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TOWARD THE INCREASED INTERNATIONAL MOBILITY OF CAPITAL UNDER THE ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND

George U. Nelson, III*

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*B.A. 1975, Middlebury College; J.D. 1979, Yale Law School; attorney with Foley & Lardner, Milwaukee, Wisconsin.
Introduction

The Articles of Agreement of the International Monetary Fund (IMF) distinguish between payments for current international transactions and capital movements; the Articles generally prohibit members of the IMF from restricting or delaying the former, while permitting members to restrict or control the latter. This distinction seems to have been a product of the members' concern that, under fixed exchange rates, they must retain the capacity to control capital movements in order to preserve the autonomy of their domestic monetary policies, to insure that the exchange rates established by the IMF would not be undermined by speculative movements of capital, and to preserve a tool by which payment imbalances in the capital account might be remedied, should the established exchange rates appear to be (temporarily) inappropriate.

The recent change from "fixed" to flexible exchange rates eliminates, in theory at least, some of these historic bases for the distinction between payments for current and capital transactions. For example, capital movements enhance the effectiveness of domestic monetary policy under flexible rates (although the
effectiveness of fiscal policy may be impaired) and exchange speculation may work to stabilize rather than to destabilize the international monetary system. Further, the need to remedy payment imbalances would not exist under a system of freely floating exchange rates, for the exchange rate would adjust to maintain external transactions in equilibrium. However, the un-stated political motives for controlling the movement of capital may still exist. And its usefulness to remedy payment imbalances may continue where, as is currently the case, the exchange rates do not float freely, but are subject to occasional and heavy government intervention.

In addition to the present weakness of the historical bases for capital control, there is to be considered a "welfare" theory which holds that the factors of production must move unrestrictedly if their most efficient distribution is to be realized. The case for increased capital mobility is strong: greater mobility of capital renders monetary policy more effective and contributes to world economic growth as well.

It is therefore somewhat surprising that the Second Amendment to the Articles, while legitimating post hoc the flexible exchange-rate system, continues to preserve the distinction between payments for current and capital transactions. Flexible exchange rates eliminate the economic need for such a distinction. Yet, this continued distinction suggests that individual countries are unwilling to surrender power to control capital movements. Any proposal to amend further the Articles to withhold from members the power to control capital movements and, thereby, to increase the mobility of capital, must be analyzed carefully. The potentially deleterious effects, as well as the benefits, that are likely to attend such increased mobility of capital require consideration.

This paper will examine the distinction between payments for current and capital transactions from the several perspectives. Part I provides an institutional background to the textual definition of the distinction. Part II is a discussion of the various interpretations of the relevant provisions of the Articles. In part III, an analysis of judicial interpretations is undertaken in an effort to determine whether, in fact, the courts look to the character of the underlying transaction in passing upon the legality of restrictions on
related payments. In part IV, the historical background of the Bretton Woods Conference is examined to elucidate the concerns of the drafters of the Second Amendment, which formed the basis of their decision to reserve to member governments the power to control capital movements. Finally, in part V, the role of capital mobility is scrutinized from an economic perspective; analysis of flexible exchange rates reveals that the drafters' concerns for potentially adverse effects from capital movements no longer apply and the corresponding provisions of the Articles are inappropriate to the IMF's purpose of economic growth and development.

The potential which increased capital mobility has to enhance the effectiveness of monetary policy and to contribute to greater world welfare also involves costs. Thus, a conclusion as to whether the distinction between payments for current and capital transactions ought to be maintained depends upon the relative weight assigned to the various costs and benefits that are likely to accrue to either alternative. This weighing is performed in part VI.

I. Institutional Background

The Articles of Agreement of the International Monetary Fund were drafted at the United Nations Monetary and Financial Conference, which met at Bretton Woods, New Hampshire, in July of 1944. From their entry into force on December 27, 1945, the Articles have been the legal foundation of the IMF and the world monetary system. The First Amendment became effective in 1969, and the recently proposed Second Amendment was accepted by the United States on October 19, 1976, and became

1. For a text of the Final Act and related documents of the Conference, see UNITED NATIONS MONETARY AND FINANCIAL CONFERENCE, BRETON WOODS, NEW HAMPSHIRE, JULY 1, TO JULY 22, 1944 (Department of State Publication 2187, Conference Series 55, 1944). The International Monetary Fund [hereinafter referred to as the "IMF"] has also published the original and amended Articles in pamphlet form.

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effective on April 1, 1978. The Second Amendment formally acknowledges the change from the familiar "par value" or "adjustable peg" system of exchange rates, which had been established by the original Articles and maintained until March of 1973, to the generalized "floating" rates which exist today.

Among the purposes of the IMF, the Articles set forth what must be a primary objective of every modern country:

to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members...

The operative provisions of the Articles establish the IMF's essential functions and the rules of conduct for its members.

The original Articles called for each member to declare a par value for its currency and to maintain its market value within 10 percent of par. Under the


All further references to "the Articles" shall be to the Second Amendment to the Articles of Agreement, unless the reference is otherwise identified. Parallel citations will be made where appropriate.

4. See Article IV, Second Amendment, supra note 3. See also R. SOLOMON, THE INTERNATIONAL MONETARY SYSTEM 1945-1976, at 12-13 (1977) for a brief description of the par value system. It is this system that, due to international reluctance to adjust par values, came to be known as the system of "fixed" exchange rates.

5. See R. SOLOMON, supra note 4, at 267; see generally id. at 267-89.

6. Article I(ii), Second Amendment, supra note 3.

7. Article IV, §(5)(c),(f), original Articles, supra note 1.
Second Amendment, members are merely required to choose appropriate exchange arrangements and to conduct exchange transactions consistently with specified "good faith" standards. The IMF's monetary resources, derived both from members' subscriptions and from special drawing rights, are available to members according to each member's quota. Although members may use these resources to finance temporary or cyclical imbalances or to obtain needed currencies, they may not use the IMF's resources to meet "a large or sustained outflow of capital" or in any other manner "contrary to the purposes of the Fund." With some exceptions for those countries availing themselves of the "transitional arrangements" provided by the Articles, members are subject to several obligations, notably: to maintain the convertibility of their respective currencies, to avoid discriminatory currency practices, and to provide the IMF with specified national data.

8. See Article IV, Second Amendment, supra note 3.
9. See Article III, Second Amendment, supra note 3.
10. Special drawing rights are a form of international liquidity generated by the International Monetary Fund according to rules specified in Articles XV through XXV, Second Amendment, supra note 3. They are sometimes described as "paper gold" and are similar in concept to Federal Reserve Notes. For a more complete description of special drawing rights, see R. SOLOMON, supra note 4, at Chapter VIII; IMF, INTERNATIONAL MONETARY REFORM: DOCUMENTS OF THE COMMITTEE OF TWENTY 15-17 (1974).
11. See Article V, §3(b)(iii), Second Amendment, supra note 3.
12. Article V, §3(a), Second Amendment, supra note 3.
13. Article VI, §1(a), Second Amendment, supra note 3.
15. See Article XIV, §2, Second Amendment, supra note 3. The transitional arrangements, for countries not prepared to undertake the full responsibilities of the Articles, excuse such countries from the obligation to refrain from restricting payments for current transactions. Article VIII, §2(a), Second Amendment, supra note 3.
16. See generally Article VIII, Second Amendment, supra note 3.
17. Article VIII, §4, Second Amendment, supra note 3.
18. Article VIII, §3, Second Amendment, supra note 3.
19. Article VIII, §5, Second Amendment, supra note 3.
II. The Distinction Between Payments for Current International Transactions and International Capital Movements

A. The Articles

In addition to the obligations of members listed above, the IMF requires that members distinguish between their treatment of payments for current international transactions and their treatment of international capital movements. Article VIII, Section 2(a), prohibits members from imposing restrictions "on the making of payments and transfers for current international transactions" unless such restrictions are approved by the IMF. It should be emphasized that the terms of this provision apply only to restrictions on the making of payments and transfers. This section does not prevent a member from regulating or prohibiting either the receipt of such payments by its residents or their entry into the underlying transactions that give rise to such payments.21

Yet Article VI, Section 3, expressly permits members to "exercise such controls as are necessary to regulate international capital movements," except where the controls are exercised in a manner "which will restrict payments for current transactions or which will unduly delay transfers of funds in settlements of commitments...."22 Indeed, the IMF may render this provision more permissive by excusing a member from the

20. However, members availing themselves of the transitional arrangements of Article XIV, §2, may impose restrictions on payments for current international transactions. See note 15 supra.
22. Joseph Gold, General Counsel of the IMF, notes that this clause is ambiguous. See J. GOLD, INTERNATIONAL CAPITAL MOVEMENTS UNDER THE LAW OF THE INTERNATIONAL MONETARY FUND 55 n. 22 (IMF Pamphlet No. 2, 1977) [hereinafter cited as J. GOLD, INTERNATIONAL CAPITAL MOVEMENTS]. It is not clear whether "commitments" relates to current or capital transactions, or to both. However, in view of the terms of Article VIII, Section 2(a), supra note 3, prohibiting members from restricting "payments and transfers for current international transactions" (emphasis supplied), to limit the reference to this clause to current transactions would seem to render it superfluous. A reasonable interpretation
inhibitions of the above-quoted exception when that member's currency has been declared "scarce." And the IMF may even require a member to impose such controls when these are deemed necessary to remedy a large or sustained outflow of capital. And

The characterization of a particular control is therefore of considerable importance to members. Generally speaking, if a control is on capital movements, it will be consistent with the Articles. But, if it restricts the making of payments for current transactions, it will be inconsistent with the Articles and its imposition may subject the member to the sanctions of ineligibility or compulsory withdrawal from the IMF.

Whether a particular control is consistent with the Articles is a fundamental question in the resolution of disputes regarding certain commercial relationships between private parties. Article VIII, Section 2(b) provides that: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member...." On the basis of this provision, numerous cases have arisen which deal with the propriety of certain controls on current payments and capital movements.

In order to determine the character of a particular control, it is necessary to inquire into the nature of the underlying transaction. The informal rules that

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22. (Continued)

would be that the clause exempts from regulation any transfer made in respect of a current or capital transaction which was entered into prior to any capital control which purports to restrict such transfer. So interpreted, the clause is vaguely similar to the prohibition in the United States Constitution of laws impairing the obligation of contracts. U.S. CONST. art. I, §10, Cf. Evans, supra note 21, at 32.

23. See Article VII, especially §3(b), Second Amendment, supra note 3.

24. Article VI, §1(a), Second Amendment, supra note 3.

25. Article XXVI, §2, Second Amendment, supra note 3.
are commonly applied to distinguish current from capital transactions are quite straightforward. A transaction that involves the exchange of goods or services for prompt payment between residents of different countries commonly is identified as a current international transaction. A capital transaction, however, is one which does not entail a quid pro quo in goods and services, but which gives rise to an obligation or expectation that the recipient will reimburse the lender or payor in the future, or which establishes a claim on the part of the payor to the currency or foreign exchange reserves of the recipient country. Generally, then, a payment for a current transaction has as its counterpart the receipt of goods or services, whereas a capital movement or transfer has as its counterpart a claim to a future return.

