVELOPED" CAPITAL MARKETS

Financial markets in the EEC countries are typically characterized as relatively backward in comparison with those in the United States and United Kingdom. This remains true even though continental Europe has had higher ratios of saving and fixed investment to national output than have the Anglo-Saxon countries, and despite evidence that European companies resort to external as opposed to internal finance relatively more often than is done in the United States and Great Britain.¹ The most commonly voiced complaints concerning the financial markets of the EEC countries can be summarized briefly.² It must be borne in mind, however, that there is considerable diversity

¹ See Ira Scott, *European Capital Markets: Present Structure and Prospects for Integration*, Washington, D.C., 1968, esp. Chapter 7.

² Two official studies have provided a wealth of information on European financial markets. These are the OECD *Capital Markets Study*, especially Volume III, *Functioning of Capital Markets*, Paris, 1968; and European Economic Community, *The Development of a European Capital Market* [known as the Segré Report], Brussels, 1966. See also U.S. Treasury Department, *A Description and Analysis of Certain European Capital Markets*, Washington, D.C., 1964; and Kurt Richebächer, "The Problems and Prospects of Integrating European Capital Markets," *Journal of Money, Credit, and Banking*, August, 1969, pp. 336-346.

among the markets of the Six, and easy generalizations can be only partially correct.

First, the financial markets of the EEC countries are small and relatively uncompetitive. The small size is a consequence of (1) the relatively small flow of savings and investment of the EEC members taken individually, (2) the relatively low stock of outstanding debt and resulting inadequacy of secondary markets, and (3) the failure until recently of merging to any considerable degree the separate national markets into one or more larger ones.

The submarkets within the national markets (the Netherlands being the possible exception) are generally more highly compartmentalized than is true in the United States. This results in a sluggish transmission of credit pressures from one segment to another, and a slow and constrained accommodation between the demand and supply of funds in the submarkets. The excessive domestic segmentation stems from a number of sources. Important among these are legal, administrative, and fiscal restraints on the behavior of financial institutions (and others) that limit the scope of their asset portfolios and also their ability to compete in issuing liabilities. Another factor tending to slow the transformation to a more highly developed financial system is the existence of institutional rigidities stemming from a history of currency instabilities, inflations, and government involvement in the nonbank financial sector. Also, the government often supplies services (e.g., pension plans), which has suppressed the mobilization of large amounts of funds actively seeking high returns and willing to substitute among assets on the basis of yield.

One result of this is that competition among potential sources of funds by ultimate borrowers is not very intense and particular channels of finance are heavily insulated from developments in other channels. Furthermore, the flow of funds into the long-term capital market is suppressed by the superstructure of regulations and institutional rigidities, and in some cases a distortive tax structure, which often penalizes certain types of investments. Nonbank financial institutions have not developed into the major sources of long-term funds to the financial markets that characterizes the United States and United Kingdom. As a result, secondary markets for marketable securities in most EEC countries are thin, and capital issues tend to be less liquid. This, in turn,

forces borrowers to use the traditional sources of short-term finance, mainly banks, which results in a structure of private finance heavily weighted in short-term liabilities.

A reinforcing factor in most EEC countries is the proclivity of the government and government financial institutions to "preempt" funds from the long-term segment of financial markets by issuing their own securities, or securities that are subsidized or guaranteed by the government. This adds to the thinness of the markets for securities not so favored, and limits the range of choice open to the investor and the alternatives available to private borrowers.

An important reason for the perpetuation of these characteristics is that some EEC nations utilize such devices as policy tools to implement national economic programs, or at least to guide real investment into preferred channels. The use of financial incentives for such purposes occurs in each of the EEC countries to a greater or lesser degree. It poses a major problem in harmonizing monetary and fiscal policies among the members and even more of a problem in integrating capital markets.³

BENEFITS OF FINANCIAL-MARKET INTEGRATION

Given the characteristics of the national financial markets and the disparity among the EEC members, "integration" of financial markets (as opposed simply to free currency convertibility and removal of controls over capital outflows) involves a painful process of establishing in each member national priorities that are compatible with those of the others and of harmonizing financial regulations and structures.⁴ The expected benefits must then be sizable if the EEC countries are, as it appears, willing to undertake these burdens.⁵

Integration of financial markets, taken to mean that national borrowers and lenders have meaningful alternatives for sources and uses

³ Milton Gilbert, "Reconciliation of Domestic and International Objectives of Financial Policy: European Countries," *Journal of Finance*, May, 1963.

⁴ See the Segré Report, Chapters 4 and 5.

⁵ At least one eminent observer of the EEC doubts the advantage of going beyond the mere freeing of capital flows to positive steps to make national submarkets a part of a genuine EEC market. See Raymond Bertrand, "A Comment," *Journal of Money, Credit, and Banking*, August, 1969, pp. 347-349.

of funds in other countries, may give rise to at least two identifiable economic benefits as well as to other advantages in the context of economic integration in general. First, the integration of financial markets, by increasing the effective size of the market, may lead to *operational* economies of scale, i.e., to enhance the operational efficiency of the market.⁶ This means that the economic resources employed in transforming a given amount of savings into investment is reduced. It may occur by means of larger underwritings of securities, narrower specialization by financial institutions, lower cost per unit of obtaining financial information, and greater competition in financial markets.

Second, financial-market integration may improve the *allocational* efficiency of the financial process. This comes about because the borrower of one nation has a broader spectrum of sources of funds open to him, and he may be able to choose a cost-repayment combination more to his liking than would be the case if he were confined to his national market. Likewise, the savers may be able to choose a more efficient risk-return combination by diversifying their asset portfolios internationally.⁷ Furthermore, the risk-return spectrum faced by investors may itself be transformed as a result of the deepening and widening of financial markets. Increased secondary-market activity, which would likely accompany integration, may reduce anticipated fluctuations in yields and reduce the risk with constant return. To the extent that organized money and capital markets become more active with integration, the liquidity of marketable securities is increased and the "money risk" reduced.

Another result of improving allocational efficiency is that discontinuities in the range of available financing which existed in isolated national markets may disappear with integration. The maximum size of firm that can be financed is increased. If the rationalization of industry structure is a goal of the integration process, as it is in the EEC, an integrated financial market may be necessary to provide financing for the optimum-sized, large firms that would result.

Integration of financial markets may thus be an important complement to the integration of goods and labor markets. By equalizing bor-

⁶ On these points, see A. W. Sametz, "The Capital Markets," in M. Polakoff, ed., *Financial Institutions and Markets*, Boston, 1970.

⁷ See H. G. Grubel, "Internationally Diversified Portfolios," *American Economic Review*, December, 1968, pp. 1299-1314.

rowing costs among countries, competitive distortions among firms, based on nationality, are reduced. Integrated financial markets would permit the optimum location of new industry to minimize transport costs, an optimization that might not be possible with a customs union alone.

THE COSTS OF INTEGRATION

Integration carries considerable costs in independence and sovereignty over economic policy for the integrating nations.⁸ Integration of financial markets involves a loss of independence in two basic areas; a loss which at least some of the EEC members have been reluctant to sustain. First, the degree to which an individual nation may influence its own monetary aggregates in the pursuit of independent economic stabilization is greatly reduced. This would be true whether a currency union were quickly established early in the integration process or a slower step-by-step removal of controls over capital flows and elimination of distortive regulations and taxation policies were used as the strategy to accomplish the integration. The ability, for example, of one member to lower interest rates while rates of other members were rising would be circumscribed if, in fact, alternative sources and uses of funds were readily available without reference to nationality. Similarly, the supply of credit within one member nation could not be independently determined if full integration existed. Despite the tendencies in the EEC to eliminate external investment controls, members retain enough independence in the formulation and execution of monetary policy to prevent an advanced state of integration of financial markets.⁹

A second facet of the loss of national policy independence involves the ability to guide the flow of saving into preferred channels of investment. Some EEC countries rely heavily on the control of the allocation

⁸ These costs are succinctly described in Richard N. Cooper, "Toward an International Capital Market," Yale Economic Growth Center Discussion Paper No. 68, July, 1969.

