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## PAYMENTS RESTRICTIONS AND THE INTERNATIONAL MONETARY SYSTEM\*

Jay H. Levin\*\*

The primary objective of any international monetary system should be to facilitate international trade and capital movements. The proposition that countries gain mutually from free international trade was first established by the classical economists as a corollary of their theory of comparative advantage. The additional proposition that capital is most productive if it is free to move from regions of low rates of return to regions of high rates of return is a strong argument against the use of capital controls. It would lead us too far astray here to discuss these propositions in detail. Let me simply say that most economists are in broad agreement with them, and they can serve as useful criteria with which to judge the success of any international monetary system.

I believe that the lack of an automatic balance of payments adjustment mechanism in the present international monetary system fosters a strong tendency for countries to adopt restrictions on international transactions. In this way the system subverts its own basic objectives. This argument must begin with a description of the international monetary system devised at Bretton Woods, New Hampshire, in 1944,<sup>1</sup> followed by a discussion of how countries get into balance of payments difficulties and the options which the system affords for removing payments imbalances. I will then demonstrate why countries frequently choose payments restrictions as a method of balance of payments adjustment.

### I

#### THE INTERNATIONAL MONETARY FUND SYSTEM

The designers of the I.M.F. system believed that the primary

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<sup>1</sup> PROCEEDINGS AND DOCUMENTS OF THE UNITED NATIONS MONETARY AND FINANCIAL CONF., PUBLICATION No. 2866; CONF. SER. NO. I, 3, (U. S. Dept. State, 1948). For amendments; see Hearings on S.10162 Before the Senate Committee on Foreign Relations, 87th Cong., 2nd Sess. (1962

objective of free trade and capital movement, would best be served if countries maintained more or less fixed exchange rates vis-à-vis each other for prolonged periods. It was argued that continuous fluctuations in exchange rates inhibit the activities of traders and investors by introducing elements of risk into their calculations. Under the present system governments are obliged to intervene in the foreign exchange market to prevent fluctuations in their currencies.<sup>2</sup> For example; suppose that because of the activities of traders and investors more francs are supplied than are demanded in the foreign exchange market at the so-called parity price of 20 cents per franc. The price of the franc would tend to decline, and the French authorities would undertake to purchase this excess supply by selling dollars in exchange for francs. Here we have a case in which France is faced with a balance of payments deficit; the supply of francs, which reflects French demand for imports and foreign investments exceeds the demand for francs, which reflects the foreign demand for French exports and investments in France. The government must intervene in order to preserve the parity exchange value of the franc, and the volume of intervention measures the balance of payments deficit. On the other hand, if the private demand for francs exceeds the private supply; the French authorities can only prevent the exchange rate of the franc from rising by selling francs in the foreign exchange market and acquiring dollars.

In the case of a balance of payments deficit; the authorities surrender foreign exchange reserves; whereas in the case of a balance of payments surplus they accumulate them. In addition to foreign exchange, countries also hold gold as a form of reserves. The U. S. government agreed to fulfill its obligations to the I.M.F. not by intervening in the exchange markets but by selling gold to and buying gold from foreign authorities at thirty-five dollars an ounce. Occasionally countries with a balance of payments deficit sell gold to the United States in order to acquire dollars with which they can finance their deficit.

Thus, the system is characterized by official ownership of

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<sup>2</sup>The particular governmental agency responsible for exchange market intervention will be the central bank; the treasury, or an exchange equalization account.

dollars and gold (and to a lesser extent British sterling) as foreign exchange reserves. The function of these reserves is to finance balance of payments deficits that are believed to be temporary. New reserves are generated whenever the U. S. balance of payments is in deficit--foreign central banks are obliged to prevent their exchange rates from rising in relation to the dollar by buying up the excess dollars in the exchange market. Prior to March 1968 central banks also acquired gold whenever the private supply exceeded the private demand at \$35 an ounce. However, central banks no longer intervene in the gold markets; and as of now gold is not a source of reserve growth.

A final characteristic of the I.M.F. system is that countries are permitted to occasionally alter their exchange rates whenever their payments imbalances appear to be chronic, a situation which the I.M.F. describes as "fundamental disequilibrium."<sup>3</sup> However, frequent changes in exchange rates are not envisioned as they would undermine the presumed benefits of fixed exchange rates.