Although the Articles do not define capital movements, Article XXX(d) defines "payments for current transactions" as "payments which are not for the purpose of transferring capital," including without limitation:

1. all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
2. payments due as interest on loans and as net income from other investments;

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26. J. Gold, INTERNATIONAL CAPITAL MOVEMENTS, supra note 22, at 19. For an illustration of a current transaction, see H.R. Heller, INTERNATIONAL MONETARY ECONOMICS 54-44 (1974). Often, a transaction will be regarded as "current" even though the goods that are traded are "real capital" rather than consumer goods. See id. at 11.

27. See Heller, supra note 26, at 145.


29. Evans, supra note 21, at 30. Note, however, that balance-of-payments accounting may further distinguish between capital movements, as payments of financial capital which give rise to obligations or expectations of repayment or claim of ownership, and capital transfers, as a movement of capital without a quid pro quo or future claim (e.g., charitable contributions or government grants-in-aid). If the payment is repayable, it is a capital movement; if it is not repayable, it is a transfer. See Heller, supra note 26; P. Høst-Madsen, BALANCE OF PAYMENTS 6-15 (IMF Pamphlet No. 9, 1967).
(3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and
(4) moderate remittances for family living expenses.

The broad scope of this definition is indicated by the phrase "without limitation" and by the final sentence of the subsection. Clearly, the definition does not purport to exhaust the list of possible payments for current transactions. Indeed, several of the enumerated examples extend the definition beyond the common rule to include payments in respect of transactions that otherwise might be considered to be of a capital nature.

With the informal rules thus modified, the nature of many frequent and important international transactions can be readily identified. The first of the enumerated examples confirms the informal rule by guaranteeing current status to all payments for trade, current business, and services. Obviously, then, purchases of goods and services are current transactions, the payment for which may not be restricted by members. It should be noted that goods or services so purchased need not be imported into or performed within the member country where the purchaser resides. Where a resident of member country A purchases goods in country B, processes them in C, and sells them in D, he has engaged in a series of current transactions; the fact that the goods were never imported into A does not affect the current status of the transactions. Similarly, tourist expenditures and other personal expenditures abroad (e.g., medical, educational, and other living expenses) are regarded as current, though there is not necessarily a flow of goods or services into the home.

30. J. GOLD, INTERNATIONAL CAPITAL MOVEMENTS, supra note 22, at 19.
32. Evans, supra note 21, at 34.
33. Id.
country.34 Also, disbursements for foreign and international transportation are treated as current payments.35

The character of a transaction for domestic accounting or tax purposes is not determinative of its characterization under the Articles. Hence, the purchase abroad of large productive machinery which is installed in the home country, though it may be viewed as a capital expenditure by a tax accountant, will be a current transaction for the purposes of the Articles.36

Although providing "normal short-term banking and credit facilities" would qualify as capital transactions under the informal rule, these are expressly afforded "current" status in the Articles. The question arises whether the terms include all commercial bank and intercorporate loans maturing in one year or less.37 However, the limiting adjectives, "normal" and "facilities," suggest that only such short-term banking and credit as is necessary to sustain current trade and business is comprehended in the definition of payments for current transactions.38

Payments of interest on loans and net income from investments, though not within the informal rule, are defined as payments for current transactions. The definition is not confined to the interest and income of short-term loans and investments, but rather it applies to all such interest, regardless of the term of the investment. Therefore, the payment of stock dividends, operating income, and interest may not be restricted by members.39 The question might arise whether the redemption of stock or the proceeds of liquidation and redemption are productive activities from which current income may be derived. In fact, they terminate the investment and free the investor's capital therefrom. Thus, the payment of redemption or liquidation proceeds would not meet the requirement that a current payment be one "which is not for the purpose of transferring capital." Therefore, under Article VIII, Section 2(a) such payments may be restricted.

34. Id.
35. See P. SAMUELSON, ECONOMICS 655–57 (9th ed. 1973);
36. Evans, supra note 21, at 30.
38. See Evans, supra note 21, at 35.
Additionally, the amortization of loans, depreciation of direct investments, and remittances for family living expenses, if "moderate" in amount, are regarded as payments for current transactions. The concepts are familiar and require little explanation. For determining the propriety of the amount of depreciation or amortization payments, the qualification that they be moderate seems to draw on generally accepted principles and local circumstances regarding such variables as the method of computation and the useful life of an asset.\textsuperscript{40} Any appropriate method of computing depreciation or amortization would probably qualify under this definition.\textsuperscript{41} However, it is doubtful that highly-accelerated methods would be regarded as "moderate," especially if such acceleration were not for an acceptable business purpose, but rather for the sole purpose of transferring capital.

Capital transactions include long-term loans and direct investments,\textsuperscript{42} though the amortization and depreciation thereof, as noted above, are current payments. Direct investment is perhaps best described as a special sort of long-term loan, in which "the 'borrower' and 'lender' are parts of the same corporate family."\textsuperscript{43} For example, a parent corporation may finance the construction abroad, by its subsidiary, of an industrial plant. Thus, the parent would utilize its own internal efficiencies as well as obtain the advantages of an equity interest in a plant that is desirably located.\textsuperscript{44}

Also, portfolio investments in stocks and debt obligations of foreign issuers constitute capital transactions.\textsuperscript{45} Most such investments will be made for the long term and for purposes that are not directly related to current transactions. As discussed above,

\textsuperscript{40} Cf. Evans, supra note 21, at 34.
\textsuperscript{41} Id.
\textsuperscript{42} "Long-term" indicates a loan for a term exceeding one year. See P. Høst-Madsen, supra note 29, at 13-15.
\textsuperscript{44} Cf. id., at 18.
\textsuperscript{45} Cf. J. Gold, INTERNATIONAL CAPITAL MOVEMENTS, supra note 22, at 57 n. 45; P. Høst-Madsen, supra note 29, at 14.
where short-term investments are undertaken not in support of current trade and business, but rather for the purpose of transferring capital, then such short-term banking arguably may be capital transactions. Therefore, it is most likely that short-term loans engaged in for purposes of exchange speculation would qualify as movements of capital rather than current payments.

"Transfer" payments comprise a group of transactions that are difficult to classify as "capital" or "current."46 Such payments are unilateral—they have no quid pro quo, nor do they give rise to a claim for future repayment or to equity interests.47 Private transfers take such forms as charitable contributions, remittances to relatives, and other gifts and inheritances. Government transfers can take many forms,48 such as the provision of commodities, machinery, or funds, but the largest component of government transfers is economic aid in the form of grants.49 In some contexts, the nature of a transfer is determined by inquiring into whether it would constitute income or capital to the recipient.50 However, such a test is not appropriate with respect to the Articles. A payment for which there is no return in goods or services represents a net loss to the capital reserves of the transferor country. Such payments are therefore for the purpose of transferring capital51 and may be subject to restriction under Article VI, Section 3.

It is important to note that the concept of "controls" is broader than that of "restrictions" and, indeed, may comprehend the latter term. A control need not restrict payments for current transactions or capital movements; it may merely influence or regulate them.52

46. Evans, supra note 21, at 32, 33.
47. Cf. P. HøST-MADSEN, supra note 29, at 11-12; Evans, supra note 21, at 32.
49. Id.
50. Evans, supra note 21, at 34.
51. Id.
52. J. GOLD, INTERNATIONAL CAPITAL MOVEMENTS, supra note 22, at 5.
For the remainder of this paper, controls in their broader, non-restrictive sense are not at issue, for they do not directly affect the mobility of capital. Henceforth, "controls" and "restrictions" are considered to be equivalent. Unless specified otherwise, "controls" refers to regulations that are restrictive or prohibitive of capital movements, transfers, or current payments. The discussion of several interpretations and decisions of the IMF will help to distinguish controls which the Articles permit from those which they prohibit.

B. Interpretation by the International Monetary Fund

The final sentence of the definition of current transactions (Article XXX (d) of the Second Amendment) provides that the IMF, after consultation with the members concerned, may "determine whether certain specific transactions are to be considered current transactions or capital transactions." Article XXIX of the Second Amendment further expands that power: "(a) Any question of interpretation of the provision of this Agreement arising between any member and the Fund shall be submitted to the Executive Board for its decision...." The power of interpretation created by this Article is both final and wholly internal, for there is no recourse to agencies external to the IMF.53 An appeals procedure is established utilizing an IMF committee at the first level; if the issues are not resolved, the members may seek to be heard by a tribunal of three arbitrators and an umpire (chosen by the IMF, each of the two objecting members, and the International Court of Justice, respectively).54 The Fund has only rarely exercised its power of final interpretation. More often, interpretations have been adopted through "decisions" of the Executive Directors.55 As the Executive Directors are also the body empowered to render final interpretations, their decisions have great weight, without the formality and inflexibility of final interpretations.

53. See Article XXIX, Second Amendment, supra note 3; J. GOLD, INTERPRETATION BY THE FUND 1-3 (IMF Pamphlet No. 11, 1968).
54. Article XXIX (b), (c), Second Amendment, supra note 3.
55. See J. GOLD, INTERPRETATION BY THE FUND, supra note 53, at 3-4, 14-16.
An early interpretation, in response to an inquiry from the United States, construed the Articles to mean that members' use of IMF resources should be limited according to the IMF's purpose of giving "temporary assistance in financing balance of payments deficits on current account for monetary stabilization operations." This left in doubt what has been understood to be the members' right to use IMF resources to finance capital outflows that were neither large nor sustained (Article VI, Section 1). A later decision of the Executive Directors clarified the earlier interpretation by explaining that it had not been intended to "preclude the use of the Fund's resources for capital transfers in accordance with the provisions of the Articles, including Article VI." Thus, outflows that were neither large nor sustained could be financed through use of those resources. This decision is of practical value for, in permitting members' use of the IMF's resources for such purposes, the general propensity to impose controls on small or temporary outflows of capital was probably reduced. However, this decision is not of great value in distinguishing capital from current transactions.

