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GUIDELINES FOR BALANCE-OF-PAYMENTS ADJUSTMENT UNDER THE PAR-VALUE SYSTEM

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International Finance Section

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INTRODUCTION

The policies that countries may adopt in dealing with imbalances of payments are to some extent regulated by the provisions of intergovernmental agreements. For example, the Articles of Agreement of the Fund limit the freedom of action of member countries with respect to changes in par values (exchange rates), the imposition of exchange restrictions on current transactions, the adoption of multiple-currency practices, and so forth, while the General Agreement on Tariffs and Trade limits the freedom of action of the contracting parties with respect to tariffs, import restrictions, export subsidies, and the like.

This framework of legal obligations, however, is far from sufficient to ensure that the self-regarding actions of countries in dealing with their payments problems will mesh together into a satisfactory system of mutual accommodation and adjustment calculated to promote on a worldwide scale the objectives of high employment and real income, development of productive resources, and expansion of international trade set forth, for example, in the Purposes of the Fund. International organizations, both worldwide and regional, therefore, carry out many activities, other than administering a legal code, to assist their members in solving their payments problems. Thus, the financial assistance provided by the Fund, and, to a lesser extent, by the European Fund and the Bank for International Settlements, assists countries in meeting temporary payments deficits and so makes it possible for them to avoid resort to measures such as restriction of international transactions, excessive devaluation, or undue deflation that would be destructive of national or international prosperity, while pursuing sounder, if slower, methods of restoring equilibrium. In the case of the Fund, at any rate, such assistance is often made conditional on the adoption of satisfactory adjustment policies. Finally, a number of international agencies, notably the Fund and the Organization for Economic Cooperation and Development, regularly advise their members on the policies that appear to be required in the prevailing circumstances to maintain or restore internal and external equilibrium, and occasionally make statements of general application regarding the types of policies which they favor.

While the prescriptions offered by international bodies such as the

Fund and the OECD to their member countries are doubtless imbued with the philosophy characteristic of the organization in question, they are for the most part tailor-made to fit the concrete circumstances of particular cases, and cannot be entirely free from the defects of the "*ad hoc*." It has, therefore, sometimes been felt that they might gain in consistency and stability if made in the light of an explicit "code of good behavior" with respect to balance-of-payments adjustment somewhat more detailed and comprehensive than any that could be derived from the present framework of international legal obligations in this sphere.

One or two attempts to formulate such a code were made during the lifetime of the OEEC, but much the most comprehensive and fully worked out formulation to date is that contained in the pioneering Report on the Balance of Payments Adjustment Process recently prepared by Working Party No. 3 of the Economic Policy Committee of the OECD (Organization for Economic Cooperation and Development, Paris, August 1966).

The present paper is intended to explore the possibility of elaborating a code more precise and, in a way, more ambitious than the guidelines set forth by the intergovernmental OECD Working Party. The system outlined below, like that of Working Party No. 3, is based upon the existing legal foundations provided by the Articles of the Fund and the provisions of the GATT. No new international agreements are envisaged and no new invasions of sovereignty proposed. Nevertheless, it may very well be that some of the suggestions made below would put a greater strain on the willingness of countries to cooperate internationally than is likely to prove practicable. It has seemed to the writer that there was much to be learned at the present stage from a presentation of the full implications for international cooperation of a wholehearted attempt to make the present system work well, and he has therefore refrained from any premature application of the "art of the possible."

EARLIER ADJUSTMENT SYSTEMS

Before outlining a code of balance-of-payments adjustment designed to meet present day conditions, it may be useful to mention two main systems of policy in this area that have in the past found favor with many economists. These might be described for convenience as pre-Keynesian and Keynesian, respectively.

The pre-Keynesian or gold-standard view is that the exchange value of currencies should be fixed in terms of gold and of each other, that budgets should be balanced (with perhaps a small Sinking Fund to absorb the public indebtedness accumulated in previous wars), and that

monetary policy should be aimed primarily at maintaining and restoring balance in international payments, in the short run through its effect on capital movements and in the longer run through its effect on domestic expenditure and prices. The aims of preserving full employment and ensuring optimal growth would not be served directly by these policy instruments, at least in their over-all aspects, but would be safeguarded by the presumed flexibility of wages and prices—in conjunction with a low or negative elasticity of price expectations—and by the propensity to save in the private sector.

What is here called the "Keynesian view" is really the view of the later Keynes, as synthesized from scattered evidences—for example, by Ragnar Nurkse.* This is that fiscal and monetary policy should be applied in a mutually reinforcing manner, with a view to securing full employment without inflation, while the needs of the balance of payments should be met initially by the use of reserves (supplemented as desired by controls over capital flows, compensatory credits, official intervention in the forward exchange market, and so forth) and then by temporary import restrictions and by exchange-rate adjustment. This view was based on four assumptions: (1) that wages and prices are too sticky in a downward direction to enable a gold-standard or fixed-exchange system to work successfully, (2) that reasonably full employment is normally possible without inflation, (3) that monetary policy itself is too feeble or chancy an instrument to secure internal stability without the supplementation of budgetary deficits or surpluses, and (4) that private international capital flows are undesirable if they are of a disequilibrating character, that is, if they are such as to intensify rather than relieve balance-of-payments difficulties.

The ideas regarding the international adjustment mechanism that are built into the provisions of the Fund Articles of Agreement and of the GATT are largely based on this Keynesian view, modified by a more conservative tendency originating in the U.S. Administration, which laid greater emphasis on the importance of exchange-rate stability and on the avoidance of restrictions on current transactions, particularly restrictions of a discriminatory kind.

The last two decades have witnessed some weakening of the Keynesian presuppositions but no emergence of a stable post-Keynesian orthodox view. First came a phase in which, behind a protective wall of discriminatory restrictions and with the help of substantial devaluations, trade was liberalized, originally on a bilateral, subsequently on a regional basis. There followed a euphoric phase, based partly on the emergence of a

* Cf. "Conditions of International Monetary Equilibrium" (Princeton University, Essays in International Finance No. 4, 1945) and "Domestic and International Equilibrium," in Seymour Harris, ed., *The New Economics* (New York: Knopf, 1947).

temporarily favorable structure of international payments, partly on the realization that in postwar conditions price inflation was more of a danger than massive unemployment. In this phase a conservative reaction took place towards a gold-standard-like system, in which changes in exchange rates would be regarded as but a remote possibility and demand policies would be geared primarily to the state of the balance of payments. There was even a short-lived enthusiasm for the complete liberalization of capital flows.