⁹ See Samuel I. Katz, *External Surpluses, Capital Flows and Credit Policy in the EEC, 1958 to 1967*, Princeton Studies in International Finance No. 22, Princeton, N.J., 1969. Also, see Scott, *op. cit.*, Part II.

of credit to influence the structure of investment spending. While, theoretically, fiscal incentives could be substituted for selective credit policies, in practice the latter are both politically and administratively more feasible.

This conflict between financial integration and independence in controlling the allocation of credit is magnified because the EEC members have rather different types of financial structures and institutions. And the structural goals that are the object of allocational credit policy also differ from member to member. Thus, a high degree of financial-market integration must inevitably reduce the efficacy of a credit policy designed to produce a desired allocation of real resources. If financial markets are to be integrated, either the selective credit controls must be given up in favor of economic efficiency or the structural priorities of the integrating members must be made compatible.¹⁰

2 THE EEC APPROACH TO FINANCIAL-MARKET INTEGRATION

IN THE abstract, the integration of financial markets may be accomplished via two routes, depending upon the nature of the domestic markets of the members. Take, on the one hand, a situation in which the domestic financial markets of the members are themselves highly integrated and efficient, and are without noticeably distortive regulation or monopoly elements. In such a situation, the freeing of all barriers to intraunion flows of funds in only *one* submarket (say the money market) will accomplish a high degree of integration in *all* of the financial markets of the members.

If, on the other hand, the domestic financial markets of the integrating members are compartmentalized with little communication among the submarkets, direct integration among the members of one segment of the national markets will be insufficient for full financial-market integration. Rather, two alternatives exist. One is to rationalize the domestic markets and subsequently to integrate via one submarket.

¹⁰ The latter is precisely what is recommended by the Segré Report (Chapters 5 and 6).

The other is to attempt to integrate each of the submarkets by eliminating barriers to *international* flows while leaving largely unchanged the domestic market segmentation.

The EEC countries have more closely approximated the latter approach in the 1960's. Economists have, however, analyzed the former situation much more extensively. Their concern has been to explicate the balance-of-payments adjustment process when an abstract international investment moves frictionlessly among union members with "perfect" financial markets.¹¹ The EEC has avoided the alternative of establishing early in the integration process a monetary union in favor of a more piecemeal approach. This has involved the removal of explicit restrictions on capital movements and the loosening of some regulatory impediments that have tended to keep financial institutions from favoring foreign borrowers or lenders. Indeed, the Segré Report recognized the close approximation of the EEC countries to the second situation above and recommended that a broad range of members' submarkets be integrated in parallel.

The Rome Treaty is vague concerning the obligations of the members with respect to capital-market integration. It commits the members only to progressively abolish restrictions on intra-EEC capital movements to the extent necessary "to ensure the proper functioning of the Common Market."¹² Although the common market in commodities was completed in 1969, the progress toward financial-market integration has been slow, and as will be seen below, of fairly small magnitude. Furthermore, policy measures taken as a result of the currency crises and exchange-rate adjustments of 1968 and 1969 resulted in a temporary disintegration of financial markets.

The movement to eliminate explicit restrictions on *international* capital movements has been much more visible than have efforts to break down discriminatory portfolio regulations and other measures that have segmented the domestic financial markets of such members

¹¹ The literature here is voluminous. See particularly R. I. McKinnon and W. F. Oates, *The Implications of International Economic Integration for Monetary, Fiscal, and Exchange-Rate Policy*, Princeton Studies in International Finance No. 16, Princeton, N.J., 1966; N. M. Mintz, *Monetary Union and Economic Integration*, New York University, Institute of Finance Bulletin No. 64, New York, 1970; and Cooper, *op. cit.*

¹² Article 67 of the Rome Treaty. For a more detailed evaluation of the obligations of the members, see E. S. Kirschen *et al.*, *Financial Integration in Western Europe*, New York, 1969, pp. 42-46.

as France, Italy, and Belgium. For example, exchange controls established during World War II were gradually relaxed and free external convertibility restored in 1958. Retained, however, was a complex of controls over foreign investment by residents as well as some degree of control over investment from abroad. The vague commitment in the Rome Treaty to eliminate these controls led to the adoption of two directives of the EEC Commission (1960 and 1962). These obligated the member countries to remove restrictions on certain types of foreign investments: direct investment, dividend and interest payments and repatriations of foreign investments, loans to finance international trade, portfolio securities listed on securities exchanges, and transactions involving real estate. *Not* liberalized were new securities issues by a resident of one country on the securities markets of another, accounts (deposits) with foreign financial institutions, and certain other short-term investments. Thus, by 1969, each country (aside from Germany) still retained regulations on the sales of new foreign securities to residents and, in some instances, other types of lending to foreigners.¹³ In addition, indirect discrimination against foreign borrowers in the form of double taxation on investment income still exists.

The EEC Commission attempted further to liberalize capital flows through a third directive, which would obligate each member to permit foreign new issues on its securities markets equal to a minimum percentage of all new public issues. This directive has not, however, been adopted by the member countries.

The limited success in achieving integration of financial markets plus the disruption of the process with currency crises and parity changes have contributed to recent decisions by the EEC to adopt a program of gradual monetary union. The initial steps were to create intermember credit lines and acceptance of a commitment to pool a part of international reserves and to eliminate gradually the range of fluctuation in exchange rates among the members. This avenue, if implemented, would force individual members to remove additional regulations on intra-EEC capital flows and to harmonize domestic policies with respect to credit markets. In addition, this sequence, by reducing the range (and likelihood) of changes in the exchange rate,

¹³ See OECD, *Code of Liberalization of Capital Movement*, Paris, 1969.

would partially or wholly remove another factor tending to isolate financial markets.

It is important to note that *all* past measures to liberalize capital movements taken by EEC members have not discriminated against nonmember countries. That is, removing restrictions on certain types of foreign investment were made to apply to all such investments regardless of recipient country—EEC member or not. In addition, exchange-rate variability was the same among the member countries as it was between members and nonmembers, thus giving no relative incentive for intra-EEC capital flows. The result, which one might expect, is that the EEC has become more integrated with the financial markets of other advanced countries in general, including each other, but not simply integrated on a regional basis.

However, the question posed here is whether the EEC countries have achieved a degree of financial-market integration higher than among the developed countries generally. Some factors suggest that this might be the case, even though the policy changes made by the EEC and the major integrating devices of the Eurodollar and Euro-bond markets have not been confined to the EEC countries. The very movement toward integration of product and labor markets may have been accompanied by an acceleration of intra-EEC capital flows. Improved information on investment opportunities in other member countries, some degree of tax harmonization, and attempts to harmonize antitrust laws and encourage unionwide mergers would generally tend to intensify intra-EEC financial flows. In addition, some institutions of the EEC itself—such as, the European Development Bank, the High Commission of the European Coal and Steel Community, and the Common Agricultural Fund—tend to raise the intra-EEC flow of funds. By so doing, the separate national markets are tied more closely together.

3 INTRA-EEC CAPITAL FLOWS

Two separate bodies of evidence are examined to shed light on the degree of integration. The first is the flow of capital among the EEC

members, relative to total flows of capital between the member countries and all other countries. My hypothesis is that relatively greater financial-market integration among EEC countries would be accompanied by a higher proportion of intra-EEC capital movements relative to capital movements with all countries. The second type of evidence is the similarity of interest-rate movements in EEC countries. Closer integration should, in theory, be accompanied by a narrowing of yield differentials among the members brought about by increased actual or potential intra-EEC capital flows. By extension, the narrowing of interest-rate differentials would also cause a closer coincidence (in time) of interest-rate movements among countries. The evidence on interest rates is presented in Section 4.

Consistent data on intra-EEC capital flows are notoriously deficient. Balance-of-payments figures constitute the most comparable and complete information on the matter, but even here the extent of coverage, comparability among countries, and the time span of detailed series requires that they be used with care and the usual caveats.