A decision of the Executive Directors, in June of 1960, dealt with the provisions of Article VIII, Section 2. The Directors determined that "[t]he guiding principle in ascertaining whether a measure is a restriction on payments and transfers for current transactions ... is whether it involves a direct governmental limitation on the availability or use of exchange as such." This criterion is quite important, for it requires that a direct quantitative limit upon or a prohibition of the use of exchange in current international transactions must be a "restriction" within the terms of Article VIII. Such a restriction, under most circumstances, is prohibited and inconsistent with the Articles. Conversely, however, an indirect limitation is not regarded as a "restriction" and would be permitted. Import licenses

58. Decision No. 1034 - (60/27), June 1, 1960, reprinted in SELECTED DECISIONS, supra note 56, at 81, 81-82. See also J. GOLD, THE IMF AND PRIVATE BUSINESS TRANSACTIONS, supra note 31, at 10.
59. Decision No. 1034 - (60/27), supra note 58.
and quotas, whether for health or protectionist purposes,\textsuperscript{60} would not violate the Articles so long as exchange were freely available for the transactions that come within the quota or for those that are properly licensed,\textsuperscript{61} despite the inevitable impact of such measures upon the demand for and use of foreign exchange. Similarly, a member could declare a category of international transactions to be illegal in its domestic law without contravening the Articles. Article VIII, Section 2(b), however, would not compel other members to recognize such a declaration. That section provides for the unenforceability of exchange contracts that are contrary to members' exchange control regulations imposed consistently with the Articles. Thus, a law within a country which prohibits certain transactions does not constitute an impermissible exchange control regulation; rather, it is a domestic regulation of commerce or trade.

Though the guiding principle articulated in this decision is formalistic, the distinction between direct and indirect limitations reflects the members' practical and political objectives in establishing the IMF. The members did not intend the Articles to apply to trade policy and they left themselves free to regulate underlying current transactions,\textsuperscript{62}

The motive or purpose of a member in imposing exchange regulations is immaterial to determinations of the consistency of the regulations with the Articles. The Executive Directors in July, 1956, decided that:

\begin{quote}
Subject to the provisions of Article VI, Section 3 concerning payments for current transactions and undue delay in transfers of funds in settlement of commitments:
(a) Members are free to adopt a policy of regulating capital movements for any reason, due regard being
\end{quote}

\textsuperscript{60} Import quotas and other restrictions on trade may come within the purview of other international agreements, but such quotas are not themselves subject to the provisions of the IMF Articles. Perhaps the most extensive international treatment of trade policy is the General Agreement on Tariffs and Trade (GATT), in which United States participation was effected by an executive agreement under the authority of the Reciprocal Trade Agreements Act of 1934, as amended. See 19 U.S.C. \S 1351(a)(1) (1976).


\textsuperscript{62} Cf. \emph{id.} at 10.
paid to the general purposes of the Fund and without prejudice to the provisions of Article VI, Section 1.

(b) They may, for that purpose, exercise such controls as are necessary, including making such arrangements as may be reasonably needed with other countries, without approval of the Fund.63

Although the decision of June 1960, discussed above, recommended that exchange regulations for non-balance-of-payments reasons "be avoided to the greatest possible extent,"64 it did not rescind this 1956 decision making motive immaterial.

Therefore, so long as an exchange control neither restricts payments and transfers for current transactions (Article VIII, Section 2(a)), nor causes undue delay in transfers for the settlement of commitments (Article VI, Section 3), nor causes a scarcity of the member's currency (Article VII), it will generally be permitted, even if motivated by noneconomic reasons. Countries, then, may impose politically motivated controls that are restrictive of capital movements. The system of controls that members imposed upon Rhodesia was therefore permissible.65 Additionally, members are entitled to impose exchange controls for security reasons, if they do not violate the specific articles mentioned.66

Exchange surrender requirements are a form of regulation that is not direct, yet neither are they so essential as to bear on national security. Thus, a country may require its residents to surrender the foreign exchange proceeds of current transactions, but a member may not forbid its residents access to the foreign exchange needed for payments on current transactions, for limitations on such access would consti-

64. Decision No. 1034 - (60/27), supra note 58, at 82.
66. Decision No. 144 - (52/51), August 14, 1952, reprinted in SELECTED DECISIONS, supra note 56, at 75.
tute direct restrictions and, therefore, would contra-
vene the decision of the Directors.67

Article VIII, Section 2(b), set forth on page 8, supra, renders unenforceable any exchange contract which is contrary to exchange control regulations that have been imposed consistently with the Articles. A decision of the Executive Directors in June, 1949, interpreted this Section to mean that parties entering such contracts "will not receive the assistance of the judicial or administrative authorities of other members in obtaining the performance of such contracts...."68 The decision further states that when a party to such a contract seeks enforcement thereof, the courts of the member country where the action is brought "will not, on the ground that they are contrary to the public policy (ordre public) of the forum, refuse recognition" of another member's exchange control regulations that are consistent with the Articles.69

This provision was not drafted to encourage or perpetuate those exchange controls which prove to be vexatious in private business transactions,70 nor should it have that effect. Instead it promotes the integrity and consistent application of such controls as the Articles permit or require and curbs the pre-
Bretton Woods tendency of most courts to refuse to recognize exchange regulations foreign to their juris-
diction.71 Article VIII, Section 2(b), as interpreted by the Directors, does not go so far as to make foreign exchange controls part of the domestic law of each member. It does, however, render unenforceable those contracts which contravene the valid controls of another member whose currency is involved even if the contract would not offend the domestic laws of the forum.72

68. Decision No. 446 - 4, June 10, 1944, reprinted in SELECTED DECISIONS, supra note 56, at 73, 73.
69. Id. at 74.
71. Id. at 22-24.
72. 2 J. GOLD, THE FUND AGREEMENT, supra note 65, at 80.
C. Summary

The Articles establish an international monetary system which prohibits member countries from restricting payments and transfers for current international transactions, except where authorized by the IMF (Article VIII, Section 2(a)). However, members may control capital movements for any purpose, unless their controls restrict current payments or the settlement of commitments (Article VI, Section 3). Exchange contracts that involve a member's currency and that violate that member's valid exchange control regulations are unenforceable in the courts of other members (Article VIII, Section 2(b)). If a member abides by the Articles, the motive of the member in imposing its own exchange control regulations is immaterial.

The Articles define current transactions as those transactions not for the purpose of transferring capital and list several transactions that are expressly declared to be current, though they may appear to have attributes of capital transactions. This list serves to extend the definition somewhat beyond the common understanding of current transactions and includes some transfers of funds for which there is no corresponding flow of goods and services. The guiding principle in ascertaining whether a measure is a restriction on payments for current transactions is whether it is a direct limitation on the use of foreign exchange. Indirect limitations, such as import quotas, are unaffected by the Articles.

The following section discusses cases in several jurisdictions where controls in current payments and capital movements have been challenged, either directly or implicitly. The judicial interpretations of the relevant provisions of the Articles, and the conclusions regarding the character of underlying transactions, expand the definitions already discussed.

III. Judicial Interpretation

Much of the international movement of capital results from direct investment, portfolio investments, and long-term loans,73 the character of which is seldom

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73. See P. HØST-MADSEN, supra note 29, at 14.
obscure. Controls on such movements, expressly permitted under the Articles, are unlikely to be contested in the courts. Conversely, controls that clearly restrict payments for transactions in goods and services are unlikely to be imposed, especially if it is assumed that governments tend to abide by agreements to which they have adhered. For these reasons, controls affecting many economically significant transactions will never come before the courts. And, although the IMF may declare a member ineligible to use IMF resources and require a member to withdraw in the event that a member fails to fulfill its obligations under the Articles, it has used this power only rarely. Moreover, the IMF has never expelled a member where its sole infraction was an inappropriate exchange restriction. Where controls are economically significant and inconsistent with the Articles, informal persuasion may be the preferred means by which other members effect their removal.

Some controls, though held to be consistent with the Articles, nevertheless may affect current payments, while others may be imposed on payments that are not easily classified as either current or capital. Overbroad and ambiguous exchange regulations are more likely to inhibit commercial activity and, thus, to be challenged by private parties. Such challenges might occur where a transaction possesses both current and capital characteristics or where the settlement of a commitment necessitates a movement of capital.

Though the controls that come before the courts are generally of less economic significance than those that are not challenged or that are dealt with informally, the judicial reasoning in the cases helps to identify current and capital attributes of transactions that are ambiguous in character. Further, a judicial exposition of the criteria that determine the consistency of exchange regulations with the Articles would be a valuable

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74. See Article XXVI, supra note 3; J. GOLD, MEMBERSHIP AND NONMEMBERSHIP, at Ch. 16, especially 337-41.
75. See J. GOLD, MEMBERSHIP AND NONMEMBERSHIP, Ch. 16, especially at 357 (recommendation of the Executive Directors that Czechoslovakia be required to withdraw is based on several grounds, one of which is that member's failure to consult with the Fund regarding the retention of restrictions that were inconsistent with Article VIII).
tool for the analysis of close cases. Unfortunately, the constellation of cases is far from ideal and the rationales are not well-articulated.

Most of the cases arise between private parties under Article VIII, Section 2(b), relating to the unenforceability of exchange contracts that are contrary to appropriate exchange controls. Often, therefore, analysis of the underlying transactions and the consistency of regulations thereon with the Articles, though important, is treated as ancillary to the determination of enforceability and its consequences. Other issues, treated somewhat more extensively in the cases are (1) whether the contract being litigated is an "exchange contract" within the meaning of the Section, and (2) which country's currency is "involved" in the contract.

These latter issues are of minor importance to this paper (though they may be determinative of the outcome in a case) for they are threshold questions which must be reached before the validity of an exchange control regulation can be determined. They are only briefly dealt with below. Other cases are grouped according to subject matter rather than by the few tests or criteria that have been articulated.

A. On the Meaning of "Exchange Contract" and "Involve the Currency of any Member," in Article VIII, Section 2(b)

The concept of "exchange contracts" has been defined by Dr. F.A. Mann as "contracts which affect the currency resources of any member."76 From the broad reading of the term "currency," which seems fairly compelled by the purposes and structure of the IMF Agreement, Dr. Mann considers that gold, securities, moveables, and even land may become "the subject-matter of exchange control and their transfer may involve the currency of a

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member."  

This view of an "exchange contract," which turns upon whether a contract affects a member's currency, necessarily determines the meaning of the term "involve the currency."  

A much narrower view—that "exchange contracts" are limited to those contracts which have an exchange or transfer of currencies as their immediate objective, and which "involve" a currency only if that currency is the medium of payment or is referred to within the contract—has been proffered by Professor A. Nussbaum and supported by the seventh and eighth editions of Dicey's treatise on the conflict of laws.  

Although such contracts are clearly within the meaning of "exchange contracts," there is no reason to construe the terms of such a document as the IMF Articles in a strictly legal sense rather than in their broader economic sense. Indeed, an expansive notion of international economic policy pervades the document and its declarations of purpose.

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77. Mann, The Private International Law of Exchange Control under the IMF Agreement, 2 Int'l. & Comp. L.Q. 97, 102 (1953). See also 1 J. Gold, THE FUND AGREEMENT, supra note 76, at 92-93 (quoting Mann, Der Internationale Währungsfonds und das Internationale Privatrecht, 8 JURISTENZEITUNG (Tübingen) 442-46 (1953)).  

78. See Gold and Lachman, The Articles of Agreement of the International Monetary Fund and the Exchange Control Regulations of Member States, 89 JOURNAL DU DROIT INTERNATIONAL 666, 674, 684 (1962) (suggesting that a contract which affects the exchange resources of a member ipso facto "involves" the currency of that member).  


