

balances in international payments should be easier in the future. Trade flows will respond more sharply to given small "disturbances;" but they should also respond more quickly to policy measures designed to influence them. If a small relative increase in the price level will lead a national economy into greater balance of payments difficulties than heretofore, a relatively small decrease should undo the difficulties. Similarly, international capital flows will respond more rapidly to small differences in national credit conditions; but small differences in national credit conditions directed to correcting the imbalance can induce equilibrating flows of capital. Thus if the national authorities can recognize disturbances early, are willing to use some of the tools at their disposal for correcting imbalances in international payments, and act reasonably quickly in doing so, then the increased sensitivity of international payments to various disturbances need cause no undue difficulty—provided that policy instruments are properly chosen and adequately coordinated among countries.

INTERDEPENDENCE BEFORE 1914

There is a natural inclination to compare the international economy today, especially under the claim that it is becoming more integrated, with the international economy before 1914, when, it is often said, the world was highly "integrated" economically. In the four decades before World War I most of the major countries were on the gold standard (implying fixed exchange rates) most of the time, capital was free to move into or out of most countries, trade was impeded only by comparatively moderate tariffs and quotas were generally absent. Even labor was generally free to migrate from country to country without visas, security checks, and immigration quotas.

In one important sense, however, the comparison is not at all apt. Today national governments are much more ambitious about the objectives of national economic policy than they were in the 19th century. Governments have taken on the responsibility for assuring high levels of employment and, increasingly, a rapid rate of growth; and they attempt actively to influence the allocation of resources and the distribution of income to a much greater degree. These new tasks place greater burdens on the available instruments of policy. Before 1914, by contrast, preoccupation with "defending the currency" was dominant, and the (admittedly more limited) policy instruments at hand were more willingly devoted largely toward that end. Thus the intrusions of international economic integration on national economic policy was more readily accepted because national economic policy was far less ambitious in its aims.

In addition to this important difference, economic relations among industrial countries are probably potentially much closer today than they were even before 1914, despite the characteristics of the pre-1914 world noted above. True, British and French capital moved overseas readily and British investors built railroads around the world. The proportion of Britain's annual savings which went abroad was staggering by modern standards.² Nonetheless, communications were far less perfect than they are today and foreign investors ran far greater commercial risks arising from imperfect knowledge (except in the case of colonial bonds which in effect had the sponsorship of the home government).

Despite the freedom of capital to move, it did not in fact move in sufficient volume to erase differences even in short-term interest rates. Over the period 1876-1914 short-term interest rates in New York averaged more than one percentage point higher than corresponding rates in London and there was only a weak correspondence in movement between short-term rates in the two financial centers. Short-term interest rates in London and Paris were much closer together and the correspondence in their movement was higher but still far from perfect.³ Long-term rates showed similar divergence in their levels and

² ALEXANDER CAIRNCROSS, *HOME AND FOREIGN INVESTMENT, 1870-1913*, 104-06 (1953) estimates that in 1907 no less than 40 percent of British national saving went to foreign investment.

³ See O. MORGENSTERN, *INTERNATIONAL FINANCIAL TRANSACTIONS AND BUSINESS CYCLES* (1959) for an exhaustive study of interest rate movements in the 19th century. The correlation coefficient between monthly averages of the commercial paper rate in New York and the open market discount rate in London was only +.45; the correlation between open market discount rates in London and Paris was +.67. Simple correlations of short-term interest rates in New York, London, Paris, and Berlin can be found in *Id.* at 109.