With the recrudescence of payments problems in the later 1950's, came a bifurcation or trifurcation of thinking on the process of balance-of-payments adjustment. First, an academic revolt against the par-value system of Bretton Woods sought to achieve or preserve the freedom of international transactions through a general adoption of a flexible or floating rate of exchange. This school of thought, which probably predominates in academic circles, has more recently trimmed its sails somewhat towards an advocacy of a par-value system with wide exchange-rate margins, or of a par value—the "crawling peg"—that would gradually but continuously vary in response to payments conditions. Bankers and officials, however, together with a proportion of the academic community, still adhere by and large to the Bretton Woods system of adjustment, albeit with a recognition that the adjustment process needs to be improved. Within this consensus, one school lays greater emphasis on the need for the provision of an adequate volume of official compensatory financing, including if necessary the deliberate creation of a reserve asset supplementary to traditional reserves, to provide adequate time for underlying adjustments. Another school lays more emphasis on the need for a speedier adjustment process, to be achieved by means that are not always clearly specified but appear at any rate to involve greater control over private capital movements. Both schools give at least lip service to an idea, propagated partly in official, partly in academic circles in the last five years, according to which monetary policy would be directed primarily towards influencing the international movement of capital in such a way as to rectify the balance of payments (even if this had excessive or undesirable effects on internal demand), while fiscal policy would be directed primarily towards attaining target levels of internal demand (even if this meant moving in the "wrong" direction from the standpoint of the balance of payments).

There has been an impressive corpus of first-rate *analytical* work on international trade and payments, including, in the case of J. E. Meade in particular, minute analyses of the effects of alternative balance-of-payments policies. Nevertheless, attempts by academic economists to set forth a coherent *normative* system, based on the legal framework of the Fund and GATT for the adjustment of different sorts of imbalances in

international payments, were almost entirely lacking from 1947, when Nurkse wrote the articles previously mentioned, to 1966, when Fellner, Machlup, Triffin and eleven other economists wrote a book entitled *Maintaining and Restoring Balance in International Payments.* It is significant that the initiative to call the meetings, for which the papers in the book were prepared, was taken by some of the officials participating in Working Party 3 of the OECD. Perhaps the reluctance of academics to venture on their own initiative into the code-building terrain is an indication of the foolhardy nature of the enterprise. The writer of the present paper has derived considerable stimulus from this volume, particularly from the three comprehensive papers by the named authors and from a short, but pithy, paper by James Tobin, on "Adjustment Responsibilities of Surplus and Deficit Countries."

FEATURES OF THE PROPOSED SYSTEM

It is convenient to mention at this point some of the general features of the system of adjustment outlined below. In the first place, being, as already indicated, consistent with the Articles of Agreement of the Fund, it is based on the assumption that exchange rates (par values) should be adjusted only to correct fundamental disequilibria (that is, long-term imbalances that cannot be corrected by aggregate demand policy in a reasonable time without an excessive degree of unemployment or inflationary pressure). Subject to this constraint, the merits of which will not be argued in this paper, the object of the code will be, as far as practicable, to maximize economic welfare.

The problem of adjustment is approached on a country-by-country basis. Each country is expected to take action with respect to its own balance-of-payments situation without making its actions conditional on actions by other countries. While each country's payments surplus or deficit is, of course, related to the surpluses and deficits of all other countries, it seldom reflects the deficit or surplus of any single other country or small number of other countries, and if each country waits for others to save it the trouble of taking action, adjustment is likely to be long delayed.

There may be appropriate partial exceptions to this individualistic approach in the case of disequilibria affecting very large countries or countries that are heavily dependent on the economy of a single other country. In general, however, it is the only approach that is practicable for world organizations like the Fund, or even organizations of more limited membership like the OECD, to adopt. This does not mean that account should not be taken of probable developments in the rest of the world in assessing the probable direction of, and hence appropriate prescriptions for, the disequilibrium of any given country. Nor does it mean

that countries, in dealing with their own payments imbalances and domestic goals, are free to ignore the interests and objectives of other countries. What it does mean, as we shall see, is that the necessary element of international cooperation is sought to be provided through general prescriptions regarding the types of policies that are commendable in different types of disequilibrium situations affecting individual countries, and through collective judgments as to the extent to which these situations prevail in particular instances, rather than through specific prescriptions for coordinated action by a number of countries.

Broadly speaking, symmetry is maintained in the treatment of "surplus" and "deficit" countries. Countries are expected to take action roughly commensurate with the magnitude and character of their respective imbalances, whether these be positive or negative. As has been pointed out by Fritz Machlup in the volume previously referred to, the methods of adjustment open to surplus countries, especially in the sphere of demand policy, capital restrictions, and trade restrictions, are generally less costly in terms of economic welfare than those open to deficit countries, and on this criterion it might be appropriate that the main responsibility for adjustment should lie with surplus countries. However, as the same author has also indicated, imbalances are more often caused by bad policies on the part of deficit than of surplus countries. To avoid ill effects on incentives, it therefore seems best to try to assign responsibilities for adjustment to both classes of countries. It is sometimes argued that the international community is so much less able to bring pressure to bear on surplus than on deficit countries that it is unrealistic to call on the former to make any sacrifice of domestic objectives. From a less cynical standpoint, however, the difficulty of applying sanctions to surplus countries would make it seem all the more necessary that the responsibilities of these countries should be clearly stated, and the moral pressure on them vigorously applied.

The prescriptions contained in the code of behavior are determined by the characteristics of the over-all balance of payments and not by the composition of that balance with respect to current and capital-account transactions, except insofar as that composition may affect the "time shape" of imbalances—their reversible, temporary, or persistent character. By contrast with what is recommended by the Report of Working Party 3, it is not here proposed that account be taken of countries' targets for their balances of payments on current account. As between countries that are free from restrictions on international transactions (and from undue unemployment) imposed or incurred on balance-of-payments grounds, the prospect of a persistent over-all payments deficit, for example, will be taken as *prima facie* evidence that the current-account

balance, if negative, should become less so, and if positive, should become more so, irrespective of whether that balance exceeds or falls short of any national target. The underlying assumption here is that over any long period of years voluntary flows of funds are likely to provide a better indication of the appropriate flow of real capital—as distinct from aid—than are politically determined national targets—which are, moreover, certain to be mutually incompatible.