80. See Mann, The Private International Law of Exchange Control under the IMF Agreement, supra note 77, at 102.
An English case, Sharif v. Azad, adopted the broader view of Dr. Mann. Lord Denning there declared that: "The words 'exchange contracts' are not defined, but I think that they mean any contract which in any way affect the country's exchange resources." The ninth edition of Dicey & Morris, The Conflict of Laws (1973) abandoned its earlier, narrow position, in favor of the one expressed by Lord Denning, above. Joseph Gold, General Counsel of the International Monetary Fund, has concluded that these broader formulations recognize "quite properly that the concept of "exchange contract" must be given an economic meaning." Therefore, he considers that transactions in any of the five categories recognized by the IMF in its Balance of Payments Manual may affect the exchange resources of a member and thus qualify as the subject matter for an exchange contract. These categories are: purchases and sales of goods and services, barter, exchange of means of payment (currency and gold), provision or acquisition of goods or services without requittal (grants-in-kind), and provision of means of payment without requittal (gifts of money). This approach is

81. [1967] 1 Q.B. 605, [1966] 3 All E.R. 785 (C.A.) involved an arrangement made in England between two Pakistanis. One Latif obtained £300 cash and gave Sharif his check for 6000 rupees drawn on a Pakistani bank; the payee's name was left blank. Sharif gave the check to Azad, in exchange for a check for £300 in favor of Sharif; Azad was unable to collect when payment was blocked by foreign exchange authorities in Pakistan. The court found the arrangement to be an "exchange contract" within the meaning of Article VIII, §2(b). The check for 6000 rupees contravened the exchange regulations of Pakistan, but the check for £300, running from Azad to Sharif, offended neither English nor Pakistani law. Therefore, the court enforced the latter check, anticipating that it might teach a "sharp" lesson to the defendant.


84. 2 J. GOLD, THE FUND AGREEMENT, supra note 65, at 79.


86. 2 J. GOLD, THE FUND AGREEMENT, supra note 65, at 79.

87. Id. See also IMF, BALANCE OF PAYMENTS MANUAL (3d ed. 1961). It is perhaps surprising to find barter included in this broad concept of exchange contracts. But barter and grants-in-kind may well affect members' exchange resources where, but for the barter or grant, currency would necessarily change hands.
supported in many of the cases. However, the narrow-

88. The broad reading of exchange contracts as including those transactions which affect a member's exchange resources is supported either expressly or implicitly in several cases.

An unreported case, decided by Chamber 12 for Commercial Affairs of the Hamburg Landesgericht, involved a contract by which Belgian defendants had agreed to purchase an amount of ammonia sulphate from a West-German firm; payment was to be made in dollars. Defendants had failed to obtain an import license, and plaintiffs brought suit on the contract for defendants' failure to take the goods. The court viewed the purchase agreement as an exchange contract (the purchase of goods may affect members' exchange resources); it held that the action must fail, for the import regulation was valid. See 1 J. Gold, The Fund Agreement, supra note 76, at 82-84.

In Lessinger v. Mirau, decided by the Schleswig-Holstein Oberlandesgericht (April 1, 1954), the court regarded the view of F.A. Mann — that an exchange contract is any contract that affects a member's exchange resource — as "the only [interpretation] compatible with the purpose of the regimentation of foreign exchange resources." See 1 J. Gold, The Fund Agreement, supra note 76, at 90-94.

In Southwestern Shipping Corp. v. National City Bank of New York, 6 N.Y. 2d 454, 160 N.E. 2d 836, 190 N.Y.S. 2d 352 (1959), cert. denied, 361 U.S. 895 (1959), an agreement of an Italian importer to purchase from the plaintiff a certain volume of "fatty acid" for $37,222 was assumed by the court to be an exchange contract within the meaning of Article VIII, § 2(b), supra note 1. The transaction contemplated the purchase of dollars in Italy and the transmission of these funds to the United States. The court viewed the import contract to be violative of Italian exchange control regulations, for the importer had not obtained the necessary import license. But it regarded the credit drawn against defendant as enforceable, for it was independent of the antecedent exchange contract. The bank was not entitled to plead the illegality of the underlying contract in this action, which was based on the bank's negligent breach of its obligations under the credit arrangement.

White v. Roberts, 33 Hong Kong L. Rep. 231 (1949), involved an agreement between plaintiff and defendant, both exchange brokers in Shanghai, by which plaintiff paid Chinese currency to defendant in return for defendant's promise to make payments in foreign currencies to third persons in other countries. Defendant's promise to pay contravened Chinese exchange control regulations, which rendered such contracts illegal and criminal. The agreement was held to be an "exchange contract" within the meaning of the original Articles, supra note 1, and was unenforceable. Reviewed in
er, literal interpretation of Professor Nussbaum is also not without its adherents; indeed, recent cases in the U.S. and England have taken the literal view. 89

Nevertheless, the weight of authority and the purposes of the IMF support the definition of "exchange contracts" as those which in any way affect the exchange resources of a member. Only this broad definition will achieve the consistent recognition of other members' exchange control regulations under Article VIII, Section 2(b) and thus impose the requirement of consistency with the Articles upon the many exchange control regulations which impinge on the business relationships between private parties.

B. Regulations Affecting Exchanges of Currencies

An early Netherlands decision, Frantzmann v. Poinjen90 (1959), determined that a sale or exchange

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1 J. GOLD, THE FUND AGREEMENT, supra note 76, at 87.

The broad definition of exchange contracts is also supported in the cases of In Re Anna de Boer, 89 JOURNAL DU DROIT INTERNATIONAL 721 (Ct. App. Paris (Cour d'appel) 1961), and Societe Filature et Tissage X. Jourdain v. Epoux Heynen-Bintner, 22 Int'l L. Rep. 727 (Tribunal d'Arrondissement de Luxembourg (Civil) Feb. 1, 1956), reviewed in 1 J. GOLD, THE FUND AGREEMENT, supra note 76, at 94.

89. A narrower definition of exchange contracts, see note 76 supra, is adopted in Wilson, Smithett & Cope, Ltd. v. Terruzzi, 1 Q.B. 703 (C.A. 1976); J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda) Ltd., 37 N.Y.2d 220, 333 N.E.2d 168, 371 N.Y.S.2d 892 (1975), cert. denied 423 U.S. 866; and by the Hamberg Court of Appeals, Entscheidungen zum Intersozialen Privatrecht (OLGE Hamburg July 7, 1959), where a contract for the purchase of goods was held not to be within the meaning of "exchange contract", even though the purchaser was required to pay in the seller's currency. See 2 J. GOLD, THE FUND AGREEMENT, supra note 65, at 1-9.

of currencies, as must be expected, is a capital trans-
saction subject to members' control under Article VI,
Section 3. The case involved a 1955 agreement made in
Indonesia between Dutch parties by which the plaintiff
paid defendant a sum of rupiah in return for defen-
dant's promise to pay to plaintiff a sum of guilders
in the Netherlands. According to the court's opinion,
such agreements were subject to licensing in Indonesia,
pursuant to the Indonesian Foreign Exchange Ordinance
of 1940 and a Decree thereunder. The necessary li-
cense was not granted to the defendant. Upon defen-
dant's partial payment, plaintiff sued in the Nether-
lands for the balance.

Although the District Court of Maastricht refrain-
ed from evaluating in detail the Indonesian foreign
exchange provisions, it found that the "Foreign Ex-
change Decree must be considered as exchange legisla-
tion of that country--maintained in accordance with
the Fund Agreement,"91 and proceeded to discuss the
capacity of members to regulate capital movements.92
Having determined the Indonesian exchange controls to
merit recognition under Article VIII, Section 2(b),
the court held the agreement contrary thereto to be un-
enforceable and denied plaintiff the relief sought.

This case is important, not only in its holding
that the exchange of currencies is the proper subject
of legitimate capital controls, but also in its method.
In deciding that the Indonesian control regulated capi-
tal movements consistently with Article VI, Section 3,
and that therefore it must be recognized under Article
VIII, Section 2(b), the court in effect defined "ex-
change control regulations" of the latter Section to
include both the restrictions on payments for current
transactions (Article VIII, Section 2(a)) and controls

90. (Continued) under Article VIII, § 2(b), supra note 3, and
the Statni Banka funds, as the property of the Czechoslovakian
State, were immune from attachment. The appellate court reversed
the judgment of the lower court which had found in favor of
Englander.

91. 1 J. GOLI, THE FUND AGREEMENT, supra note 76, at 114.

92. Id. However, Gold points out that the court was somewhat
misguided in reasoning that, because the controls of Indonesia
were consistent with the Articles, supra note 3, when the controls
were imposed, they must necessarily remain so. In fact, they may
not affect all transactions in a consistent fashion. Nevertheless,
infsofar as the regulations affect capital movements, as here, they
would be consistent with the Articles.
on capital movements (Article VI, Section 3). That Article VIII, Section 2(b), applies to regulations governing capital as well as current transactions is "undoubtedly correct."\textsuperscript{93} The Court's interpretation is a significant contribution since the Articles did not define the application of Article VIII, Section 2(b).\textsuperscript{94}

C. \textit{Regulations on the Payment and Transfer of Proceeds from Insurance Contracts}

The character of an insurance contract and payments made thereunder is not easily identifiable as capital or current. Although courts tend to view such transactions and payments as capital transactions and subject to members' regulations, the opinions are not unanimous.

\textsuperscript{93} Id.

\textsuperscript{94} It is noteworthy that a statement by Joseph Gold, General Counsel to the IMF, reconfirms the propriety of broad application of Article VIII, § 2(b), \textit{supra} note 3, to regulations governing capital as well as current transactions. The statement was distributed to several U.S. courts which were then hearing the "Cuban insurance cases" (see pp. 29-35 \textit{infra}). It reads in relevant part as follows:

A member of the Fund, like Cuba, which has accepted the obligations of Article VIII is \textit{required to obtain Fund approval of exchange restrictions on current transactions} ... pursuant to Article VIII, §§ 2 and 3.... The Fund has approved the maintenance by Cuba of a two percent exchange tax on remittances abroad. Any other existing restrictions on current transactions ... do not have the Fund's approval.

In accordance with the Articles of Agreement, Fund approval for controls of capital transfers is not required. Thus, \textit{to the extent any controls are confined to capital transfers, they are maintained or imposed consistently with the Fund's Articles of Agreement.} \textsuperscript{[Emphasis added]}

The last quoted sentence seems clearly to apply the requirement of Article VIII, § 2(b)--that exchange control regulations be maintained consistently with the Articles, \textit{supra} note 3--to controls on capital transfers.

In *Catz and Lips v. S.A. Union Versicherung* \(^95\) (1949), defendant, a Czechoslovakian insurance company, had authorized a Dutch firm in 1934 to enter into certain insurance contracts in its behalf. The Dutch firm entered into such contracts with plaintiffs, who were agents for the insured parties. Claims arising during the Second World War were not paid. The Dutch firm had no funds of the defendant which could be attached, so the insured parties accepted notes from plaintiffs in the amount of their claims and assigned to plaintiffs their claims against defendant, whereupon plaintiffs sought to attach funds of defendant's agent in Belgium.