PRIVATE LONG-TERM CAPITAL FLOWS

Data on long-term private capital flows are available on a geographic basis for all of the EEC members for 1963 and thereafter, while comparable data for the three financially important countries—West Germany, France, and the Netherlands—extend back to 1960. The latter year is a reasonable starting point. The first steps implementing the Rome Treaty had been taken in 1959; the return to convertibility of 1958 had been absorbed; and all of the explicit measures toward liberalization of capital flows under the auspices of the EEC did not begin to occur until 1960. The unavailability of meaningful data for the period prior to 1960 precludes a comparison with the earlier period in any event.

For purposes of this paper, private long-term capital is defined to include direct investment, portfolio investment, and other loans and credits with an original maturity of one year or more.¹⁴ Gross inflows

¹⁴ The only exception is that long-term bank loans to foreigners are excluded, but this omission is not critical. EEC country banks make few term loans to foreigners, except for the Netherlands, and even then the flow is negligible relative to the others.

TABLE 1

Private Long-Term Capital Outflows and Inflows, EEC Countries, 1960-67

| Year | Foreign Investment by EEC Countries | | Foreign Investment in EEC Countries | |
|--|--|---|--|---|
| | Amount (\$ millions) | Per Cent of Total in Other EEC Countries | Amount (\$ millions) | Per Cent of Total by Other EEC Countries |
| <i>Germany, France and the Netherlands</i> | | | | |
| 1960 | 598 | 50 | 1,295 | 31 |
| 1961 | 771 | 37 | 1,254 | 17 |
| 1962 | 696 | 38 | 1,373 | 29 |
| 1963 | 522 | 49 | 1,507 | 23 |
| <i>All EEC Countries</i> | | | | |
| 1963 | 1,023 | 38 | 2,998 | 15 |
| 1964 | 1,014 | 34 | 2,907 | 23 |
| 1965 | 1,314 | 43 | 2,450 | 25 |
| 1966 | 1,814 | 35 | 2,191 | 34 |
| 1967 | 2,349 | 23 | 2,500 | 31 |

SOURCE: Compiled from Statistical Office of the European Communities, *Balances of Payments, 1958-1967*, Brussels, 1968; EEC Commission, *The Development of a European Capital Market*, Brussels, 1966, Table 14; and *Deutsche Bundesbank, Monatsberichten, Statistische Beihefte*, September, 1969.

and outflows (net of repayments) are treated separately; the measures used, then, are flows of investment funds into and out of the individual member countries.

The summary measures are shown in Table 1. The table is divided into two parts, the lower one showing the annual inflows and outflows for all EEC countries from 1963 to 1967, and the upper one containing data only for Germany, France, and the Netherlands for 1960 to 1963. The table shows the dollar equivalent of the outflows and inflows and the percentages of each accounted for by outflows to and inflows from EEC members.

The table reflects, of course, the fact that capital inflows in the early and mid-1960's greatly exceeded capital outflows. It also reflects the absolute decline in foreign investment in the EEC countries after 1963. This decline was largely the result of the U.S. interest equalization tax and, later, the foreign-investment restrictions that reduced the volume of new American investment in the EEC. As the absolute volume of long-term capital inflows from the United States declined, the percentage accounted for by the other EEC members rose fairly consistently, so that intra-EEC investment as a percentage of total long-term capital receipts of EEC members was substantially higher in 1966-67 than earlier.

Foreign investment by EEC members was relatively stable until 1965, when a rapid expansion occurred, mainly from Germany. There is no observable trend in the proportion of outflows from EEC members going to other members. If anything, the tendency has been for the percentage to fall; i.e., EEC foreign investment in nonmember countries has tended to rise faster than such investment in member countries.

These trends are evident also in the average rate of change in the flows of private long-term investment. From 1963 to 1967, the average annual rate of growth in intra-EEC long-term capital flows was about 14 per cent. Foreign investment by EEC members in all countries grew at about 23 per cent per year, while total foreign investment in EEC countries from all sources declined by about 4 per cent per year. Thus, the evidence as to the pace of capital market integration derived from the aggregate data on private long-term capital flows is somewhat mixed. As a proportion of capital inflows, intra-EEC movements tended to increase; as a proportion of capital outflows, they tended to decline.

Some additional indication of the changes in interpenetration of financial markets can be obtained from these data by comparing them with fixed capital formation in the EEC countries, or with total domestic savings of the members. To the extent that changes in total savings and investment are accompanied by similar relative changes in financial flows, investment and saving can serve as an indication of financial flows. For the three years 1960 to 1962, the gross long-term capital inflows into EEC countries was equivalent to between 8 and

10 per cent of fixed capital formation (excluding residential construction).¹⁵ The inflows from EEC members amounted to 2–3 per cent of fixed investment. Despite the rapid average growth in capital formation in the EEC (about 6.5 per cent per year from 1958–67) the 14 per cent annual growth in intra-EEC long-term investment was greater, thus raising the intra-EEC capital flow somewhat, but not above the relatively low figure of 5 per cent of total capital formation. This suggests that there was a very moderate increase in the interdependence of the financial markets of the EEC during the period of integration, at least until 1967–68.

The private long-term capital flows of the individual member countries are shown in Table 2. The period 1960 to 1967 (1968 for Germany) is broken into three subperiods to avoid the distortions of special factors that affect individual years.

In general, the individual country data confirm the findings based on the aggregate data that (1) there is no consistent upward movement in the relative importance of intra-EEC capital *outflows* in the total (indeed, France and the Netherlands show marked downward movements), and (2) capital *inflows* from EEC members have taken on somewhat greater importance, especially for Italy and the Netherlands.

There are two particular circumstances that distort the data in Table 2. First, the French data on capital outflows indicate a sustained net repayment on the foreign securities held by the French. Indeed, these reductions in French holdings of foreign securities were greater than gross new acquisitions in some of the earlier years, thus turning the total outflow of portfolio capital into a negative figure. At the same time, France acquired, net, some new securities of her EEC partners. This distortion explains the rapid fall in the importance of EEC outflows in the total for France from period to period. Similarly, the unusually high figure for capital inflows from the EEC to Italy in 1966–67 was again the result of a running down (repayment) of Italian debt held in non-EEC countries.

Aside from these special cases, the degree of dependence on capital flows with the EEC partners relative to the total is strikingly similar (20–30 per cent of total inflows or outflows) for each member except

¹⁵ Calculated from data in OECD, *Statistics of National Accounts, 1952–62*, Paris, 1964.

TABLE 2
Private Long-Term Capital Flows by Country: Intra-EEC
as Per Cent of Total

| | 1960-63 | 1963-65 | 1966-67 |
|-------------|-------------------|-----------------|-----------------|
| Germany | | | |
| Inflows | 32 | 24 | 30 ^a |
| Outflows | 20 | 37 | 21 ^a |
| France | | | |
| Inflows | 20 | 25 | 24 |
| Outflows | 111 | 57 | 24 |
| Italy | | | |
| Inflows | n.a. ^b | 17 | 83 |
| Outflows | n.a. ^b | 26 | 29 |
| Netherlands | | | |
| Inflows | 21 | 27 | 30 |
| Outflows | 56 | 42 | 26 |
| BLEU | | | |
| Inflows | n.a. ^b | 9 ^c | 28 |
| Outflows | n.a. ^b | 56 ^c | 52 |

SOURCE: Compiled from Statistical Office of the European Communities, *Balance of Payments, 1958-1967*, Brussels, 1968; EEC Commission, *The Development of a European Capital Market*, Brussels, 1966, Table 14; and *Deutsche Bundesbank, Monatsberichten, Statistische Beihefte*, September, 1969.

^a Denotes that last period covers 1966-68 rather than 1966-67 as for other countries.

^b Data is unavailable.

^c Data for BLEU for 1963 and 1964 includes an unspecified amount of short-term capital.

Belgium-Luxembourg (BLEU). The latter sends by far the highest portion of her foreign investment to other members, but there is no indication that this proportion has increased in the course of implementing the Rome Treaty.

To summarize, there is little evidence that a dramatic shift in the structure of private long-term capital flows has occurred during the period since the formation of the EEC, although it appears that the intensity of intra-EEC flows has risen slightly relative to inflows from

outside the area. And the evidence suggests that no one country has a disproportionately large dependence on her partners as a source or a use of foreign investment funds. The possible exceptions are Italy and BLEU, on opposite sides.