Since the system proposed contains a variety of methods both of financing imbalances and of removing them, it has considerable flexibility in adapting to the circumstances of particular countries. However, no attempt has been made to provide radically different codes of behavior for different classes of countries. The system described is primarily designed to meet the needs of relatively stable countries, including, one hopes, all the industrial countries, and a proportion of the less developed ones. This matter is touched upon again at a later point in the paper.

THE CODE OF ADJUSTMENT

In this section a par-value system of balance-of-payments adjustment is presented in outline form on the left side of the page. A commentary on various features of this system is provided in the notes appearing on the right side of the page opposite to the relevant sections of the text.

Text

(1) A country should be deemed to be in balance-of-payments deficit if it is

(a) losing reserves[1] *on a larger scale, or gaining them on a smaller scale, than corresponds to its share in world reserve growth,*[2] *or*

(b) avoids this only by undertaking for balance-of-payments reasons one or more of the following measures:

- *(i) official borrowing;*
- *(ii) promoting an "artificially" favorable net international flow of capital by one or other of the methods described at (13) below;*
- *(iii) providing abnormally restricted aid to foreign countries;*

Notes

[1] If there were no holding of reserve currencies by monetary authorities, it would be natural to measure changes in reserves on a gross basis. As things are, the question arises to what extent, if any, changes in liquid liabilities to foreign monetary authorities should be subtracted from changes in the gross reserves of reserve-currency countries. Such netting could be carried out on a 1:1 basis (each dollar of liabilities counting as negative reserves to the extent of one dollar), or it could be omitted altogether, or reserve changes could be calculated on a semi-gross basis (for example, each dollar of liabilities counting as negative reserves to the extent of 50 cents). Whatever procedure was adopted for reserve countries would have to be adopted also in calculating aggregate reserve changes. The argument for complete netting is that any accumulation of liabilities to foreign monetary authorities, even if not solicited by the reserve center in question, represents financing of a compensatory character rather than a capital inflow that is justified by its effect on

Text

(iv) restricting imports;
(v) subsidizing exports; or
(vi) maintaining a level of aggregate demand that is less than optimal[3] *from the standpoint of its effect on price inflation and unemployment.*

(2) A country should be deemed to be in balance-of-payments surplus if it is

(a) gaining reserves on a larger

Notes

world productivity. Unless offset by an accumulation of reserves by the reserve center—which is equivalent to an outflow of official compensatory financing—it therefore signifies *prima facie* an imbalance which, if persistent, should be corrected. The main argument for a less-than-complete netting of such liabilities is that in the present state of uncertainty regarding the adequacy of deliberate reserve creation the world cannot do without the supplement to reserves arising from the accumulation of currency reserves. Nor can that supplement be distributed suitably throughout the world unless the reserve centers have, over the long run, some—though not an equivalent—payments deficit on a net official basis.

[2] The object of asking countries to take account of the growth of world reserves in deciding what to regard as equilibrium is to try to prevent too many countries from adopting restrictive measures to meet payments deficits when the total amount of world reserves is falling or rising too slowly, and to prevent too many countries from adopting expansionary measures when world reserves are rising too fast. It would, of course, be simpler to allow countries to base their balance-of-payments policies on a more "natural" definition of equilibrium and to influence their behavior by adjusting the net sum of payments surpluses through an appropriate amount of deliberate reserve creation. However, until an internationally agreed system of deliberate reserve creation exists and is in satisfactory operation countries must be asked to adapt their balance-of-payments targets to the actual growth of world reserves.

[3] By the "optimal" level of aggregate demand for any country at any time is meant either one compatible with the "normal" relationship between unemployment and price increase described below at *(7), Alternative A*, or one compatible with the "national" norm described at *(7), Alternative B*.

scale, or losing them on a smaller scale than corresponds to its share in the growth of world reserves, or

(b) avoids this only by undertaking for balance-of-payments reasons one or more of the following measures:

- *(i) official lending;*
- *(ii) promoting an "artificially" unfavorable net flow of capital;*
- *(iii) providing abnormally expanded aid to foreign countries;*
- *(iv) subsidizing imports;*
- *(v) restricting exports; or*
- *(vi) maintaining a level of aggregate demand that is more than optimal from the standpoint of its effect on price inflation and unemployment.*

(3) A country should be deemed to be in chronic deficit if the conditions described at (1) above are expected to prevail, in the absence of measures of adjustment, over the average of the ensuing five years.[4]

(4) A country should be deemed to be in chronic surplus if the conditions described at (2) above are expected to prevail, in the absence of measures of adjustment, over the average of the ensuing five years.[4]

(5) Any country that is in chronic surplus, and does not have a weak liquidity position,[5] *should be urged to remove not only balance-of-pay-*

[4] The condition for a chronic deficit or surplus should be deemed to be satisfied if an actual deficit or surplus exists, and is not clearly likely to disappear within the next two or three years. It is, however, possible for a country to be in chronic deficit and actual (temporary) surplus, or in chronic surplus and actual (temporary) deficit.

[5] The strength of a country's liquidity position depends primarily on the level of its gross reserves relative to its international transactions with an allowance (on less than a 1:1 basis) for liquid liabilities,

ments restrictions of all sorts but also, to a degree commensurate with its surplus, any other restrictions on imports and capital exports that are contrary to the interests of the international community.[6]

(6) Any country that has an appreciable[7] *chronic deficit, and does not have a relatively strong liquidity position,*[8] *should pursue such a combination of aggregate demand policy and incomes policy as is likely to result in stable prices. Any country that is in approximate payments balance should pursue such a combination of aggregate demand policy and incomes policy as is likely to result in slightly rising prices. Any country that has an appreciable chronic surplus, and does not have a relatively weak liquidity position, should pursue such a combination of aggregate demand policy and incomes policy as is likely to result in moderately rising prices.*[9]

and an allowance for access to balance-of-payments financing. It should be noted that a reserve-center country that is maintaining balance on the basis of a definition that involves a full netting of reserves for liquid liabilities to official holders may nevertheless be improving its liquidity position, since only a partial netting of such liabilities may be required to sustain its external liquidity. On the other hand, it may be suffering a deterioration in external liquidity if balance is maintained only thanks to an accumulation of liquid liabilities to private holders.