However, "in execution" of their power to control capital movements under Article VI, Section 3, Czechoslovakia and the Netherlands had entered an agreement in 1946 which prohibited the transfer between these countries of funds in respect of debts incurred before 1945. Noting that plaintiffs could not have obtained direct payment from defendant in Czechoslovakia, the court declined to allow the same result to be achieved indirectly. The court also regarded the assignment of rights as contrary to the exchange laws of all three countries. \(^96\) Plaintiffs therefore failed to recover on their claim, since it had accrued prior to 1945. In so holding, the court assumed that claims on insurance contracts constitute capital movements, subject to members' regulation.

There is some doubt as to whether insurance contracts, and payments and claims thereunder, are indeed predominantly capital transactions. \(^97\) The view that payments on insurance claims are within the definition of current payments is not unreasonable, since they are payments "due in connection with foreign trade, [and] other current business, including services."\(^98\)


\(^{96}\) See 1 J. GOLD, THE FUND AGREEMENT, supra note 76, at 31.

\(^{97}\) See Meyer, Recognition of Exchange Controls After the International Monetary Fund Agreement, 62 YALE L.J. 867, 903 (1953).

\(^{98}\) Article XXX (d), supra note 1; see Meyer, supra note 97, at 903.
has regarded insurance premiums and the payment of claims as "invisible" transactions, which may correspond to the definition of payments for current transactions. The insurance feature of an insurance contract is a service and, just as the premium represents the payment for a current service, so the payment of a claim constitutes the settlement of a commitment and, thus, should be free from members' restrictions. Whether the cash surrender value of a policy represents another form of the service of protection, or a repayment of an investment and, therefore, a capital payment, is not so clear. If a policy is viewed as a "contingent asset" of the holder and as a "contingent liability" of the issuer which will be made "current" upon the occurrence of certain specified conditions, then a recovery on the cash value should be treated as a current transaction. The weight of authority indicates that the insurance-service feature of an insurance policy is the predominant element of an entire, indivisible contract. These arguments militate in favor of the characterization of all payments relating to insurance contracts as "payments for current transactions" within the meaning of the Articles.

Perhaps unfortunately, courts have not characterized premium and recovery payments on insurance contracts as current payments beyond the power of members to restrict or prohibit. Although the courts appear reluctant to declare members' exchange control regulations to be inconsistent with the Articles, they seem eager to provide relief to plaintiffs bringing actions on insurance contracts, the recovery on which is prohibited by such regulations. To reconcile these

100. See W. SCAMMELL, INTERNATIONAL MONETARY POLICY 18-19 (1957); Paradise, supra note 99, at 68-69.
102. Comment, supra note 101, at 472.
apparently inconsistent perspectives, the courts have resorted to other, somewhat less direct means. One might ask, whatever happened to the path of least resistance?

A line of cases, known as the "Cuban Insurance Cases," arose in the early 1960's as a result of Cuban refugee insureds seeking to recover on insurance policies issued in Cuba by non-Cuban insurance companies. The cases deal with certain exchange control laws and regulations promulgated by Cuba while it was a member of the IMF.104 The first of the relevant controls was Law No. 13 of December 1948, establishing the National Bank and displacing the U.S. dollar with the peso as the legal tender of Cuba.105 Law No. 568 was enacted in October, 1959, after Fidel Castro had taken office. That law declared it a felony to export, import, transfer or in most other fashions to move currency, securities, funds and claims thereon, into or out of Cuba, except when and through the medium authorized by the Currency Stabilization Fund.106 Law No. 851 of July 1960 and Resolution No. 3 of October 1960 nationalized all properties and firms owned by U.S. persons, including the Cuban assets of the U.S. insurance companies that were defendants in the cases. The nationalized properties were to be paid for by bonds (the performance of which was dependent upon U.S. sugar purchases). Law No. 930 of February 1961 established a state monopoly of all transactions involving foreign currencies, to be administered by the National Bank.107

In Pan American Life Insurance Co. v. Blanco108 (1966), plaintiff Blanco had purchased from defendant

104. See generally J. GOLD, THE CUBAN INSURANCE CASES, supra note 103, at 1-6. Cuba became a member of the Fund in 1946 and availed itself of the transitional arrangements of Article XIV, § 2, supra note 1, until 1953, when it notified the Fund of its acceptance of the obligations of Article VIII, §§2-4, supra note 1.
105. Id. at 3. See R. Paradise, supra note 99, at 34-35.
107. Id. at 4-5.
108. 311 F.2d 424 (5th Cir. 1962), on remand 221 F.Supp. 219 (S.D. Fla. 1963), rev'd in part 362 F.2d 167 (5th Cir. 1966).
insurance company three single-payment annuity contracts for the benefit of plaintiff's daughters, to become payable as each daughter attained the age of 21 years. Each contract was signed and notarized in Havana, and plaintiff paid the single premium there. The contract provided that liquidations thereunder were payable at defendant's headquarters in New Orleans and that the contracts were exempt from restrictions as to residence and travel. Plaintiff, having fled Cuba, sought to obtain the cash surrender value of the policies; defendant refused to pay, and plaintiff brought suit on the contracts.

In this case, defendant argued that the Cuban expropriations relieved it of liability and substituted the Cuban Government as the obligor on the contracts. It argued further that the exchange control regulations of Cuba were valid and should render the contract unenforceable. The U.S. District Court for the Southern District of Florida granted plaintiff's motion to strike portions of Pan American's answer and dismissed its counterclaim. On interlocutory appeal, the Court of Appeals for the Fifth Circuit acknowledged the relevance of the issue, raised by appellant Pan American, of whether the Cuban exchange control laws were "maintained or imposed consistently with" the Articles. But the court found no proof of such consistency and declined to take judicial notice of the Cuban laws. Nevertheless, it held that the District Court had erred in striking the counterclaim and remanded the case for a decision on the merits.

Had the Cuban laws been judicially noticed, analyzed, and found overbroad and inconsistent as applied to the arguably current insurance transactions of Blanco, the regulations might have been denied recognition. On that basis, the court could have enforced the contracts and provided Blanco with the relief sought.

However, the District Court, on remand, reached similar results by a quite different route. It considered that it was not compelled to recognize the

109. 311 F.2d at 427.
110. Id.
111. Id. at 428.
112. Id.
decrees of the Castro Government that were confiscatory and (thus) violative of international law. 113 Although it did not discuss further the decrees or the current or capital attributes of the transactions affected, the court did hold the exchange control regulations to have no extra-territorial effect. 114 As both the plaintiff and the defendant were now resident in the U.S., and as the contract did not require settlement in Cuba, neither the persons nor the funds were subject to the Cuban laws. The court considered, then discarded, the possibilities that the cases might require the application of the Act of State Doctrine or of the IMF Agreement. 115 Plaintiff was entitled to recover.

The Blanco case was consolidated by the District Court with several other cases that had come up on similar facts, except that they involved life insurance rather than annuity contracts. The territorial limitations imposed by the District Court on Cuba's exchange control regulations were grounds for relief to the plaintiffs in these cases as well. 116 As Joseph Gold, General Counsel of the IMF has pointed out: "The court seemed to be reaching for a thesis that Article VIII, Section 2(b), did not require the recognition of exchange control regulations if they purported to control nonresidents in transactions involving assets outside the jurisdiction." 117 Implicit in this

113. 221 F.Supp. at 226, 227.
114. Id. at 227.
115. Id. at 229. The Court defined as an issue the applicability of the Bretton Woods Agreement, id. at 226, but considered the Agreement not to apply. Id. at 229.
116. See Aguirregaviria Zabaleta v. Pan American Life Insurance Co., Conill v. Pan American Life Insurance Co., and Lorido y Diego v. American National Insurance Co., jointly reported in Pan American Life Insurance Co. v. Blanco, 221 F.Supp. 219 (S.D. Fla. 1963). It should be noted that on appeal, only the Blanco and Conill cases were affirmed. 362 F.2d 167 (5th Cir. 1966). Diego and Zabaleta were reversed and remanded upon a construction of the facts different from that of the District Court. Because Cuba had withdrawn from the Fund before the appeal was decided, the court was of the view that a judgment on the policies would not be precluded by the Articles. Id. at 171.
statement and in the rationale of the cases is that the Articles would require recognition of the regulations to the extent that they do not purport to control non-residents or assets outside the jurisdiction. This suggests that the court, in addition to noting Cuba's withdrawal from the Fund, was of the opinion that the Cuban currency was not "involved," and that therefore the regulations did not merit recognition. But this, if not the wrong criterion, is certainly incomplete; the Articles require recognition of the regulation (by holding a contrary contract unenforceable) where the member's currency is involved and where the regulation is consistent with the Articles. 118

In most of the Cuban insurance cases, the courts followed an approach similar to that of the District Court in Blanco, relying on territorial limitations of the regulations and suggestions that the policies were not exchange contracts (and therefore not required to be held unenforceable). This approach was adequate to uphold the insurance contracts and provide relief to the plaintiffs. 119 However, in Confederation Life Association v. Ugalde, 120 the policy was payable in

118. Article VIII, § 2(b), supra note 1, reads in relevant part as follows: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member...."

119. The plaintiff was successful in Theye y Ajuria v. Pan American Life Insurance Co., 154 So.2d 450 (La. Ct. App. 1963), rev'd, 245 La. 755, 161 So.2d 70 (1964) (reinstating judgment for plaintiff), cert. denied, 377 U.S. 997 (1964); and Pan American Life Insurance Co. v. Raij, 156 So.2d 785 (Fla. Dist. Ct. App. 1963), cert. dismissed, 164 So.2d 204 (1964), cert. denied, 379 U.S. 920 (1964). See also Varas v. Crown Life Insurance Co., 204 Pa. Super. Ct. 176, 203 A.2d 505 (1964), cert. denied, 382 U.S. 827 (1965). The trial court found that defendant had offered to make payment to plaintiff in Havana, but that it was impossible, and thus plaintiff was not required, to collect in Havana. The theory of quasi-contract was suggested by the trial court as a ground for granting relief to the plaintiff. On appeal, however, the Superior Court held that the contract was enforceable in Pennsylvania.

120. 151 So.2d 315 (Fla. Dist. Ct. App. 1963), rev'd in part, 164 So.2d 1 (Fla. 1964), cert. denied, 379 U.S. 915 (1964),
dollars in Havana and, upon plaintiff's request for the cash value, defendant offered to make payment there in Cuban pesos according to the terms of the policy as modified by Cuban law. The defendant suggested, on appeal to the Florida District Court of Appeals, that the character of the transaction be analyzed as to its current and capital attributes and that the cash surrender of a policy is akin to "the most obvious kind of capital transaction." The court did not engage in the suggested analysis, but it appears to have assumed that the transaction was of a capital nature, as argued by defendant, and that the Cuban regulations were consistent with the Articles. Nevertheless, the District Court of Appeals did not view the Cuban laws as barring the plaintiff's claim; rather it considered the issue to be one of proper exchange rates—i.e., should the recovery be computed at the current exchange rate or at the exchange rate which pertained when the contract was entered?  