It may be argued that the inclusion of direct investment together with portfolio investments and long-term credits in one category conceals potential evidence of financial integration. Direct investment flows, and their geographic structure, may depend on one set of variables, including the competition and merger policy of the EEC Commission, while indirect long-term investment is a function of other variables, including monetary policies, regulations applied to financial institutions and the like. Indirect investment may be more relevant as an indication of financial *market* integration.

Unfortunately, data that disaggregate direct and indirect investment are not available for each member for the entire period, however, consistent disaggregation is possible for the most financially important members. This is shown in Table 3. There the average annual capital inflows and outflows for all countries are shown, and the proportion of it accounted for by direct investment. In addition, the percentages of direct and indirect investment by EEC countries are shown separately.

The data indicate that direct and indirect investment were roughly evenly split and relatively stable in their total outflows. There was a sharp rise in the proportion of direct investment by these countries going to the EEC in 1963-65, but a retrenchment in 1966-67. More relevant, however, is that portfolio outflows to the EEC as a per cent of total fell even more and were still relatively low in 1966-67.

As for capital inflows, direct investment as a per cent of total inflows rose dramatically in the middle period, and leveled off thereafter. And the proportion of direct and indirect inflows accounted for by EEC members appears to have undergone inverse cycles. The EEC indirect investment percentage rose substantially from 1960-62 to 1963-65, and then fell, but less than it had risen. This reflects partially the United States policy of stemming capital outflows, which lowered the gross flow of American portfolio investment in the EEC after 1962. Intra-EEC direct investment as a per cent of inflows, on the other hand, fell in the middle period and partially recovered in the more recent one.

TABLE 3

Foreign Direct Investment and "Other" Private Long-Term Capital Flows for West Germany, France, and the Netherlands; Total and Intra-EEC

| | 1960-62 | 1963-65 | 1966-67 |
|---|---------|---------|---------|
| Capital Inflows | | | |
| Total private long-term capital inflow (annual average, in millions of dollars) | 1,280 | 1,372 | 1,847 |
| Direct investment as a per cent of total inflow | 36 | 64 | 60 |
| Intra-EEC direct investment as a per cent of total from all areas | 30 | 24 | 27 |
| Intra-EEC portfolio and other long-term as a per cent of total from all areas | 25 | 38 | 31 |
| Capital Outflows | | | |
| Total private long-term capital outflows (annual average in millions of dollars) | 688 | 858 | 1,409 |
| Direct investment as a per cent of total outflow | 50 | 52 | 49 |
| Intra-EEC direct investment as a per cent of total to all areas | 30 | 40 | 33 |
| Intra-EEC portfolio and other long-term capital as a per cent of total to all areas | 52 | 5 | 20 |

SOURCE: Compiled from Statistical Office of the European Communities, *Balances of Payments, 1958-1967*, Brussels, 1968; EEC Commission, *The Development of a European Capital Market*, Brussels, 1966, Table 14; and *Deutsche Bundesbank, Monatsberichten, Statistische Beihefte*, September, 1969.

Better evidence is available on the degree of interpenetration of capital markets from new issues data and portfolio capital flows. Integration of financial markets certainly requires that both new issues of securities and trade in secondary markets be free of national discrimination. Table 4 presents data on the total public issues of securities for the EEC countries as compared with international portfolio

TABLE 4
Portfolio Capital Inflows of EEC Countries as Related to
Net New Public Securities Issues

| Year | Public Net New Issues of Securities in EEC Countries (\$ millions) | Net Inflows of Capital on Account of Portfolio Investment | | |
|------|---|--|------------------|------------------------------------|
| | | From All Areas (as % of net securities issues) | From EEC Members | |
| | | | (\$ millions) | (as % of net securities issues) |
| 1963 | 8,880 | 14 | 163 | 1.8 |
| 1964 | 10,360 | 2 | 112 | 1.1 |
| 1965 | 11,670 | 2 | 152 | 1.3 |
| 1966 | 10,980 | ^a | 143 | 1.3 |
| 1967 | 12,810 | 3 | 98 | 0.8 |

SOURCES: *Net Public Issues*—European Investment Bank, *Annual Report*, various issues. *Portfolio Capital Flows*—EEC Statistical Office, *National Accounts and Balances of Payments, 1958-1967*.

^a Negligible.

investment in the EEC for the 1963-67 period. While the data are not strictly comparable, the trends shown are, no doubt, valid. The data show a steady rise of new public issues. When such issues are compared with portfolio investment in the EEC countries from outside, it is seen that there was a sharp drop after 1963, when the American market was made unattractive. From 1964 to 1967, only 2-3 per cent of new issues was accounted for by foreign portfolio issues.

The evidence is more striking when portfolio inflows from other EEC members is shown as a percentage of total securities issues. Here, the figure remained under 2 per cent for each of the five years, and was very close to only 1 per cent in four of the years. There is no indication from these data that the capital markets were highly integrated or that they became more so in this period.

The sum of the evidence remains mixed. There is *little evidence* from these admittedly inadequate data that the EEC countries forged

strong new ties among capital markets and investments in the process of integration prior to 1967. But there was a perceptible tendency for a slightly larger intra-EEC flow of long-term investments to emerge, although even this may have been reversed in 1968-69.

PUBLIC AND INTERNATIONAL-AGENCY LONG-TERM CAPITAL FLOWS

While private long-term capital flows among EEC members show no marked relative increase, other types of interpenetration of markets might have occurred. Among these are capital movements resulting from public sector and international agency operations, discussed here, and short-term private movements, discussed below.

Government lending and borrowing among EEC countries has not intensified in the period since 1958. Indeed, the major changes in public long-term assets and liabilities have been with nonmembers of the EEC rather than between members.¹⁶ Government long-term foreign assets have risen as aid to developing countries (especially Germany and France) has expanded, while claims on other EEC members have remained constant or have been repaid. Likewise, government long-term liabilities to foreigners have decreased (except for Italy) rather consistently as loans from the United States have been repaid. Liabilities to other EEC members have changed very little in absolute terms. Thus, long-term government capital flows have not been an integrating vehicle, nor have official transfer payments among EEC governments.

Besides government credits and transfers, some institutions of the EEC may themselves serve as a means of tying the financial markets of the member countries closer together.¹⁷ These institutions may raise funds in one country and spend them in another member country. They include the European Investment Bank, the High Authority of the ECSC, the Common Agricultural Fund, and the operating budget of the EEC itself.

Although these activities may have a great future potential to

¹⁶ Based on balance-of-payments data in EEC Statistical Office, *National Accounts and Balances of Payments, 1958-1967*, Brussels, 1968.

¹⁷ For a general discussion of these institutions, see Kirschen, *op. cit.*, Chapter 4.

redistribute funds among EEC members, the magnitude has not been sizable as yet. By far the most important of them has been the EIB. But even it has served as much as a vehicle for capital inflows from outside the EEC as it has as a redistributor of funds. From 1961 through 1967, approximately \$1 billion in loans were made by the EIB.¹⁸ About half of these were made in Italy and another 20 per cent to nonmember countries. Of the funds raised, less than one-half was raised in the EEC countries themselves; the majority came from bond issues outside of the EEC. Thus, the scope for the redistribution of funds among the members has been relatively limited. The other EEC institutions noted above have been even less of a force.

SHORT-TERM CAPITAL MOVEMENTS

Short-term capital movements were generally decontrolled by the member countries in the early stages of the EEC. This liberalization was not, however, restricted to intra-EEC movements but was applicable to foreign assets regardless of nationality. Despite this general movement toward liberalization, there have been a number of lapses, and in 1968 and 1969 at least three countries reinstated controls over short-term money inflows or outflows.¹⁹

Data are not available with which to appraise the degree of change in the interdependence of EEC money markets. It seems likely that interdependence has risen as coordination of monetary policy among the member countries became more highly developed. But there is little evidence to suggest that the member nations have given up the ability to control to a substantial degree their own short-term money market conditions. Indeed, a principal reason for the reinstatement of controls in 1968 and 1969 was to insulate the German, French, and Italian money markets from external pressures.

