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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]

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.

(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]

[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-