The Supreme Court of Florida, also apparently ignoring the invitation below to analyze the underlying transaction and the regulations thereon, and assuming the consistency of these regulations, said:

The Cuban laws relating to the establishment of currency control are similar to those which have been enacted in this country...and are not violative of United States policy. The Florida courts are obligated by the International Monetary Fund Agreement to apply the cited Cuban laws to the contract here involved.

The Supreme Court reversed the lower court, and dismissed plaintiff Ugalde's action, finding that the defendant had offered to make payment in Havana and was therefore not in breach of the contract.

It may seem idle to speculate on the outcome of this case had the court applied different criteria. But such speculation will serve to highlight the inadequate criterion applied by the courts in the Cuban insurance cases. So long as the plaintiff and defendant

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122. 151 So.2d at 323.
123. 164 So.2d at 2.
were not residing in Cuba and so long as the contracts were payable outside of Cuba in non-Cuban currencies, the courts could uphold the Cuban regulations and still award relief, as in Blanco, on the basis of the territorial limitations of Cuba's regulatory jurisdiction and of the fact that its currency was not involved. However, where the contract was payable in Cuba, in pesos, plaintiffs failed because the courts assumed the consistency of Cuba's regulations with the Articles. Therefore the contract was unenforceable as contrary to valid regulations. Had the court, in Ugalde, examined the nature of the contract and had it found the payments and recoveries on the contract to be partially or wholly of a current nature, or in the settlement of commitments, then it could have held the Cuban restrictions thereon to be inconsistent with the Articles; the plaintiff should then have succeeded in his claim. The defendant's offer to make payment in Havana, though a powerful defense against a suit for breach of contract, would not have resolved the case, for plaintiff could have proceeded on a theory of quasi contract.\textsuperscript{124}

D. Regulation of the Transfer of Investment Proceeds

Another case involved the Cuban exchange control regulations is French v. Banco Nacional de Cuba.\textsuperscript{125} Ritter, an American who had invested some $350,000 in a Cuban farm in 1957, had obtained official permission to exchange the proceeds from his investment for U.S. dollars or other foreign currency and expatriate the same, free of the Cuban tax on the exportation of money. In June 1959, Ritter possessed certificates from the Cuban Government's Currency Stabilization Fund committing the Banco Nacional de Cuba to exchange a total of $150,000 worth of pesos. In July of 1959 the Stabilization Fund suspended payment on these and similar certificates and the Bank denied plaintiff French (Ritter's assignee) the funds represented by the certificates. He brought an action against the Bank in the courts of New York and obtained a favorable judgment from the Supreme Court. The Appellate Division affirmed.

The Court of Appeals of New York, however, reversed the judgment and dismissed the complaint. It viewed

the suspension decree as "nothing more than... an exchange control regulation similar to regulations enacted or promulgated by many other countries, including our own." 126 The court considered a currency regulation such as the one in issue, which alters the value or character of money to be paid in satisfaction of contracts, not to be a "confiscation." 127 Plaintiff French, his exchange certificates having been suspended, then had to accept pesos. Although the court did not specifically discuss the character of the transaction, it is again apparent that it must have regarded the exchange of pesos—which Ritter had received as proceeds from the liquidation of his investment—for dollars as a capital transaction. The exchange, therefore, was seen as rightfully subject to members' controls under Article VI, Section 3. 128

Judge Keating, in a strong dissent, saw the suspension decree as "nothing other than an act of confiscation." 129 Even if the decision originally served to protect Cuba's foreign exchange resources,

it does not follow that it remains valid under international law permanently.... Though this might be justified when the currency regulations of the country are in accord with the principles of the International Monetary Fund, even though the enacting country is not a member or has subsequently withdrawn, this view is not justified when these monetary policies are inconsistent with the purposes of the Fund. 130

The facts of the case reveal the inconsistency found by Judge Keating. Although no real confiscation had occurred, for Ritter had received his pesos, his right ever to receive any income from his investment in any medium but Cuban pesos had been indefinitely suspended.

126. Id. at 55, 242 N.E.2d at 710, 295 N.Y.S.2d at 442.
127. Id.
129. 23 N.Y.2d at 77, 242 N.E.2d at 724, 295 N.Y.S.2d at 461.
130. Id. at 88, 242 N.E.2d at 730-31, 295 N.Y.S.2d at 470 (emphasis added).
This "suspension," an effective prohibition, abrogated the exchange license granted him by the Cuban government. The mere exchange of currencies, unrelated to international transactions, is a capital movement, subject to members' regulations. But where, as here, the prohibition of an exchange of currencies interferes with the effective payment of income from an investment, such restriction is inconsistent with the Articles. Judge Keating, then, was quite correct.

E. Regulations Affecting the International Transfer or Assignment of Equity Interests

The case of Moojen v. Von Reichert, decided in June 1961 by the Court of Appeal of Paris (First Chamber), raised the question of whether a transfer or sale of equity interests would be subject to restriction by members of the IMF. Moojen, a Dutch national residing in France, assigned shares of the Gutenberg Corporation, a French corporation located in France and dealing in French real estate, to Von Reichert, a German national resident in Bonn, in consideration of a sum of French francs. The instrument was dated in Paris and had been registered and deposited with the Commercial Tribunal of that city, but it was alleged to have been signed in the Netherlands. The instrument and the corporate bylaws provided that disputes were to be litigated in the French courts.

Moojen, the assignor, brought an action in the Netherlands, seeking to have the assignment nullified as a violation of Dutch exchange control regulations. The regulations in question required that the disposition of foreign assets by residents be licensed, and Moojen had obtained no license. The Dutch courts declared the assignment to be null. But when Mrs. Moojen, the assignor's widow, sought execution of the Dutch judgment in France, she was unsuccessful.

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The Tribunal of the Seine (Fifth Chamber) found error in the Dutch court's determination that the assignor was a resident of the Netherlands and found instead that Moojen had been residing in France. The court held the assignment to be good, for Dutch exchange control regulation did not apply to Moojen's assignment. This debate as to residence and conflict of law was carried to the Court of Appeal of Paris which reversed the lower tribunal on that issue, finding Moojen to have indeed been a resident of the Netherlands at the time of the assignment.

The Court of Appeal rejected defendant Von Reichert's suggestion that the transfer of shares did not affect the exchange resources of the Netherlands (i.e., that the Dutch currency was not involved) and his argument that the transfer was not an "exchange contract." Rather, it was of the view that repatriation of the proceeds from the disposition of foreign assets would affect the Dutch economy. The assignment was held to be unenforceable and null, apparently on the theory that it was a capital transaction, contrary to the regulations of the Netherlands which were consistent with the Articles. The Court of Appeal said:

"Although the signatories...intended to prohibit Member States from imposing, without the approval of the Fund, restrictions relating to payments for current international transactions, they did not lay the same claim in regard to instruments that do not fall within that class, as the assignment by a resident of assets situated abroad."

Despite the failure of the court to identify expressly the transfer of shares as a capital transaction and despite the argument of the defendants that the transfer was neither current nor capital but of some other, unknown character, it is a fair inference

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134. It is interesting to note the somewhat anomalous posture of this case. The petition for French exequatur of the judgment of a Dutch court brought the French courts to review and find error in the Dutch court's determination of an essential fact.
135. 89 JOURNAL DU DROIT INTERNATIONAL at 724, 725.
136. See id. at 724-27.
137. Id. at 726, 727.
138. Id.
from the structure of the Articles that such a transfer is in fact a capital transaction.\footnote{139} The transfer or sale of equity interests differs inherently from the remittance of investment proceeds. The sale or transaction of equity interests gives rise to a proprietary interest in future proceeds from the investment — in other words, such a sale or transfer has as its \textit{quid pro quo} the claim to a future return and to liquidation proceeds (to the extent liquidation is permitted and the proceeds are expatriable under local law) denominated in the currency of the country in which the investment is located. As such, the sale or transfer of equity interests is a capital transaction (see p.9 supra). However, the investment proceeds themselves are the income from current business, the entitlement to which may be affected by the sale or transfer of equity interests. As income, the payment of such proceeds is defined by the Articles to be a payment for current transactions. Thus, the suggestion that the transfer of equity interests should fall within some unidentified classification ignores the definitional scheme of the Articles. Nevertheless, the result in this case is correct, for the exchange regulations of the Netherlands were upheld — as though the affected assignment of equity interests, in violation thereof, were of a capital nature and therefore were regulable.

**F. Regulations upon the Enforcement of a Letter of Credit**

A somewhat surprising case is \textit{J. Zevi and Sons, Ltd. v. Grindlays Bank (Uganda), Ltd.},\footnote{140} which the Court of Appeals of New York decided in 1975. On March 24, 1972, plaintiff, an Israeli corporation, purchased from defendant Grindlays Bank (Uganda) an irrevocable letter of credit in the amount of $406,000 which was

\footnote{139} See Gold and Lachman, \textit{supra} note 78, at 676, para. 9, discussing the possibility of a third, unnamed category of international transactions, in addition to current and capital, that might be comprehended by the Articles.

valid until January 31, 1973. The letter was to be
drawn in ten equal amounts and it authorized any nego-
tiating bank to claim reimbursement from the First
National City Bank (Citibank) in New York, the agents
for Grindlays. The Minister of Finance of Uganda, act-
ing under the Exchange Control Act of that country, is-
sued directives on March 28, 30, and April 13, 1972,
effectively prohibiting payment in Ugandan funds of any
claims arising out of this letter of credit. Thereupon
Grindlays instructed Citibank not to effect reimburse-
ment on the letter and Citibank declined to reimburse
the Chemical Bank which had negotiated several of the
ten equal drafts received from Zeevi's supplier and
presented to them for payment.

Zeevi commenced action against Grindlays in New
York and the Supreme Court ordered attachment of defen-
dant's funds on deposit with Citibank. The order of
attachment was affirmed by the Appellate Division and
by the Court of Appeals. But the court rendered a very
narrow interpretation of Article VIII, Section 2(b),
thereby attempting to do justice and to support the
interest of New York, as the "financial capital" of the
world, in having a well-reasoned and stable body of
commercial law. To avoid defendant's argument that
"enforcement of the letter of credit would violate the
foreign exchange laws of Uganda in disregard of...[the
Bretton Woods] treaty," it held the treaty inappli-
cable. The court considered that, "even when read in
its broadest sense," the letter of credit could not
be brought within the meaning of "exchange contract."
This being so, the court declined to hold the letter un-
enforceable and the plaintiff recovered thereon.