¹⁸ European Investment Bank, *Annual Report, 1967*, Brussels, 1968.

¹⁹ This is not the place to examine the measures employed by the national governments to control and manipulate short-term capital inflows and outflows. For a review of these practices, see R. H. Mills, Jr., "The Regulation of Short-term Capital Movements: Western European Techniques in the 1960's," Board of Governors of the Federal Reserve System, *Staff Study No. 46*, Washington, D.C., 1968; and Katz, *op. cit.*, esp. pp. 11-30.

THE EURODOLLAR AND EURO-ISSUES MARKETS

Without doubt, the major integrative vehicles among national money and capital markets have been, respectively, the Eurodollar and Eurobond markets. These markets have strengthened the interdependence of national interest rates and credit conditions. The Eurodollar market was the principal means by which American monetary stringency in 1966 and again in 1968–69 was transferred to Europe. Likewise the increase in borrowing by American firms in the Eurobond market in 1968 served to tighten credit supplies in the long-term credit markets.

In both instances, a closer tie between American and European financial markets was forged. But it does not necessarily follow that the Eurodollar and Eurobond markets have produced separate and additional integration of EEC financial markets beyond the generally closer common ties to American markets. A number of considerations suggest the lack of any special integrating mechanism. For example, some EEC countries have taken explicit steps to insulate their own money markets from conditions in the Eurodollar market.²⁰ And EEC companies have not been major issuers of Eurobonds. Exclusive of EIB issues, the peak borrowing in the Eurobond market by EEC companies was \$420 million in 1967, a negligible percentage of total securities issued by such companies. On the demand side of the Eurobond market, the proportion of new issues acquired in EEC countries has been rising, but there is no precise evidence on how much of the total issues have been taken by EEC residents.²¹ The lack of an active secondary market in Eurobonds limits the degree to which long-term interest rates may be tied together by this international market, although this may be changing.

Thus, while the “international” money and capital markets have been influences tending to integrate markets, they have not as yet brought about a high degree of interdependence in the EEC. They have been more effective between hemispheres than within Europe.

²⁰ Katz, *op. cit.*, pp. 20–29.

²¹ Richebächer, *op. cit.*, pp. 342–345.

4 HARMONIZATION OF INTEREST RATES

IF SUBSTANTIAL integration of financial markets occurred during the period of establishing the EEC, one result would be that interest rates in the member countries would have moved closer together and fluctuated in more similar patterns. This could have been induced by a sizable increase in intra-EEC capital flows, or, in competitive markets, by simply the potential for such capital movements. The similarity among members in levels and movements of interest rates would have increased as integration occurred.

It is widely accepted that from the mid-1950's to the mid-1960's the differentials among national interest rates (both long and short term) of the EEC countries were somewhat reduced.²² In 1967-69, however, the differentials widened dramatically.

Statistical measurements of a tendency for national interest rates to converge or diverge must, by nature, be somewhat arbitrary. Richard Cooper²³ has calculated the standard deviation and coefficient of variation of short- and long-term interest rates for eight countries for various years. There is an observable tendency for the national interest rates to cluster closer to the mean rate until 1968. This result, however, is partially due to the closing of the differential between European rates and rates in the United States and Canada. The latter countries were included in his sample.

I have calculated the (unweighted) average of national interest-rate differentials between each pair of EEC members for each year from 1960 to 1969. The results are shown in Table 5. From 1960 to the mid-1960's, there was a measurable tendency for interest differentials to narrow. Since 1963, however, no sustained additional narrowing has occurred. Rather, in 1966 and again in 1969, the average difference between national rates widened considerably, to levels comparable with those in the early 1960's. In sum, while there is some observed tendency for differentials between interest rates of EEC members to narrow, that tendency was not strong, irreversible, or even sustained over the period of integration.

²² For more detail on this period, see W. D. McClam, "Interest Rates: Their International and Domestic Linkages," in OECD, *Capital Markets Study*, Volume III, pp. 655-709.

²³ Cooper, *op. cit.*

TABLE 5
Average Interest Rate Differences^a Among EEC
Countries, 1960-69

| Year | Average Differential | Year | Average Differential |
|------|-------------------------|-------------------|-------------------------|
| 1960 | 1.03 | 1965 | .88 |
| 1961 | 1.08 | 1966 | 1.07 |
| 1962 | .90 | 1967 | .92 |
| 1963 | .72 | 1968 | .73 |
| 1964 | .87 | 1969 ^b | 1.00 |

SOURCE: Calculated from "Average Interest Rates for the National Economy" presented in Union Bank of Switzerland, *An International Survey of Interest Rates: Patterns and Differentials*, Zürich, 1970, Table 34. The rates presented there are averages of selected borrowing and lending rates for each country.

^a The "average differential" is the sum of the differences between each pair of country rates for a given year divided by 10 (the total number of pairs).

^b Through June.

While the narrowing average spreads between EEC interest rates may be a weak indication of financial integration, stronger evidence would require a greater similarity in *movements* of rates among countries. Long-term and short-term interest rate movements for each of the EEC members were, therefore, compared with each other, as well as with the United States. The interest rate series are those published by the IMF.²⁴ The series are for yields on short-term government securities and on long-term government bonds with roughly twenty-year maturities. Average *quarterly* yields were employed.

Three separate time periods were defined so that comparisons could be made between periods. The first period covered 1957 to 1962. This represented the period of negotiation and early implementation of the measures to establish the Common Market and is not expected

²⁴ International Monetary Fund, *International Financial Statistics*. Average quarterly yields on short-term and long-term government securities were the rates used.

to indicate high interconnections between EEC capital markets. The second period covers 1963 to 1967, and contains the years when financial integration was thought to be advancing rapidly. For the sake of additional comparison, a third period was defined to cover 1963 through the first quarter of 1969. The additional five quarters contained the period of the unrest in France, the ensuing franc crises, and the speculation on the revaluation of the mark. During 1968-69 there were no new initiatives toward liberalization of financial flows and some restrictions were reintroduced.

To test the degree of similarity in interest rate movements in the three periods, simple correlation coefficients were computed between each country's interest rates and those of each other EEC member (and the United States).²⁵ The results for the long-term government bond yields are shown in Table 6. The matrix of correlation coefficients has three entries for each combination of countries; one for each of the periods. The correlations of the United States rates with each of the EEC member's rates are also shown.

The evidence as to whether long-term interest rates moved in closer harmony in the 1963-67 period than in the earlier period is by no means definitive. For six of the pairs of coefficients, the 1963-67 is higher than earlier. In general, BLEU rates behaved much more like those of the other EEC members, and the German and Dutch rates also were more closely harmonized. On the other hand, Italian bond yields were further out of step after 1963 than earlier, as was the German with the French. Thus, in some important instances, the indication is that financial market integration was insufficient to tie bond yields much closer together.

In virtually every instance, the addition of data for 1968-69 reduced the coefficients from those for the 1963-67 period. As expected, the disruptions caused by balance-of-payments disequilibrium and foreign-exchange disturbances were disintegrative and produced divergent movements in interest rates.

The coefficients also suggest that the pairs of countries with close association between interest rates and those pairs with little correlation changed from period to period. Thus the German rate was highly correlated with those of France and Italy in 1957-62 but not in 1963-

²⁵ These computations were carried out by James Farrell.

TABLE 6

Similarity of Long-Term Interest Rate Movements Among Countries: Simple Correlation Coefficients Between National Rates

| | Germany | France | Italy | Netherlands | BLEU |
|---------------|---------|--------|-------|-------------|------|
| France | | | | | |
| 1957-62 | .85 | | | | |
| 1963-67 | .56 | | | | |
| 1963-69I | .18 | | | | |
| Italy | | | | | |
| 1957-62 | .87 | .93 | | | |
| 1963-67 | -.01 | .10 | | | |
| 1963-69I | -.05 | .12 | | | |
| Netherlands | | | | | |
| 1957-62 | .76 | .78 | .76 | | |
| 1963-67 | .83 | .79 | .22 | | |
| 1963-69I | .57 | .83 | .22 | | |
| BLEU | | | | | |
| 1957-62 | .57 | .48 | .41 | .37 | |
| 1963-67 | .66 | .73 | .47 | .89 | |
| 1963-69I | .63 | .48 | .45 | .85 | |
| United States | | | | | |
| 1957-62 | -.73 | -.75 | -.81 | -.42 | -.48 |
| 1963-67 | .58 | .76 | .10 | .86 | .71 |
| 1963-69I | .15 | .87 | .11 | .84 | .43 |

67. Similarly, there was little association between the BLEU rate and the Dutch rate in the early period, but a high correlation later. Such shifts also imply an absence of strong unionwide integration in financial markets.