## II

### CAUSES OF PAYMENTS IMBALANCE

It is only natural that balance of payments deficits and surpluses arise from time to time. Countries differ in the degree to which they are willing to tolerate inflation or the speed at which they can eliminate inflationary pressures; and the resulting diverse movements in price levels will create deficits for the countries inflating most rapidly and surpluses for the countries with lower or zero rates of inflation. Another cause of payments imbalance is that countries undergo different rates or types of structural change. For example; technological progress may proceed in spurts in some countries and lag in others, or there may be secular shifts in taste patterns or demands for foreign assets. These structural changes are bound to have an impact on the volume and pattern of each country's international trade and capital flows, and the natural consequence is a payments imbalance. This is not to say that payments imbalances are always undesirable. For example, when the United States is running

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<sup>3</sup>Published in UNITED NATIONS MONETARY AND FINANCIAL CONFERENCE: FINAL ACT AND RELATED DOCUMENTS; PUBLICATION NO. 2187, CONF. SER.NO. 55 (U. S. Dept. State), T.I.A.S. No. 1501 (1945).

a payments deficit, foreign central banks are acquiring additional stocks of dollar reserves. These additions may be desirable to permit them to finance future balance of payments deficits, which we should expect to increase in magnitude in a growing world economy. On the other hand, the U. S. deficit may be so large that surplus countries are acquiring reserves more quickly than they desire. There is indeed a substantial cost involved in running a sizable balance of payments surplus; for a surplus country is foregoing the acquisition of otherwise available additional goods and services. By increasing its imports or reducing its exports the surplus country can increase its welfare as it eliminates its balance of payments disequilibrium. However, there may even be more pressure for a balance of payments deficit country to take steps to remove its payments imbalance. For example, a persistent French balance of payments deficit is not tolerable indefinitely since the deficit must be financed by the drawing down of official reserves. The cumulative deficit obviously cannot exceed the country's stock of reserves, and eventually the deficit country will be forced to take action.

### III

#### BALANCE OF PAYMENTS ADJUSTMENT ALTERNATIVES

There are essentially three methods of adjustment to restore payments balance: variations in internal demand; changes in exchange rates; and changes in restrictions on international transactions. I will discuss these in order from the point of view of a deficit country.

##### A. Variations in Internal Demand

A deficit can be removed by a sufficient reduction of internal aggregate demand. Government expenditures may be decreased, income taxes may be raised; or the central bank may undertake to restrict the supply of credit and raise interest rates. Because industrialized countries are characterized by a downward inflexibility of wages,<sup>4</sup> these actions tend to reduce the level of output and employment, and consequently the demand for imports will

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<sup>4</sup>Downward wage inflexibility may stem from trade union pressures, minimum wage laws, or even employers' reluctance to cut wages.

decline. To the extent that prices also decline, consumers have an even greater incentive to switch their purchases away from foreign goods, and foreigners will be induced to purchase more of the country's exports. In short this method of adjustment takes the form of reduced imports and increased exports that accompany deflation. The extent of the initial balance of payments deficit determines the required degree of deflation. Deficit countries have occasionally resorted to this type of adjustment. British policy prior to the November 1967 devaluation is a conspicuous example of internal belt-tightening for balance of payments reasons.<sup>5</sup> The claim has frequently been made that prior to the 1964 tax cut U. S. policy-makers were reluctant to reduce the high level of unemployment for fear of aggravating the balance of payments deficit.<sup>6</sup> I think it can be safely said, however, that the deflationary cure is worse than the disease. Deliberately created unemployment is socially intolerable, politically dangerous, and clearly a waste of economic resources.

#### B. Changes in Exchange Rates

A second alternative from the standpoint of a deficit country is a devaluation of the currency, i.e., reducing the price of the home currency in terms of foreign currencies. At the lower foreign exchange rate the country's exports become more attractive to foreigners, and imports become more expensive to domestic residents. These price effects normally work to improve the balance of payments, and an appropriate devaluation will restore balance of payments equilibrium.<sup>7</sup> Mention should be made of the fact that along with the devaluation the government must also take measures to cushion the devaluation's stimulatory effects

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<sup>5</sup>For a discussion of recent British balance of payments policy, see R. N. Cooper, The Balance of Payments. BRITAIN'S ECONOMIC PROSPECTS 147-97 (1968).

<sup>6</sup>See Goldstein, Does It Necessarily Cost Anything to be the World Banker, 2 NAT'L BANK.REV. 411-15 (1965).

<sup>7</sup>This paper does not attempt to answer the question of whether periodic exchange rate changes are more, or less, desirable than the continuous changes provided by a freely fluctuating rate system. On this question of the optimum timing of adjustment and related matters, see M. FRIEDMAN, The Case for Flexible Exchange Rates, in ESSAYS IN POSITIVE ECONOMICS 157-203 (1959).

on the economy, which would otherwise counteract the favorable balance of payments effects. Devaluation can succeed only if it is accompanied by appropriate macro-economic policies, such as increased taxation or reduced government expenditures. But I wish to stress that the major problem with the devaluation alternative is the reluctance of the authorities to make use of it. Devaluation is often regarded in official circles as a major political catastrophe. It is viewed as a disaster to the country's financial prestige and a threat to future confidence in its currency. Witness the recent refusal of the French to undertake a change in the par value of the franc. It also may be noted here that surplus countries resist making upward changes in their exchange rates because appreciation induces resources to leave export industries and industries that compete with imports. This essentially mercantilist attitude<sup>8</sup> on the part of surplus countries and the refusal to swallow their pride on the part of the governments of deficit countries is in my view largely responsible for the recourse to yet a third method of balance of payments adjustment: restrictions on international transactions.