Although the result seems correct, the rationale
of the court is awkward, if not erroneous. An inter-
national letter of credit is very clearly an exchange
contract, even under the most narrow interpretation of
the term. Not only does it "affect" the exchange

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141. 37 N.Y.2d at 227, 333 N.E.2d at 172-73, 371 N.Y.S.2d
at 898.
142. Id. at 228, 333 N.E.2d at 174, 371 N.Y.S.2d at 900,
143. Id. at 229, 333 N.E.2d at 174, 371 N.Y.S.2d at 900.
144. See Nussbaum, Exchange Control and the International
Monetary Fund, 59 YALE L.J. 421, 426 (1950). See also Gold, The
Fund Agreement in the Courts—XII, 24 IMF STAFF PAPERS 193, 222
resources of the members in whose currency it is purchased and negotiated, but it frequently must have as its immediate result, and perhaps as its object, the exchange of currencies.

Such a letter of credit is subject to appropriate regulation by members, so long as they do not transgress the Articles. However, in the case at hand, the latter was used in the purchase of merchandise, most definitely a current transaction. Moreover, even if the letter of credit were not related to current transactions, but were plainly a capital transaction, if its purchase had preceded the imposition of restrictions against payment thereon, the application of such restrictions would be inconsistent with the Articles as inhibitive of the settlement of a commitment. Further, it should be noted that the credit was to expire less than one year after the date of its purchase. Thus, payments on the credit would have been in the nature of "short-term banking and credit" and beyond the capacity of members to restrict. The Court of Appeals would have done well to avoid its narrow interpretation of Article VIII, Section 2(b), by holding the Ugandan directives to be inconsistent with the Articles as applied to Zeevi's transactions.

G. Regulations Affecting Personal Service Contracts

In Daiei Motion Picture Company, Ltd, v. Zavicha,145 the Court of Appeal of Paris (Fourth Division) accepted the broad definition of "exchange contracts" as those that involve the currency of any member. It held a transnational contract for personal services to be subject to members' regulation.

According to a contract between Daiei Motion Picture Company (Daiei), a Japanese corporation, and Zavicha, a resident of France, the latter was to represent Daiei exclusively in Europe for ten years. Zavicha undertook, at his own expense, to maintain offices and hire employees for the conduct of the business, in return for an annual salary of F, 10,000 plus bonuses. The contract was dated September 1, 1966, and Zavicha

began work and incurred expenses in October 1966. In February of 1967 the Daiei Company informed Zavicha that it was experiencing difficulty in obtaining approval of the contract by Japanese exchange control authorities. Daiei first offered to renegotiate and then, on June 5, 1967, informed Zavicha that the contract was void under Japanese law. Zavicha sued for damages on Daiei's breach of the contract.

The Court of Appeal viewed the arrangement as an "exchange contract," even though its obligations were not denominated in yen, the currency of Japan, whose regulations were in issue.146 And it held the contract to be unenforceable under Article VIII, Section 2(b), as contrary to the Japanese regulations. Plaintiff's claim on the breach was therefore denied. However, the court found a duty owed by the defendant to do all that it could to secure authorization of the contract by Japanese exchange control authorities, which duty had not been fulfilled. Although plaintiff could not recover in an action on the contract, he was entitled to a quasi-delictual remedy, analogous to restitution and tort, and damages were awarded.

In its finding of unenforceability, the Court of Appeal tacitly recognized the consistency of the Japanese control regulations with the Articles. Such recognition is surprising on first impression for Article XXX(d) expressly includes payments due in connection with foreign trade and services in its definition of "payments for current transactions." If the Japanese controls were viewed solely as a restriction on the payment for services abroad, then they would quite clearly be inconsistent with the Articles. In the case at hand, the Japanese regulations prohibited unauthorized entry into the underlying service contract as well as payment thereon. The court appears to have regarded these regulations as consistent with the

146. The court in Daiei seemed to take a view similar to that in Moojen v. Von Reichert, 85 JOURNAL DU DROIT INTERNATIONAL 718 (1958), that the exchange reserves of a country might indeed be affected by a transaction in which that country's currency was not directly involved. See note 88 supra regarding the predominance in the cases of the broad definition of "exchange contract."
Articles, for the entry into contracts is legitimately within the control of members' domestic laws, as are most regulations upon the import and export of goods.

Such reasoning permits the conclusion that the Japanese controls, prohibiting both entry into and performance of unauthorized service contracts, are less offensive to the Articles than they at first appear. However, recognition of Japan's domestic contract regulations by foreign courts is not an appropriate application of the IMF Articles. Such recognition would lend the imprimatur of international law to national regulations on personal service contracts, a result not warranted by the Articles. Perhaps the Court of Appeal should have achieved its result by holding the Japanese regulations, insofar as they proscribe the payment or performance of personal service contracts, to be inconsistent with the Articles. It could then have awarded damages on the contract directly and left redress for the violation of the prohibition against entry into such contracts, if any redress there be, to the domestic law of Japan.

H. Limitations on the Transferability of Benefits Accrued under Pension Agreements

The transfer of pension benefits lies somewhere between an exchange of currencies and the transfer of the proceeds from insurance contracts. Such benefits

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148. See Gold, The Fund Agreement in the Courts—XII, supra note 144, at 198. See also Decision No. 1034–(60/27), supra note 58, which establishes the guiding principle, for the determination of whether a regulation is a restriction on payments for current transactions, to be whether the restriction imposes a direct governmental limitation on the use of exchange as such.
might well have both current and capital elements (see pp. 23-27 supra), yet the receipt of such benefits is often contingent upon certain conditions such as age, duration of employment, and place of residence. The entitlement to such benefits, and the payment thereof to the beneficiary, fall within the definition of current payments discussed in part II above. And certainly such payment, according to the terms of the instrument creating the pension, qualifies as a remittance in the settlement of commitments. So viewed, both the entitlement to such benefits and their payment to the beneficiary would be beyond the capacity of members to restrict. However, the transfer of funds which have been paid to the beneficiary or to his account could be viewed as a capital transaction not directly related to the prior payment. If the transaction were treated as though it had two separate parts, Article VI, Section 3 might permit restriction of the latter, "capital" transfer.

The case of Perutz v. Bohemian Discount Bank in Liquidation149 raises these questions. That case involved a contract, made in Prague, between plaintiff's decedent, Perutz, and his employer, the defendant, in 1938. Under the contract, Perutz was entitled to a monthly pension which was payable "'always [at] the place of business of the bank.'"150 The laws of Czechoslovakia, in effect from 1924 until after the action was commenced, forbade residents to make any payment in currency or foreign exchange to a nonresident, unless the Czech exchange authority licensed such payment. Perutz left Czechoslovakia in 1940 and became a citizen of the United States; although he received his pension until 1942, thereafter it was paid into a blocked account in Czechoslovakia for which no licenses for payment or withdrawal were granted. Before his death in 1949, Perutz commenced an action against the defendant. His widow obtained a judgment in her favor from the Appellate Division.

This judgment, however, was reversed by the Court of Appeals of New York, which observed that,

150. 304 N.Y. at 536, 110 N.E.2d at 7.
our courts may...refuse to give effect to a foreign law that is contrary to our public policy. But the Czechoslovakian currency control laws in question cannot here be deemed to be offensive on that score, since our Federal Government and the Czechoslovakian Government are members of the International Monetary Fund....151

The Court of Appeals did not discuss the provisions of Article VIII, Section 2(b), but its rationale suggests that it felt bound to recognize the Czech exchange regulations and that it regarded them as consistent with the Articles. The opinion suggests either that the transfer of pension benefits was a capital transaction or, if current, that the restrictions imposed were consistent with (then) Article XIV, Section 2, which excused transitional members from many of the obligations of Article VIII. Significant, too, are the terms of the pension agreement, which made the benefits payable at the offices of the bank. The fact that these terms had been fulfilled facilitates the separate treatment of the component parts of the transaction. Though Czechoslovakia did not permit the plaintiff to transfer his benefits out of the country, which effectively frustrated his entitlement to them, it did not restrict their payment. Nor was the blocked account a restriction on the settlement of a prior commitment, for the bank had performed its duties under the pension agreement.

Although the court did not deal explicitly with the character of the transaction or with the severability of its parts, one concludes that members may restrict the transfer of pension benefits, as distinct from their payment. To be sure, the facts of the case limit the rule. Had the pension agreement provided for payment to the beneficiary where ever he resided, the court might have decided differently. Alternatively, if members' restrictions on the transfer of all forms of capital were forbidden, except where authorized by the IMF, courts could avoid outcomes such as that in Perutz.

151. 304 N.Y. at 537, 110 N.E.2d at 7 (citation omitted). Czechoslovakia announced its withdrawal from the Fund on December 31, 1954, which withdrawal the Fund acknowledged on January 5, 1955.
I. Legal Tender Laws and Exchange Surrender Requirements

The courts of some members have denied international application to the legal tender laws of member countries, even where such laws affect the exchange resources of members by prescribing the acceptable currency for the conduct of certain transactions. Such denial is based upon the characterization of legal tender laws as part of the domestic law of members, not within the meaning of "exchange regulations" as used in Article VIII, Section 2(b), and limited therefore to the domestic jurisdiction of the enacting member.

In *Loeffler-Behrens v. Beerman*, the Mannheim (Germany) Regional Court confronted a Brazilian decree which, as applied to German nationals resident in Brazil, prohibited the contractual incurrence of obligations denominated in foreign currencies. In alleged violation of this decree, plaintiff had delivered $5,500 to defendant in April 1959 in return for defendant's promise to pay the equivalent in cruzeiros by May of 1959. In October of that year, having only partially fulfilled this obligation, defendant issued another promise to pay, with modifications that are not here material.

After defendant had returned to Germany in 1961, plaintiff, as yet unsatisfied in his claim, brought suit in the Mannheim court, which awarded him judgment. On appeal the Karlsruhe Regional Court of Appeals affirmed the judgment. Referring to a letter from the General Counsel of the Fund, the court found that the Brazilian decree was not an exchange control regulation entitled to recognition under Article VIII. It concluded that, although Brazilian law governed the contractual liabilities of the parties, German law

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152. This case is reviewed in 2 J. Gold, THE FUND AGREEMENT, supra note 65, at 50-54. The judgment of the Mannheim Landgericht (Regional Court) was appealed to the Karlsruhe Oberlandesgericht (Regional Court of Appeals), which affirmed the lower court's judgment for the plaintiff on somewhat different grounds.

153. The Brazilian decree, No. 23501, of Nov. 27, 1933, prohibited "on pain of nullity" the stipulation of payment in foreign currencies in contracts to be performed in Brazil. Id., at 52.

154. See id., at 52, 53.
This is not a "bad" result. But the court was a bit disingenuous in separating contractual from monetary liabilities, where the contract appeared to consist of mutual promises to pay and contained no other duties or liabilities. Conceivably, the court could have recognized the Brazilian prohibition as affecting that country's exchange resources, and yet have awarded judgment for the plaintiff on the theory of quantum meruit.