It is interesting to note that the coefficients between the yields in the United States and those in all of the EEC countries were negative in the early period, as American rates generally tended upward while the European rates generally declined. The movements in American rates from 1963 to 1967 were as much like those of the EEC members, except Italy, as the rates in the EEC countries were similar to each other. This would suggest that there is no additional degree of capital-market integration among the EEC members.

TABLE 7

Similarity of Short-Term Interest Rate Movements Among Countries:
Simple Correlation Coefficients Between National Money Market Rates

| | Germany | France | Netherlands | BLEU |
|---------------|---------|--------|-------------|------|
| France | | | | |
| 1957-62 | .17 | | | |
| 1963-67 | .39 | | | |
| 1963-69I | -.17 | | | |
| Netherlands | | | | |
| 1957-62 | .44 | .64 | | |
| 1963-67 | .64 | .56 | | |
| 1963-69I | .40 | .49 | | |
| BLEU | | | | |
| 1957-62 | .43 | -.43 | -.29 | |
| 1963-67 | .73 | .67 | .78 | |
| 1963-69I | .70 | .27 | .67 | |
| United States | | | | |
| 1957-62 | .08 | -.37 | .12 | -.18 |
| 1963-67 | .64 | .53 | .86 | .67 |
| 1963-69I | .08 | .76 | .79 | .36 |

The correlation coefficient matrix for the short-term interest rates is shown in Table 7. Italy is omitted because a comparable rate was not published for the entire period.

It appears that the money-market rates were less similar than long-term rates throughout each of the periods. Otherwise, the results in Table 7 yield the same implications as those in Table 6. There is some indication of closer connection in the 1963-67 period than earlier, but again with one notable exception—France and the Netherlands. Another important pair of countries—Germany and France—had a surprisingly low correlation between money-market rates, even in the 1963-67 period. And as one would also expect, when the data for 1968-69 is added, the coefficients are much lower, reflecting the opposite direction of movements among some of the rates, most importantly the French and German.

The coincidence of movements of short-term rates in the United States with those of the EEC countries present a pattern similar to

that of the bond yields. Movements in American rates were much more similar to those in the EEC countries in 1963-67 than earlier, and, in fact, as similar to each as the EEC members' were to each other.

5 CONCLUSION

THERE is little convincing evidence that the financial markets of the EEC countries became very much more integrated during the first decade of the EEC. Although there have been positive actions taken to eliminate explicit restrictions on capital movements, to ease portfolio restrictions and other regulations that suppress capital flows, and to harmonize fiscal and financial policies among the members, most of these actions have been designed to facilitate, not intra-EEC capital flows specifically, but international flows in general. The data give no evidence whatsoever that the intensity of financial integration was greater among the members than between the members and non-members.

Capital movements statistics show some, but not a substantial, increase in the intensity of intra-EEC movements in recent years. Also, the evidence as to the degree to which EEC interest rate differentials have narrowed and the national rates move in tandem suggests only a slight increase in interconnections as the Common Market was established. Both sets of evidence, however, show a noticeable disintegration after 1967.

The slow pace of integration of financial markets within the Community is primarily the result of reluctance on the part of member governments to give up a measure of independence in aggregate credit policy or the ability to use financial markets and policies to influence the allocation of funds. The reversal of even this weak tendency toward greater integration in 1968-69 reflects the appearance of balance-of-payments disequilibria and the governments' responses to them. The costs, in policy independence, of financial integration appear low so long as there are no conflicts between policies for external and internal balance. For the EEC generally, there was no conflict until 1968, because there was an almost universal payments

surplus. But once deficits became a matter of concern, measures to integrate financial markets were the first to be reversed. The costs then seemed too high.

The proposal to establish a monetary union for the EEC, if adopted and implemented, will change the picture radically. Financial integration will come about concurrently. But monetary union can be viewed as a strategy by which the sovereign independence over domestic money and credit policies is transferred to EEC institutions; i.e., given up. The reluctance to do so heretofore explains the slow pace of financial integration observed.

COMMENTS

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The papers by Professors Cohen and Hawkins are mainly of a factual and statistical character and are essentially noncontroversial. Cohen deals chiefly with the changing pattern of Britain's long-term capital movements, including government loans and grants, since the early 1950's. Hawkins examines the flows of long-term capital of the countries in the European Economic Community within the framework of the larger problem of EEC capital-market integration.

A major—indeed the major—theme or conclusion of Cohen's paper, recurring time and again, is that since the 1950's Britain has increasingly shifted from its traditional role as an "international long-term investor," or an "originator" or "source" of long-term capital (these are Cohen's terms), to what he variously describes as its almost exclusive role today as an "entrepôt," "middleman," or "intermediary" for long-term investment funds. Now I would at once agree that these are apt descriptions so far as concerns Britain's role in the Eurobond market. In that market Britain uses its institutional facilities to bring together foreign borrowers and investors in dollar-denominated bonds floated in London, using virtually no funds of its own. And in the Euro-

currency market it also serves as a middleman by lending to nonresidents the great bulk of the foreign-currency deposits lodged with it.

But I think it misleading to assert that Britain has become solely a middleman when considering other categories of international capital transactions. Here, it seems to me, Britain continues to perform its traditional role, despite the reduced volume of its net long-term capital exports, as a percentage of GNP and other relevant variables, compared with what it was before 1929. Cohen justifies his use of the term middleman here on what seems to me to be a number of dubious grounds.

First, he calls attention to the fact that the margin between gross long-term capital outflows and gross long-term capital inflows (by which he really means the margin between the net outflows of British capital and the net inflows of foreign capital) has been comparatively small and has been narrowing over the period. But why are the two linked or paired off? They are distinct flows and take place independently. There is nothing in an act of foreign investment in Britain that accounts directly for an act of British investment abroad. There is no middleman role here, as in the case of the Eurobond and Eurocurrency transactions. To be sure, if the inflows of foreign investment were smaller, Britain would probably have had to restrict its capital outflows more severely. But this would presumably have been equally true had other credit items in the British balance of payments been smaller than they actually were. Even less relevant is Cohen's argument that Britain's alleged middleman role is further evidenced by the geographical pattern of its long-term capital outflows — which went mainly to sterling countries — and of its long-term capital inflows — which came chiefly from nonsterling countries.

Cohen further argues in support of his use of the term middleman that Britain's net long-term capital exports are increasingly dependent upon net short-term borrowing from abroad. In general, however, Britain has not been borrowing short and lending long so far as concerns its operations in sterling. Foreign sterling balances in Britain, net of short-term sterling claims abroad and excluding holdings of the International Monetary Fund, have remained relatively constant for the past twenty years, during which Britain has been a regular net exporter of long-term capital. Of course, if foreign sterling balances had de-

clined over the period, Britain would have undoubtedly had to cut down the scale of its net exports of long-term capital, but even this hardly seems to justify the use of the term middleman. As it happens, Cohen is able to establish his claim that net long-term capital exports have been increasingly matched by what he calls "net short-term borrowing abroad" by including in this term, not only the (relatively modest) changes in foreign sterling balances, but also the changes in Britain's gold and convertible-currency reserves, the transactions with the IMF, and even the errors and omissions item—in short, by including everything in the balance of payments except net long-term capital exports and the current-account balance.