[6] If this is not strictly a part of the code of balance-of-payments adjustment, it is a useful extension of it.

[7] Payments balance, a state in which a country is neither in appreciable chronic deficit nor in appreciable chronic surplus, may be thought of as a band of some width rather than as a mere dividing line.

[8] Countries' adjustment policies should take account, not only of the nature and extent of their payments imbalances, whether explicit or suppressed, but also of their relative liquidity positions. Deficit countries with strong liquidity positions should not be pressed to adopt premature adjustment policies that might deny to other countries the reserves the latter may require to finance subsequent deficits. Similarly, surplus countries with very low reserves should not be pressed to adopt premature adjustment policies that would prevent them from accumulating the reserves they themselves may require to finance subsequent deficits. On the other hand, it is not suggested that countries in payments balance should adopt adjustment policies merely to acquire or merely to discard, reserves, since this might involve too frequent reversals of relative price levels, and since there are other ways (for example, *ad hoc* international lending) of adjusting relative liquidity positions.

[9] The object of *(6)* is to ensure that policy instruments other than exchange-rate devaluation or revaluation are used, at least to some extent, to assist in bringing about such adjustments in the relative price levels of surplus and deficit countries as will promote balance in international payments without continued resort to restric-

Text | *Notes*

tions or distortion of international trade and capital flows. In most cases, though admittedly not in all, this will mean that these countries should adopt price policies of the kind described in (*6*). The differential target rates of price-level increase for deficit and for surplus countries, respectively, through which the desired adjustment of relative price levels is to be brought about, must be fixed with reference to some norm at which countries in equilibrium are expected to aim. In determining this norm, and also the extent to which deficit and surplus countries can be expected to aim at rates of price increase respectively below and above this norm, it has to be borne in mind that

(a) given the present strength of cost-push factors and incomes policies in relatively stable countries, most such countries find that some degree of price inflation in excess of zero is necessary to avoid what they would regard as excessive unemployment;

(b) that surplus countries are unlikely to tolerate rates of price increase, or deficit countries levels of unemployment much in excess of those corresponding to the compromise between price stability and full employment which they prefer on purely domestic grounds, merely in order to adjust payments imbalances. To illustrate the sort of figures that might be reasonable under present circumstances, anything from 0 to 2 per cent increase per annum in GNP deflator might be regarded as the degree of price stability to be expected of deficit countries, and anything from 2 to 4 per cent increase per annum as the range of price increase to be expected of surplus countries. The precise target ought, of course, to depend on the size of the chronic surplus or deficit. The rate of price increase of 2 per cent here suggested as normal for a country in a balanced payments position should be compared with the actual average rates of price increase in major industrial countries of 2.9 per cent in the quinquennium 1955-60, and of 2.4 per cent in the quinquennium 1960-65.

(7) Alternative A

A view should be arrived at, possibly on the basis of informal international agreement, as to the

[10] For any given country over any given short period, we may assume that the lower the unemployment, the higher will be the rate of price inflation. (This relationship is obviously connected with the so-called

relationship between percentage unemployment and rate of increase of price level that for an average stable country in a balanced payments position would represent a reasonable compromise between the objectives of full employment and price stability and, therefore, a reasonable target for policies affecting aggregate demand.[10] *A country that is in chronic deficit (surplus) and does not have a strong (weak) liquidity position, should maintain a level of demand somewhat lower (higher) than is likely to be compatible with the maintenance of this "normal" relationship.*[11]

Alternative B

Each country should be asked to define the relationship between percentage unemployment and rate of price increase that it regards as the least unsatisfactory compromise from a purely domestic standpoint.[12] *A country that is in chronic deficit (surplus), and that does not have a strong (weak) liquidity position, should maintain a level of aggregate demand somewhat lower (higher) than would be likely to be compatible with the maintenance of this nationally preferred relationship.*

Alternative C

Subject to (6) above, each country should be free to maintain aggregate demand at whatever level it prefers.[13]

Phillips curve, relating unemployment and wage increase, which, in some countries at any rate, appears to be fairly stable over considerable periods, when allowance is made for cyclical factors.) For each possible curve relating unemployment and inflation (which may be termed the U/I curve) there will be a point representing the best or least bad compromise between full employment and price stability. The "normal" relationship in *(7) Alternative A* may be thought of as the locus of such compromise points on different possible U/I curves. The more unfavorable the U/I curve, the higher will be *both* unemployment and inflation. The relationship in question might be a linear one, in which a low rate of unemployment is associated with a zero rate of price increase, and increments of unemployment are associated in a fixed ratio with increments in price inflation. For example, there might be some such scale as the following:

Percentage Unemployment	*Percentage Rate of Increase of Prices per Annum*
1	0
2	1.5
3	3
4	4.5
5	6

Such a uniform standard relationship not only does some violence to national preferences as between full employment and price stability but would also require, for its full justification, that the possible U/I curves of different countries, or of a given country at different times, should have similar slopes. Despite the implausibility of this assumption, a normal relationship of this sort offers a less one-sided criterion for judging the appropriateness of demand policies than would *either* a normal level of unemployment, *or* a normal rate of price increase, taken alone.

While an objective standard, such as is provided by *Alternative A*, has the advantage of defining the obligations of countries more clearly, it may be impossible to get countries to agree on, or to acquiesce in, the application of such a standard. For this reason, *Alternatives B* and *C* are given below.

[11] The appropriate degree of divergence

from the "normal" relationship would, of course, depend on the degree of payments imbalance in the country in question. It is sometimes thought to be unjustifiable to allow the level of unemployment to be increased for balance-of-payments reasons, on the grounds that unemployment is the costliest (in terms of real income) of all ways of correcting the balance of payments. This, however, is dubious, even in the short run, since in the vicinity of optimal employment an increase in unemployment may yield some gains in productivity and in allocation of labor to offset the direct loss in output. It is still more questionable, in the long run at least, if the choice is deemed to lie between unemployment and the imposition of restrictions on international transactions, since a temporary increase in unemployment may bring about a more permanent adjustment in national price levels, and reduce, for a long period, the need for restrictions.