### C. Changes in Restrictions on International Transactions

It is of course ironic that deficit countries opt for restrictions when the very objective of the system is to facilitate international trade and capital movements. The widespread use of restrictions undertaken for balance of payments reasons can be well documented. During the November 1968 exchange crisis the British government imposed the requirement on importers that they make deposits with the customs houses equal to 50 percent of the value of all manufactured imports and certain other categories of imports.<sup>9</sup> The total covers about one-third of Great Britain's imports. The deposits will be returnable in six months without interest, and the legislation is to be in effect for a maximum of 12 months. The intended effect is to restrict the supply and to raise the domestic price of imported goods with the consequence of a decline in imports and improvement in the balance

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<sup>8</sup>This refers to the belief originating in the sixteenth century that measures undertaken to enlarge a balance of trade surplus are sure ways of increasing a nation's wealth.

<sup>9</sup>See 20 INT'L FIN. NEWS SURVEY, Dec. 6, 1968 at 405 (1968).

of payments. Again, in the November 1964 crisis the British reacted by imposing a direct surcharge of 15 percent on imports of most manufactured goods, which eventually was eliminated two years later. The surcharge provoked strong protests abroad, especially from other members of the European Free Trade Area, who felt that much of the gain from tariff reduction that previously had taken place within EFTA would be destroyed.

In the case of the United States a number of restrictions can be pointed to. For example, in July 1963 the U. S. adopted the so-called Interest Equalization Tax, a 15 percent tax on purchases of long-term foreign securities designed to reduce capital outflows. The tax is still in effect.<sup>10</sup> More recently the government has introduced mandatory restrictions on direct investments by corporations in all foreign areas,<sup>11</sup> and the Federal Reserve System maintains voluntary ceilings on foreign lending by banks and other financial institutions<sup>12</sup> and has standby authority to invoke mandatory controls. Last year the administration proposed severe restrictions on foreign travel, but fortunately these failed to receive Congressional support. It has even been asserted that the restrictive Japanese import quotas were originally undertaken as an escape from balance of payments difficulties.<sup>13</sup> These in no way violated the spirit of the GATT agreements, which endorse quantitative restrictions<sup>14</sup> on imports when countries encounter severe balance of payments problems.

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<sup>10</sup>For acquisitions of stock on or before January 25, 1967, the tax on the transfer of stock was 15 percent of the stocks' actual value. For acquisitions after January 25, 1967 through August 29, 1967, the tax was 22.5 percent of the stocks' actual value. The tax on the transfer of stock made after April 4, 1969 is 11.25 percent of the stocks' actual value. The President, by Executive Order No. 11464 dated April 3, 1969, adjusted the rates to their present level. These rates will remain in effect until such time as the President deems a rate change necessary. Code Sec. 4911(b) authorizes the President to vary the rates from zero to a maximum of 22.5 percent. CCA FED. EXCISE TAX REP. ¶3193, at 3169-8 (1969).

<sup>11</sup>Restraints, Export Drive Included in Payments Program, 74 INT'L COMM. 5 (1968).

<sup>12</sup>See 55 FED. RES. BULL. 11 (1969).

<sup>13</sup>See BUS. WEEK Jan. 4, 1969, at 65.

<sup>14</sup>Article XII of the General Agreement on Tariffs and Trade, 61 Stet. pt. 5, A3 (1947), T.I.A.S. No. 1700, 55 U.N.T.S. 194 (1950).

The objection to all trade restrictions is that they are selective and inefficient. By their very nature they discriminate against some sectors of the economy in favor of others by distorting the structure of prices; consequently they result in a misallocation of resources. In the case of capital controls the benefits from freely mobile capital are foregone. It would be far preferable to avoid additional restrictions by the deficit countries by encouraging the surplus countries to adjust by unilaterally liberalizing their payments restrictions. Unfortunately, the solution appears to be politically impractical. Countries desire "concessions" from others as an inducement to relax their own restrictions. Accordingly, there appears to be little hope for balance of payments adjustment by this route.

#### CONCLUSION

I am forced to conclude that we are faced with too many economic objectives that cannot be fulfilled simultaneously. Ideally, countries want to maintain full employment, fixed exchange rates, and freedom of international payments. But when they get into balance of payments difficulties, one of these goals eventually must be sacrificed. The clear and present danger is that restrictions will be preferred, and these undermine the basic objective of the monetary system. Proponents of more flexibility in exchange rates have in mind a mechanism which automatically eliminates payments imbalances and averts the necessity for restrictions. The real question is whether we are willing to view exchange rates as a means and not as an end of economic policy.

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