Cohen discusses briefly Britain's "capacity" as a net exporter of long-term capital. He tells us bluntly that this capacity is limited by Britain's current-account surplus, and that the only way to increase long-term capital exports is to increase that surplus. This is one way, and a common way, of looking at the matter, but it is not one that would command universal acceptance. It could also be argued that a country's capacity to export long-term capital should be related, not to the state of its current-account balance, but to its real wealth, savings, and development; and that the current-account balance should be adjusted to the free outflow of long-term capital, thereby permitting an appropriate transfer of the real resources, rather than the other way around. However, I would admit that there are in fact many practical advantages in choosing to adjust the capital account to the current account.

At the end of his paper, Cohen attempts to measure the relative costs to Britain of restrictions on capital exports, restrictions on the trade account, and domestic-demand reduction as means of correcting balance-of-payments deficits. His calculations are in terms of national income annually foregone by use of each of these three methods. On this basis, he finds that the least costly method has been the restrictions on capital exports. Apart from the facts that this criterion may not in itself give us a complete accounting of the relative costs of capital and trade controls and that the time span he has in mind is not clear, I question his conclusion that the British authorities, by choosing the route of capital-export restrictions first at times of balance-of-

payments crises, perhaps "have known what they were doing after all." If the authorities really knew what they were doing, they would, in my opinion, have devalued the pound, not in 1967, but in 1964.

The core of Professor Hawkins' paper lies in his statistical examination of EEC long-term capital movements and interest rates in an effort to determine whether appreciable progress can be said to have been made toward the integration of the capital markets of these countries since 1960. His conclusion, somewhat mixed though his statistical results are, is that no marked increase in the degree of capital-market integration has in fact occurred, despite a substantial liberalization of exchange controls and other regulations inhibiting the flow of long-term capital and despite the rapid growth of the Eurobond market, both of which have tended to make the capital markets of developed countries generally more interdependent. He attributes what he calls the slow pace of EEC capital-market integration mainly to the reluctance of individual members to relax more rapidly their direct and indirect restrictions on the flow of long-term capital, primarily from a desire to maintain a measure of autonomy in their monetary policy for purposes of domestic stabilization.

It is not entirely clear what standards Hawkins is applying, in his various tests relating to capital movements, to determine what would constitute an appreciable rate of progress towards EEC capital-market integration. Nor, in fact, does he give us a clear-cut operational definition of capital-market integration itself. It is not always evident, moreover, whether he is referring to the level or to the rate of integration, although he is presumably concerned only with the latter. And he does not make sufficiently explicit the differing degrees of significance that the different categories of long-term capital movements may have for the process of capital-market integration, a point that is stressed in the OECD report on capital markets. While these shortcomings make it somewhat difficult to evaluate his results, I believe there would be general agreement with his main conclusion.

Although aware of the limitations of the official data he uses on long-term capital movements, Hawkins does not specifically indicate that the data comprise only *net* outflows of domestic capital and *net* inflows of foreign capital. If the gross flows differ appreciably from the

net flows in either direction, the data might not reflect the true degree of significance of these movements as forces integrating national capital markets.

In his various tests with the data on capital movements, Hawkins seems to be more interested in whether the EEC countries have undergone a higher rate of capital-market integration than developed countries in general, rather than in whether the rate of integration among EEC capital markets themselves has significantly increased (his originally stated intention). This is evidenced by his extensive use of percentages of intra-EEC capital flows to total EEC capital inflows and outflows, or categories thereof, as contrasted with an examination of the absolute trend of intra-EEC capital movements alone. His conclusion here that European capital markets are not becoming appreciably more integrated seems, in fact, to be based largely on the fact that the percentages show no pronounced or consistent trend. Yet the underlying data that he uses do clearly show that the *absolute* volume of intra-EEC long-term capital movements increased during the period, sharply in some categories. One must of course beware of equating the rate of growth of intra-EEC capital movements with the rate of growth of EEC capital-market integration. But, in any event, Hawkins provides us with no standard by which the two could be related.

Hawkins' preference for relative rather than absolute comparisons also shows up in his discussion of the integrative effects of the Eurobond market. He argues, though not on the basis of statistics, that the Eurobond market has been more effective in integrating the capital markets of the EEC countries with outside markets, mainly those of the United States, than with each other. This is undoubtedly true, but clearly it would not be, and has not been, inconsistent with a greater absolute (even if indirect) degree of linkage among the EEC capital markets.

Hawkins gets closer to the core of the matter when he examines the pattern of interest rates in the EEC countries. Closer integration of capital markets should show up most directly, not in any particular pattern of long-term capital movements, but in a greater similarity in levels and especially in movements of long-term interest rates in the markets concerned. While Hawkins' evidence here proved mixed among pairs of countries, so far as comparisons between the periods

1957-62 and 1963-67 were concerned, no pronounced uniform trends towards greater similarity in interest-rate patterns emerged. And in 1968-69, as he observes, there was a marked tendency for interest-rate movements to diverge. Hawkins' findings here generally confirm those of other investigators.

Making a similar set of comparisons between *short-term* interest rates in the different markets, Hawkins finds that the covariation was less than in the case of bond yields. This is a surprising result. If the comparisons were made between *covered* short-term interest rates, however, the result might have been more in keeping with expectations.

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A common concern of these two very enlightening papers is with the benefits and costs of free or freer international capital movements, both from the standpoint of an individual country and from that of regional integration. Anticipating the entrance of Britain into the Common Market, I propose to deal with the two papers on an integrated basis.

It seems convenient to set forth in an orderly way the relevant factors in judging the case for the export of direct-investment capital. From the standpoint of the economic welfare of an individual country, direct-capital export ought to be considered on the following bases: (1) the role of foreign investment in facilitating trade; (2) a comparison of the social returns on capital investment abroad with that on domestic capital; and (3) its impact on the balance of payments. For an integrated area, such as the EEC, it is necessary to consider allocative efficiency and other benefits shared by the members of regional groups. As in the case of the benefits of free trade, the benefits from free factor movements are not going to be distributed equally among the members of the group.

With respect to the EEC, Hawkins rightly regards the freeing of capital movements as constituting an important contribution to integration, complementing the freeing of trade. The benefits from the

spread of technical knowledge, improved allocative efficiency, scale economies, and the integration of markets associated with direct-investment flows are likely to be substantial even where the actual volume of capital flows among the EEC members is not large. Moreover, the generally nondiscriminatory nature of the liberalization of direct investments by the EEC makes it possible for multinational firms with headquarters in the United States to promote factor movements associated with the flow of direct investment within the EEC. I suspect that some of these direct-investment flows within the EEC are concealed in the internal accounts of multinational firms with headquarters outside the Common Market.

Hawkins suggests that financial integration within the EEC may facilitate structural adjustments required for both balance-of-payments equilibrium and stable economic growth. Thus the movement of direct-investment capital provides a vehicle for distributing technical progress and productivity growth more evenly throughout the Common Market. It may be noted, however, that there is some tendency for the more rapidly growing countries to attract more capital from abroad than they export. For example, there is considerable evidence that direct investments by the United States in manufacturing abroad have expanded more rapidly in those countries with the highest growth rates. It is also worth noting that during the period 1960-68, Germany imported more direct-investment capital from her EEC partners than she invested in them, and Germany's growth rate was somewhat higher than the average for the EEC as a whole. A tendency for those countries with the most dynamic growth to attract direct investment from the rest of the economically integrated areas could have adverse consequences for interregional balance.

The problem faced by Britain with regard to the free movement of direct-investment capital is somewhat different, at least so long as Britain remains outside the EEC. A certain amount of direct foreign investment is a concomitant of modern trade. A country cannot be a successful exporter of manufactures without investing in marketing and assembling facilities abroad; in some cases it may be forced by competition to produce certain components abroad. On the other hand, a country can be a successful exporter without massive amounts of foreign investment. The ratio of Japanese direct foreign investment

to her exports of manufactures is a small fraction of that for the United States and is smaller than that for Britain as well. I strongly suspect that direct investment by American corporations through acquiring large European firms that buy relatively little from the United States does not provide social returns equal to the opportunity costs of investment in the United States. On the other hand, there are costs in trying to set up a system of direct-investment controls that would separate foreign investments that yield net social returns over opportunity costs to the investing country from those that do not.