[12] This is something of a half-way house between *Alternatives A* and *C*. It permits a more flexible adaptation of policies to current and anticipated situations than does *A*, corresponds more closely to national preferences, and puts less of a strain on willingness to cooperate in an international system. It might therefore be preferable to *A*, if only countries would keep their "preferred" relationships constant through periods of balance-of-payments surplus and deficit. However, countries would doubtless insist on the right to change their minds about the relationship at least with the advent of every new government, so that some of the objectivity characteristic of *Alternative A* would be lost under *Alternative B*.

[13] *Alternative C* is introduced for the sake of completeness, but it amounts to renouncing the imposition of any obligation on countries to adjust their demand policies in the interest of balance in the foreign payments, and would be likely to put an impossible strain on incomes policies under (*8*). The result might be either a failure to adjust, and a consequential necessity to revert to restrictions and distortions, over long periods, or a frequency of recourse to exchange-rate adjustment difficult to reconcile with the assumptions of the par-value system.

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(8) Countries should pursue more severe incomes policies when they are in appreciable chronic deficit and do not have a strong liquidity position than when they are in appreciable chronic surplus and do not have a weak liquidity position. If possible they should pursue incomes policies which, in conjunction with the demand policies under (7), are likely to eliminate the chronic imbalance.

(9) If a chronic disequilibrium is too great to be corrected within a reasonable period of time by the policies described at (6) to (8) above, it should be corrected by exchange-rate adjustment.[14]

[14] A moot question is whether, when a country's rate of price increase remains stubbornly in excess of that compatible with balance in its foreign payments, the country should over-devalue (so as to become a surplus country) in expectation of a continuance of the inflationary tendency. Given the rate of inflation, this might be justifiable as reducing the average need for balance-of-payments restrictions over time, but the over-devaluation might itself stimulate the inflationary tendency.

(10) Any short-term imbalance, and any chronic imbalance in course of correction by the methods described above, should be financed through reserve movements and compensatory official financing, or suppressed through diversion of private capital flows, rather than suppressed through restriction of imports.[15]

[15] The preference here expressed for adjustment to meet short-term imbalances through the capital rather than through the current account does not derive from pure considerations of economic welfare. From that standpoint the contrary presumption prevails: that diversion of current and diversion of capital transactions (including reserve movements) should go together. The preference derives partly from the Articles of the Fund, which regard capital restrictions much more leniently than current restrictions, and partly from the consideration that restriction or diversion of current-account transactions tend to undermine the structure of international agreements relating to trade and current payments, whereas no such structure exists in the case of capital transactions.

A difficult question is where in this scale of preferences to place export subsidization (for deficit countries) and export taxation (for surplus countries). Export subsidization may be positively beneficial from the standpoint of resource allocation, and may

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	pave the way for a necessary exchange-rate adjustment. However, it is contrary to the provisions of the GATT and is peculiarly likely to be resented by other countries and to evoke imitation or retaliation on the part of countries not in payments difficulty. Export taxation is open to the same objections on grounds of resource allocation as is import restriction, but is much less resented and less likely to endanger trade agreements. It is not a matter of great moment, from the standpoint of resource allocation, to what extent payments imbalances are financed by reserve movements, financed by compensatory official capital flows, or diminished by diversion of private capital flows. In order to avoid disequilibrating exchange speculation, which would intensify the short-terms payments imbalance, however, it is prudent to limit the role of reserve movement to what the deficit country can clearly afford to sustain.
(11) Countries in deficit, unless their liquidity position is strong, should attempt to finance or diminish their deficits through compensatory official borrowing and inward diversion of private capital flows. If adequate official financing cannot be obtained on reasonable terms, and adequate diversion of private capital flows is impossible or cannot be brought about without undue distortions, and if the liquidity position is weak, such countries may apply restrictions, preferably in the form of surcharges, on imports and other current expenditures. *(12) Countries in surplus, unless their liquidity position is weak, should attempt to finance or diminish their surpluses, through compensatory official lending (including, if so required, lending to the Fund and other international*	

financial agencies), debt repayment, and outward diversion of private capital flows. They may also tax or otherwise restrict exports.

(13) Diversion of private capital flows for balance-of-payments reasons should be achieved as far as possible through measures providing price incentives rather than through quantitative controls, "voluntary" or otherwise. While there may be a case for discrimination by country,[16] *there should be as little discrimination as possible by type of capital flow.*[17] *There are a number of ways by which a relatively nondiscriminatory diversion of international capital flows can be brought about:*

(a) Countries in payments deficit could tax purchases of assets by domestic from foreign residents and subsidize the sale of assets by domestic to foreign residents, while countries in payments surplus could tax the sale of assets by domestic to foreign residents and subsidize the purchase of assets by domestic from foreign residents.[18]

(b) Countries in payments deficit could maintain abnormally low taxes on income from investment at home and relatively high taxes on income of domestic residents from investment abroad, while countries in payments surplus could maintain abnormally high taxes on income from investment at home and relatively low taxes on income of domestic residents from investment abroad.[19]

[16] There is a case, on balance-of-payments grounds, for countries that are diverting capital flows towards themselves to grant partial exemption from such measures to other countries that are also in balance-of-payments difficulty or that hold reserves and idle balances in currencies of countries in payments difficulty. On more general welfare grounds, there is a case for favoring capital flows to countries of low per-capita income. On the other hand, even this kind of discrimination is subject to objections analogous to those discussed in the following note.

[17] There is a high degree of substitutability between different types of capital flow. If capitalists are induced, by measures such as those discussed at *(13) (a)*, *(b)*, and *(c)*, to divert capital flows of a particular type, say short-term banking funds, from country A to country B, while analogous incentives to divert are not given in the case of another type of capital flow, say long-term bonds, the diversion of the first type of flow from A to B will be partly offset by a diversion of the second from B to A, which will become more profitable as a result of the first diversion. Such substitution not merely reduces the effect on the balance of payments of any given amount of diversion of the first type of flow; it also normally entails that any given net improvement in the balance of payments will be achieved at a lower level of real income than would otherwise be the case.

[18] The interest-equalization tax is a partial measure of this type but one that discriminates, not only by countries but by type of funds since it is not used to restrict American purchases of short-term assets or American direct investment abroad, nor is there a corresponding subsidization of sales of assets by domestic to foreign residents.

Official intervention in the forward exchange market whereby monetary authorities take a credit position in the currency of a deficit country and a debit position in

Text

(c)(i) Countries in payments deficit could subsidize, and countries in payments surplus could tax, private-investment expenditure.

(ii) Countries in payments deficit could adopt a budgetary position involving either an artificially low rate of public saving or an artificially high rate of public investment or both, and countries in payments surplus could adopt a budgetary position involving either an artificially high rate of public saving or an artificially low rate of public investment or both.

Either (i) or (ii) above would enable interest rates to be higher in deficit countries, and lower in surplus countries, than would otherwise be possible without detriment to domestic targets for aggregate demand.[20]

Notes

the currency of a surplus country may be regarded as a measure of the type described at *(13)(a)*. However, it applies only to short-term capital flows of a commercial, banking, or speculative character.

One way of achieving the result described at *(13)(a)* would be for countries to have separate exchange rates for current and capital transactions, respectively. In the absence of official intervention, such "floating" capital exchange rates would tend to choke off all net capital movements into or out of each country. However, monetary authorities would be expected to prevent their capital exchange rates from falling to a discount unless their countries were in payments deficit, and to prevent them from rising to a premium unless their countries were in payments surplus. This system, whatever its technical interest, could hardly be regarded as compatible with the Articles of Agreement of the Fund relating to exchange stability and multiple-currency practices.

[19] Ideally, taxes on investment income should be levied only by the country whose residents own the investments. In this event, the prescription would be for both deficit and surplus countries to discriminate, in taxing their respective nationals, in favor of investments in the former. Double-taxation arrangements, however, usually lead to investors paying taxes at the rate of the country of investment or the investing country, whichever is the higher. Hence the rather mixed form of the prescription in the text.

[20] The policies described in *(13)(c)* constitute the fiscal/monetary mix in its "static" form. Action under *(13)(c)(i)* is assumed to leave the budget balance at a normal level but to act on the private incentive to invest. Action under *(13)(c)(ii)*, on the other hand, affects the magnitude of the surplus or deficit of the budget on a national-income basis. The saving and investment levels achieved through *(13)(c)* may be described as "artificial," in the sense that they do not correspond to what the saving and investing propensities of private individuals and public authorities would dictate at the interest rates required on balance-of-payments grounds and in the absence of preoccupations about maintain-

ing a target level of aggregate demand. A deficit country in the sense of *(1)*, if it does not restrict imports or divert capital movements in some other way, will be unable to reduce its deficit without undue unemployment unless it maintains artificially low savings or artificially high investment.

If the marginal propensities to import (or to reduce exports) associated with consumption expenditure and investment expenditure, respectively, are equal, the levels of savings and investment in a deficit country should be such as would result from the application of a domestic rate of interest common to both savings and investment, but lower than the rate at which the country must pay (or must forfeit) internationally in order to keep its external accounts in balance. This is what would result from a policy such as *(13)(a)*—and any combination of policies under *(13)(c)*, the results of which differ from those of *(13)(a)*, would be inferior to the latter. Since, in general, investment is believed to be more sensitive than saving to interest rates, it would seem that, under the conditions described, the bulk of the adjustment, quantitatively speaking, should fall on investment, public and private, rather than on saving. This would be less true, or not true at all, for countries where the marginal propensity to import (or reduce exports) is greater for investment than for consumption expenditure.

In maintaining artificially high, or artificially low, consumption and investment, a proper balance should, of course, be maintained between private and public consumption, and between private and public investment.

(14) If a country has sufficiently effective, and sufficiently flexible, instruments of the type of (13)(a) to be able to achieve its desired balance of payments (in the statistical sense), irrespective of the level of domestic interest rates,[21] *it can devote monetary as well as general fiscal instruments to the attainment*

[21] This implies that the country, if a deficit country in the sense of *(1)* above, for example, will be able to achieve a sufficiently large inward diversion of international capital flows to limit its statistical deficit to tolerable proportions.

Text	*Notes*
of its desired level of internal demand.	
(15) If a country relies, at least at the margin, on the methods of (13)(c) for the attainment of its objectives with respect to the (statistical) balance of payments and the level of internal demand, the safest simple rule is to direct monetary policy towards the balance-of-payments objective and budgetary policy towards the internal-demand objectives.[22/23]	[22] This is a dynamic approach to the fiscal/monetary mix envisaged at *(13)(c)*. Interest rates and scarcity of funds (proximately determined by monetary policy) should be such as to promote the level of capital transfers that is appropriate in relation to the balance-of-payments situation; fiscal policies should be such as, given these interest rates and that degree of scarcity of funds, will promote the level of demand appropriate in the light of *(7)*. Any measures that may be applied under *(13)(a)* or *(b)* will, of course, affect the level of domestic interest rates at which monetary policy under *(13)(c)* should aim. While fiscal policy should attempt to maintain a proper balance between public and private investment, and between public and private consumption, it will not be possible for it, consistently with its demand objective, to avoid, in a country in payments deficit (surplus), promoting both an artificially high (low) level of investment, and an artificially low (high) level of savings, and it may have difficulty in avoiding other types of misallocation of resources. It is for this reason that countries that may have overcome their statistical deficits or surpluses by these means are nevertheless, in *(1)* and *(2)* of the Text, still considered to be in deficit or in surplus, respectively, and if their condition is chronic, are expected to apply the prescriptions of *(5)* and *(6)* of the Text. [23] Both fiscal and monetary policies affect both internal demand and the balance of payments, but the former instrument has a comparatively larger influence on the former target, the latter instrument on the latter target. The pairing of instruments with targets, suggested in *(15)* of the Text, will, as Professor Mundell has shown, avoid any danger that the system may fail to converge on the two targets in question. However, this pairing will not always lead to the desired levels of the balance of payments and of internal demand by the shortest route. For example, if a country has a deficiency in demand and an undesired payments surplus, the "mix" indicated by the formula in the text would

be that of a more expansionary budget and lower interest rates. However, if the demand deficiency were small and the undesired payments surplus large, such a policy combination might lead to a state of excess demand, and the best mix would be a reduction of interest rates combined with a slightly less expansionary budget. On the other hand, if the demand deficiency were large and the payments deficit small, the best combination would probably be a more expansionary budget and a slight increase in interest rates.