Cohen is concerned with the net social gain or cost for the British economy of capital exports for direct investment abroad. Estimating the balance-of-payments effects of direct foreign investment, however, requires more than a simple comparison between social returns from domestic and from foreign investment. This is mainly because the investing country may be employing a higher social rate of discount to foreign exchange than to domestic income. In the face of a balance-of-payments crisis, the social rate of discount for calculating the present value of annual increments of foreign-exchange income may conceivably be 100 per cent. However, this is rarely the case, given the sources of external borrowing that are available today. But for countries with chronic balance-of-payments difficulties, the rate of discount applied to foreign-exchange income is usually substantially above that applied to domestic income.

Cohen examines the question of whether Britain should restrict direct foreign investment, in terms of the trade-off between capital restrictions on the one hand and trade restrictions or unemployment on the other. In so doing he compares the annual social costs to Britain of improving the balance of payments by £100 million under three alternatives—capital restriction, trade restriction, and domestic demand reduction. Based on a study by Richard Cooper, Cohen estimates that the annual cost to Britain of improving her balance of payments by £100 million is £3 million, if direct capital exports are restricted, and £45 million if Britain applies trade restrictions, the next best alternative. Now in making a comparison of this kind, it is important to specify whether the £100 million of direct foreign investment is only postponed for a year (and added to next year's normal foreign investment) or whether the £100 million is never restored. In the

latter case, the comparison is between a once-for-all cost (£45 million) of imposing trade restrictions to improve the balance of payments by £100 million for one year, and the discounted value of £3 million per year in perpetuity, the loss from not investing abroad £100 million for one year. The choice would seem to depend upon the social rate of discount, but if we employ the 3 per cent rate assumed by Cohen (and Cooper) one would have to opt for trade restrictions and against cutting back foreign investment.¹ I might add that if a more realistic social rate of discount were used, say 10 per cent, restricting foreign investment clearly would be preferable to trade restrictions.

Now I am quite willing to admit that if a country must choose between restricting trade and restricting capital exports, the latter is preferable. But to be realistic, Britain is not faced with an absolute foreign-exchange constraint over a given time period. Given the availability of large amounts of international credit from the IMF and the Group of Ten, it is unlikely that Britain would be faced with a situation that forced her to restrict direct investment regardless of the foreign-exchange earnings from an increment of such investment. Therefore, Britain must consider whether the restriction on direct-investment outflow may not be too costly a means of securing an immediate saving of foreign exchange.

In his analysis Cohen employs the finding of the Reddaway Report that British foreign investment produces an operating return of 6 per cent a year, as compared with a domestic "opportunity" cost of capital of approximately 3 per cent per year. Both of these figures seem very low to me but I can only cite another authority in defense of my intuitive judgment. Professor J. H. Dunning, a long-time student of British foreign investment, estimates the net return on British foreign investment in manufacturing to have been 12.5 per cent per year over the 1956-63 period and the recoupment period on marginal foreign investment is estimated to be six years. Dunning believes that the Reddaway Report underestimates both the marginal return from the flow of British private direct investment and the positive balance-of-payments effects of such investment. He bases this conclusion partly on the

¹ In his reply to my comments Cohen stated that he meant a temporary postponement of foreign investment, *all of which would be restored*, but he admitted that his paper was not clear on this point.

grounds that the Reddaway Report takes insufficient account of the effects of not investing on the efficiency and profitability of existing investment and partly on a difference with the Reddaway Report's assumptions regarding the effects of foreign investment on imports by the host country.² We need more empirical evidence before judging between several possible models for determining the balance-of-payments effects of foreign investment—such as the results of the current study being undertaken at the National Bureau of Economic Research by Robert Lipsey and Merle Weiss on the relationship of American manufacturing abroad to exports from the United States. It is worth noting, however, that the British are engaged in the same type of controversy as is taking place in the United States regarding the balance-of-payments effects of direct foreign investment. Nevertheless, even if the rate of return on foreign investment estimated by the Reddaway Report can be shown to be too low, a domestic “opportunity” cost of capital of 3 per cent per year seems ridiculously low.³ Thus, this type of comparison may well favor domestic investment over foreign investment, especially if a higher rate of discount is applied to foreign-exchange income.

Turning to flows of portfolio capital and loans, Hawkins has analyzed the benefits and costs of integrating financial markets within the EEC. Among the costs, he regards the freedom of capital movement as constraining the independent exercise of domestic monetary policies. Nevertheless, I wonder whether a larger degree of financial market integration, including the intra-EEC integration of capital submarkets, might not provide a means of easing the balance-of-payments problems associated with economic integration. Tibor Scitovsky and others have argued that the high degree of integration of asset markets, plus the ability of deficit areas to create new assets, provides a mechanism of balance-of-payments adjustment between regions within a country, which is gradual and relatively painless.⁴ How much integration of financial-asset markets would be required to relieve the liquidity constraint within the EEC? Would a high degree of integration

² See J. H. Dunning, “Foreign Investment Controversy: II—The Effects of Foreign Investment on Resources,” *The Bankers Magazine*, June, 1969, pp. 354–360.

³ See for example, W. J. Baumol, “On the Social Rate of Discount,” *American Economic Review*, September, 1968, pp. 788–802.

⁴ Tibor Scitovsky, *Money and the Balance of Payments*, Chicago, 1969.

of asset markets require a common currency? I think these are important questions for the future development of the EEC.

In considering the degree to which intra-EEC financial integration has taken place during the 1960's, Hawkins finds little evidence of a strong growth of intra-EEC private long-term capital flows, either in data on the flows themselves or in any tendency toward harmonization of interest-rate movements among the domestic capital markets of the EEC countries. It seems evident that the segmented domestic capital markets of the individual countries have continued to be insulated to a substantial degree. Hawkins does point out that the major integrating vehicles are the Eurodollar and the Eurobond markets. However, he minimizes the effects of these markets by pointing to their failure to integrate the various segments of the several national capital markets. He also presents evidence that EEC companies have not been large borrowers from the Eurobond market.

I have the feeling that there has been more financial integration within the Common Market than meets Hawkins' eye. For one thing, the data on intra-EEC capital movements probably do not reflect a substantial proportion of the actual intra-EEC capital flows that take place through the intermediation of both the Eurobond and the Eurodollar markets, since many of these movements would show up in the data on EEC capital transactions with outside areas. Large international firms and large financial institutions borrow and lend in these international markets and their effects on the various segments of the domestic capital markets in the EEC countries are indirect and difficult to determine. Moreover, the domestic markets are influenced directly by national monetary policies. In addition the interest-rate differentials between the domestic markets and the international markets in assets denominated in dollars and other international currencies are affected by the swap rates, which in turn are frequently manipulated by the monetary authorities. Hawkins' findings regarding the harmonization of interest-rate movements between domestic markets are, therefore, not surprising. Nevertheless, a substantial volume of intra-EEC capital flows is taking place through the intermediation of the international markets.

Turning again to Cohen's paper and the larger issue of freeing capital movements in Britain, I am disturbed by the implication that

Britain should go on indefinitely controlling capital exports of her residents. Is this because of Britain's precarious net reserve position and the overhang of sterling balances? If so, would not a change in the role of sterling as a reserve currency along the lines suggested by Cohen in his recent Princeton essay⁵ eliminate the need for controls? Or is the necessity of capital controls based on the view that Britain cannot afford to be a substantial net exporter of real capital? Britain's per capita GNP is still one of the highest in the world so that the question of whether she can *afford* to be a net capital exporter is scarcely the issue. It is a matter for national decision as to whether she is *willing* to be a net capital exporter, and by how much. Finally, is the argument that if Britain permits free capital movements, net capital exports will inevitably be larger than Britain desires or larger than her balance of payments will support? Given a general freeing of capital movements among developed countries and perhaps within a broadened EEC, might not Britain expect to enhance her role as a financial intermediary without a large net outflow of capital? Assuming such a regime, what policies would be required to keep Britain's net capital exports within the limits set by national policy without the adoption of the alternatives of domestic demand reductions or trade restriction? These appear to me to be the relevant questions.

⁵ Benjamin J. Cohen, *The Reform of Sterling*, Essays in International Finance, No. 77, Princeton University, Princeton, New Jersey, December, 1969.