COMPARISON WITH OTHER SYSTEMS OF ADJUSTMENT

The code of behavior outlined above is basically "orthodox." It is pre-Keynesian in its assumption that the adjustment of chronic disequilibria should not be left to exchange-rate policy alone but should be promoted, if only to a limited extent, by policies affecting aggregate demand. The more modern device of incomes policy (that is, price and wage policy) is, however, invoked to reinforce the classical adjustment process. The system is Keynesian, and in accordance with the spirit of Bretton Woods, in giving preference to compensatory official financing and diversion of capital flows over diversion or restriction of trade as an expedient for meeting temporary disequilibria, but is post-Keynesian in seeking to find more systematic and sophisticated ways of achieving such diversion than the crude device of quantitative capital controls. In this context it gives a qualified support to modern ideas on the fiscal/monetary mix as among the ways, though not necessarily the best possible way, of achieving the diversion of capital flows. Finally, it is emphasized that chronic reliance on measures of restriction or diversion, whether in the sphere of trade or capital flows, is to be taken as an indication of chronic disequilibrium, irrespective of whether or not a statistical imbalance persists.

The code presented here does not differ fundamentally from that which is adumbrated in the Report of Working Party 3 on the Balance of Payments Adjustment Process, though the official document is naturally less ambitious in respect of precision. There are, however, certain differences of emphasis. As regards the approach, the present writer does not follow the Report in relating prescriptions to presumed causes of disequilibrium, such as "inappropriate levels of internal demand, inappropriate international competitive positions, and excessive inflows or outflows of capital." Such "causes" are seen, on closer examination, to be merely ways of defining the situation in terms of the remedy that is required, which makes much of the subsequent argument tautological. On substance, the present paper, as compared with the Report, places

rather more of the burden of adjustment on the surplus countries, looks rather more kindly on capital flows, which it considers can be defective as well as "excessive," and is more explicit in regarding the persistence of measures restricting or diverting such flows, as well as any other distortions in the use of resources inspired by balance-of-payments considerations, as indices of a need for fundamental adjustment.

Between the system of adjustment presented in this paper and that in Tobin's chapter on "Responsibilities of Surplus and Deficit Countries," in *Maintaining and Restoring Balance in International Payments*, there is an even more far-reaching measure of agreement, and differences are confined to matters of detail. Whereas Tobin suggests separate international norms for employment and growth (as well as prices), the present writer suggests a norm for the relationship between the two. Whereas for the present writer the perseverance of payments imbalance would justify deviations from this norm, for Tobin it would justify rather a difference between obliging and permitting a country to approach his norms. Tobin does not envisage restrictions, even for capital transactions, as part of his system and, therefore, the application of such restrictions does not appear—as in the present work—as a criterion of need for fundamental adjustment. Finally, Tobin has the interesting concept that a country's obligation to provide financing should depend not only on whether or not it is in payments surplus but also on whether or not it is failing to carry out an obligation to expand demand. To the present writer it seems safer to say that surplus countries should always be under an obligation to provide financing if in the judgment of an international body (such as the Fund) the policies of the deficit countries are such as to entitle them to receive financial assistance.

MODIFICATIONS OF PAR-VALUE ASSUMPTION

As was indicated above (page 5), the "rules of the game" here set forth are based on the assumption that the par-value system, as at present applied under the Articles of Agreement of the IMF, is maintained. The rules that would be appropriate under a system of floating exchange rates are so different from those considered here as to be unsuitable for discussion in this paper. It may, however, be worth mentioning how the rules here developed might be affected by certain modifications of the par-value system that have been suggested in academic circles.

Thus, if the margins by which exchange rates are permitted to diverge from parity were extended substantially beyond the present limits,* it would be reasonable to expect countries in payments surplus to allow

* Under Article IV, Sec. 3(i) of the IMF, exchange rates should not differ from parity by more than 1 per cent. A Fund decision under Article VIII, Sec. 3, however, permits members to maintain cross rates within 2 per cent of parity whenever these result from maintaining rates vis-à-vis a particular currency within margins of no more than 1 per cent of parity.

their rates to appreciate and those in payments deficit to allow their rates to depreciate with the margins, thus providing an incentive for equilibrating flows of private capital. Any tendency for exchange rates to remain over a substantial period of time near the upper limit would then be one of the indications of chronic surplus, and any tendency for them to remain near the lower limit an indication of chronic deficit, calling for the adoption of appropriate demand and incomes policies as set forth at points *(6)* to *(8)* of the "Code of Adjustment."

Again, if it were desired that par values, apart from any substantial changes that might be undertaken to assist fundamental disequilibria, could, as suggested by Professor Meade and others, be adjusted by microscopic amounts from month to month, such adjustment would presumably take its place as one of the measures to be adopted, along with appropriate demand and incomes policies, to deal with chronic surpluses or deficits. Such policies, while they might take some of the strain off price adjustments and render substantial exchange adjustments under point *(9)* of the Code less necessary, would presumably also in the short run increase the need for measures of the type discussed at point *(13)* to influence capital flows.

DISCRETIONARY ELEMENTS IN THE SYSTEM

Many of the criteria on which the prescriptions of the code presented above are based are imprecise and any agency attempting to apply them would have to exercise a wide discretion in determining, for example:

(a) how strong a country's liquidity position is to be deemed to be;

(b) whether a country's deficit or surplus is to be considered progressive, chronic, temporary, or reversible;

(c) to what extent a given chronic deficit or surplus calls for a departure from a country's preferred level of demand under *Alternative B* of point *(7)* of the Code, or from the "normal" relationship between unemployment and price increase under *Alternative A*; or

(d) how far it is reasonable for deficit countries to go in obtaining official balance-of-payments financing, or in diverting private capital flows inward before having resort to current-account restrictions, and how far it is reasonable for surplus countries to go in making official financing available and diverting private capital flows outward.

INTERNATIONAL ACTION REQUIRED TO IMPLEMENT OR SUPPLEMENT THE SYSTEM

Some of the criteria to be applied under the system to countries in deficit or in surplus call for the establishment of certain basing points, which could best be done on the basis of explicit, though presumably informal, international agreement. This applies, for example, to

(a) the expected rate of world reserve growth with reference to which countries would be classified as deficit or surplus countries under point *(1)* of the "Code of Adjustment";

(b) the standard or normal relationship between unemployment and price increase with reference to which the appropriate aggregate demand policy of individual countries is to be judged under *Alternative A* of point *(7)*; and

(c) the standard or normal rate of price increase against which the achievement of individual countries would have to be measured under point *(6)*.

In all these cases it should be noticed that the norms established would determine the appropriate behavior of all countries, including not only those in substantial payments surplus or deficit but also those closer to equilibrium.

In addition, insofar as countries apply the technique of the fiscal/monetary mix, as described at points *(13)(c)* and *(15)* of the Code, to approach statistical balance in foreign payments, it will be advantageous to supplement national policies designed to affect interest rates in each country relative to others by international action to raise or lower the average level of such rates in the world as a whole.

Even if the general adoption by major countries of the system of policy described at point *(13)(c)* were to result in a structure of *relative* interest rates that brought about the desired pattern of international capital flows, it would not suffice to determine a satisfactory average *absolute* level of interest rates. It might result in a level of rates that made it difficult for fiscal policy in certain countries to prevent inflation or (more probably) rates that made it difficult in other countries to maintain full employment, or it might result in a level of rates that placed too much, or (more probably) too little of the burden of fiscal distortion required to reconcile domestic and international objectives on surplus as compared to deficit countries. In the former event, it could lead to too high, in the latter to too low an aggregate level of world savings. The object of international action to influence the average level of interest rates should be to enable monetary policy, as well as fiscal policy, to make some contribution to the stabilization of aggregate world demand, to distribute fairly, as between surplus and deficit countries, the burden of fiscal distortion required to balance the international accounts, and so far as possible to ensure that undersaving in deficit countries is balanced by oversaving in surplus countries.

With the possible exception of direct action to promote the observance of the "code of behavior" itself, the type of international action with the greatest potential bearing on the operation of the international adjustment process is probably that taken to control the supply of international

liquidity, whether in the form of conditional credit facilities (for example, Fund quotas) or of unconditionally available reserves (for instance, the creation of Special Drawing Rights in the Fund).

The expansion of credit facilities whose availability is conditional on the adoption of appropriate adjustment policies is clearly favorable to the adoption of such policies, particularly by deficit countries. The supply of unconditional liquidity or reserves, however, is also relevant in this connection, since the higher the rate of reserve growth, the lower will be the statistical deficits of some countries, and the higher the statistical surpluses of others. Countries with payments surpluses in the sense of point *(2)* of the Code will have a greater incentive to apply the expansionary policies recommended for such countries; those with payments deficits in the sense of point *(1)* will have less incentive to carry out the adjustments recommended for them, but also less incentive to pursue other restrictive policies not recommended to them but tending to suppress their deficits.

The considerations relevant to international decisions to speed up or slow down the growth of reserves, which include, but are not confined to, their effect on the adjustment process, have been discussed at some length by the author in previous publications, and will not be repeated here.

APPLICABILITY TO LESS DEVELOPED COUNTRIES

It may be objected that the system of adjustment presented in this paper is not well adapted to the circumstances of less developed countries. It is true that various of its functions have been thought out with the more highly developed industrialized countries primarily in mind. Nevertheless, the objections require a little probing to separate out those that are really valid from those that are only superficially so. For example, it may be argued that the supply of capital to such countries is too inelastic with respect to interest rates to permit capital-diverting measures of the type discussed at point *(13)* of the Code to be very effective, and that the financial institutions of such countries are not such as to permit the application of a fiscal/monetary mix of the type set forth at point *(15)*. These objections are no doubt in large part valid, though with a *caveat* regarding the possibility of influencing the choice of local capitalists in less developed countries as between holding their funds abroad or at home. But, insofar as they are valid, they provide a case for placing greater reliance in less developed than in industrialized countries on the provision of official financing (for example, through the International Monetary Fund) as against diversion of private capital flows. They strengthen the case for having relatively high Fund quotas for less developed countries, but do not otherwise greatly

affect the applicability to them of the adjustment system under discussion. More fundamental are the following objections relating to different, and in some respects contrasting, categories of less developed countries. There are some such countries with respect to which the basic Keynesian assumption regarding the (downward) inflexibility of wages and other supply prices does not as yet apply. Such countries may be best served by a system of fixed exchange rates ("gold standard") in which the level of aggregate demand is made to respond not only to chronic but even to temporary payments imbalances. There are other less developed countries in which, for one reason or another, inflationary pressures are so strong that any attempt to get them to conform (under point [*6*] of the Code) to a normal rate of price increase that would be acceptable to industrial countries must be regarded as hopeless. For such countries, the only recourse is a flexible, and depreciating, exchange rate. It seems probable, however, that the number of less developed countries falling into the first category will decline, and it is to be hoped that the number falling into the second category will decline likewise. In this event, the code of behavior here set forth should become applicable, in its broad outlines, to an increasing proportion of less developed countries.

CONCLUDING REMARKS

The system of adjustment outlined above is an integrated one, and its various aspects mutually interdependent. As has already been mentioned, if the provisions for adjustment of chronic imbalances were not operative the provisions for interim financing and diversion of capital flows might cease to be appropriate. For example, if countries in chronic deficit will neither keep their prices stable nor devalue, they cannot expect to receive balance-of-payments financing on the scale envisaged. And if countries in chronic surplus will neither allow their prices to rise by a more than "normal" amount nor revalue, they must be pressed to provide compensatory official financing on a greater scale than would otherwise be reasonable.

The system is, moreover, far from foolproof. Not only would it be extraordinarily difficult to get international agreement on the various norms referred to in the section on "International Action Required to Implement or Supplement the System" above, but there are no very compelling incentives on individual surplus countries to take the actions appropriate to their situation. It is true that if deficit countries, making all appropriate efforts to adjust their prices, cannot obtain an adequate amount of interim financing they are free to adopt restrictions on capital and current account. These, however, have the effect of suppressing the deficits and removing the corresponding surpluses, thus leaving the

erstwhile surplus countries with little or no apparent obligation to adjust or to provide financing. At this point three courses lie open: (1) to make it clear that an obligation to provide financing via an appropriate international organization such as the Fund, to enable the latter to relieve the payments difficulties of other countries, lies not merely on countries in statistical payments surplus but on all countries not themselves in payments difficulty; (2) to abandon the country-by-country approach, and to urge policies of adjustment on countries that *would be* in chronic surplus if the countries in chronic deficit had not been forced into restrictive measures; and (3) to urge deficit countries to make greater use of the possibility of exchange-rate adjustment. However, surplus countries, if they consult their collective interest, should welcome the type of code of behavior that is outlined in this paper, since the burdens laid upon them by observance of the prescriptions of such a code would really be much less than those they might have to bear from the unregulated defensive actions of deficit countries.

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