While reducing or eliminating restrictions on payments for both current and capital transactions might well improve world economic welfare (see part V, infra), it is surprising that foreign courts should deny international recognition to legal tender laws obviously within the exercise of national sovereignty and not necessarily restrictive of international payments and transfers. This is especially so in view of the predisposition of the courts to uphold members' exchange control regulations without serious inquiry into their characteristics and propriety under the IMF Articles.

A New York court took an approach similar to that of the German courts in De Sayve v. De la Valdene. After the conclusion of a contract by which the French defendant agreed to pay to the French plaintiff a sum of dollars and sterling, France passed a legal tender law (cours force) declaring void as against public policy any contracts denominated in gold or foreign currencies. The court found that the law did express the public policy of France, but that it was not an "exchange control law of the type which the Bretton Woods Agreements now make enforceable." Since the French statute did not bear upon the validity of the contract or plaintiff's entitlement to the sums agreed to be paid, defendant was liable.

155. Id. at 52.
156. Although this writer is uncertain as to the existence in Brazilian law of theories analogous to those of quantum meruit and unjust enrichment, it seems reasonable to expect that such theories would have developed. Recall the quasi-delictual remedy applied in the Daiei case, supra p. 41.
158. 124 N.Y.S.2d at 153.
159. 124 N.Y.S.2d at 150-52.
Courts also have not regarded exchange surrender requirements as "exchange control regulations" and therefore litigants have not succeeded in having declared unenforceable exchange contracts that violate members' surrender requirements. \textit{Banco do Brasil, S.A. v. A. C. Israel Commodity Co.}\textsuperscript{160} involved an arrangement by which defendant, a Delaware coffee importer, had agreed to pay a Brazilian exporter directly in dollars, rather than \textit{exchanging} dollars for cruzeiros and paying the exporter in cruzeiros. The arrangement violated Brazilian law, which required that foreign currencies be exchanged with the plaintiff bank and that payment be made with the domestic currency. Plaintiff claimed damages of \$1.3 million.

The Court of Appeals of New York found that the transaction was not an "exchange contract" within the meaning of Article VIII, Section 2(b), and that the law was not an "exchange control regulation" but a "revenue law" and therefore not entitled to recognition under the Articles.\textsuperscript{161} Thus, the court saw no violation, nor did it find in the Articles an implied obligation to impose tort penalties on contracting parties who violate the revenue laws of another member. The lower court's judgment in favor of the defendant was affirmed. This approach probably has been repudiated, however, in a more recent case, \textit{Banco Frances e Brasileiro S. A. v. Doe}.\textsuperscript{162} On somewhat different facts (the \textit{Banco do Brasil} case was distinguished), the Court of Appeals of New York acknowledged strong policy reasons for favoring foreign revenue regulations, "...especially one involving currency exchange or control."\textsuperscript{163} It stated further that

\begin{itemize}
\item even assuming the continuing validity of the revenue law rule and the correctness of the characterization of a currency exchange regulation thereunder, United States membership in the International Monetary Fund (IMF) makes inappropriate the refusal to entertain the instant claim.\textsuperscript{164}
\end{itemize}

\textsuperscript{160.} 12 N.Y.2d 371, 190 N.E.2d 235, 239 N.Y.S.2d 872 (1963), \textit{cert. denied}, 376 U.S. 906 (1964); \textit{see also} 1 J. \textsc{Gold}, \textsc{The Fund Agreement}, supra note 76, at 135-139. (Discussing case).

\textsuperscript{161.} 12 N.Y.2d at 375, 377, 190 N.E.2d at 236, 237, 239 N.Y.S.2d at 874, 875.


\textsuperscript{163.} 36 N.Y.2d at 597, 331 N.E.2d at 506, 370 N.Y.S.2d at 538.

\textsuperscript{164.} 36 N.Y.2d at 598, 331 N.E.2d at 506, 370 N.Y.S.2d at 539.
If Banco Frances e Brasileiro continues to be the law, exchange surrender requirements and, perhaps, legal tender statutes will no longer be ignored as "revenue laws." Courts, then, would recognize such statutes as exchange control regulations and hold unenforceable contracts in violation thereof. Tort remedies, however, go quite beyond the "unenforceability" required by the Articles and beyond theories of quantum meruit or quasi-delictual liability. Most important is the qualification that, if such laws are indeed accorded international recognition as "exchange control regulations" under Article VIII, Section 2(b), then the courts must analyze the character of the regulations to determine whether they are "maintained or imposed consistently with" the Articles. Assuming that true legal tender laws and exchange surrender requirements do not restrict the availability of exchange as such, but merely regulate the means by which the exchange is employed, then such regulations must comport with the Articles, despite their effect on current international transactions.

J. Summary

This part of the paper has categorized and discussed several types of exchange control regulations litigated under the Articles. Most actions which call into question a particular exchange regulation arise under Article VIII, Section 2(b). Courts must resolve the threshold question of whether a particular transaction is an "exchange contract" which "involves" the currency of a member before they can determine the consistency of that member's regulations with the Articles and the enforceability of the contract.

Although the cases and commentaries are far from unanimous, the weight of authority and the economic purposes of the Articles support the theory that ex-


166. See Daiei Motion Picture Company, Ltd. v. Zavich, [1971] J. C, P, ¶ No. 21, 16751 (trial court proceedings) (the disposition on appeal is reviewed in Gold, The Fund Agreement in the Courts--XII, supra note 144, at 195-201); see also pp. 41-43 supra.
change contracts involving the currency of a member are those which in any way affect the member's exchange resources. Two recent cases have adopted the narrower view, which holds both that the exchange of currencies must be the immediate object of the contract and that the contract must be denominated in the currency of the member that claims to be involved. These, however, appear to be aberrations from the predominant, broader view.

Having determined that a transaction is an exchange contract within the meaning of Article VIII, courts must pass upon the enforceability of the contract and the liabilities of the parties thereunder. By the terms of Section 2(b), a contract will be unenforceable if it is contrary to an affected member's valid exchange regulations. A determination of validity requires a finding that the regulation is imposed consistently with the Articles—i.e., that it does not restrict payments for current transactions (Article VIII, Section 2(a)), or, if it restricts capital transactions (which are normally permitted), that it does not unduly delay transfers of funds in the settlement of commitments (Article I, Section 3).

Several of the cases confirm the definitions discussed in part II. Thus, the mere exchange of currencies, in Frantsman v. Poinjen, and the assignment of shares of stock, in Moojen v. Von Retchert, are treated as capital transactions, subject to members' restrictions under Article VI, Section 3. However, in many cases the courts do not address the economic purposes of the IMF. Occasionally the courts have chosen to decide the cases according to verbal considerations or "easy" readings of the Articles, apparently because of their unfamiliarity with the economic concepts involved. At other times, a noneconomic approach reflects considerations of policy that are not expressed. Many of the opinions are result-oriented and utilize a "forced" reading of the law in order to compensate the damages suffered by a party to a contract. In such cases, the courts often assume the consistency or inconsistency of a given regulation without discussing its fundamental nature. The "right" result often is obtained for the "wrong" reasons.

An economic application of the law would broaden the protections of Article VII, Section 2(a), and enable the courts more elegantly to derive the desired results. The insurance cases and the case involving
the personal service contract, *Daieti*, would have benefited notably from economic analysis. Had the underlying transactions been analyzed and found current, the courts would not have had to rely on territorial limitations or on quasi delictual remedies to provide the deserved relief. Similarly, in *Zeevi*, had the court viewed the letter of credit as an exchange contract relating to short-term financing of trade, it could have held the restrictive exchange laws of Uganda to be inconsistent with the Articles.

Unfortunately, the cases do not provide an exposition of criteria that are helpful in determining the current or capital nature of ambiguous transactions. Instead, they reveal the unwillingness or inability of courts to engage in the economic analysis that is necessary to apply the current/capital distinction. To the extent that judicial error is likely, these circumstances militate against the maintenance of the distinction.

To be sure, the economically significant exchange restrictions are unlikely to come before the courts. Yet, the limitations that stronger, better-reasoned opinions would impose on the scope of inconsistent or overbroad regulations would facilitate commerce that otherwise might suffer.

A more comprehensive solution to the courts' failure to deal adequately with the economic issues would be to treat capital movements like current payments and to prohibit members from restricting such movements except with the approval of the IMF. The resulting presumption against the validity of any exchange restriction would limit the issue to a determination of IMF approval. Restrictions would decrease and in litigated matters the courts would not be called upon to make economic distinctions. Further, even where courts fail to recognize the current nature of the underlying transactions, as they did in *Ugalde* and *Perutz*, such unfortunate results could be avoided if the IMF would prohibit restrictions on capital transfers. Moreover, the proposed reform would eradicate many of the economically significant but seldom litigated exchange controls.

Whatever the judicial and economic wisdom of this alternative, its adoption would be difficult to achieve. The concern of the delegates to Bretton Woods, that countries retain control over capital movements, still
prevails among governments.

IV. An Historical Background to the Distinction between Payments and Transfers for Current and Capital Transactions

The drafters foresaw the difficulty that the courts would encounter in distinguishing between payments for current and capital transactions, and in passing upon their consistency with the Articles. Committee Two at Bretton Woods, discussing the provisions of Article VI that relate to capital controls, said:

This Article is certainly a very important one because it recognizes the right of any member country to organize or to maintain an exchange control for capital movements.... Although the general purpose of the Fund is to foster free exchanges, it is remarkable that the experts have found it advisable not only to make provisions allowing exchange control for capital movements, but also recommending it in some cases. *It will certainly be difficult to draw a line between controlling movements of capital and controlling transactions for trade purposes.*

This observation not only anticipates the administrative problems inherent in the current/capital distinction, but also alludes to the fundamental inconsistency between the purposes of the IMF and its design to permit and sometimes require national controls on capital movements. To find the reasons for the experts' advice that such controls be permitted, it is necessary to delve further into the proceedings of the Bretton Woods Conference and into the contemporary understanding of the world monetary experience between the great wars.

The exchange depreciation in Europe which followed the First World War was widely believed to be a consequence of inadequate European supplies of real and financial capital. The shortages of material needed for post-war reconstruction generated heavy import demand and, consequently, heavy demand for foreign exchange (such as the dollar). This, in turn, caused the European currencies to depreciate. Although depreciations sometimes generate what have been termed "destabilizing" capital movements—i.e., movements of financial capital from assets denominated in the depreciating currency to assets denominated in other currencies in anticipation of further devaluation—the post-war depreciations in Europe initially had quite the opposite effect. Many investors, believing the depreciations to be temporary aberrations from the higher, "natural" values of the currencies, saw opportunities for future gain and purchased assets denominated in the depreciating currencies. The flows of financial capital into the depreciating currencies helped to finance the heavy demand for imports and to curb pressures for devaluation.

This pattern of investment contributed to what the IMF, in a recent Annual Report, described as the pre-1930 view "that freedom of capital movements was highly desirable in itself and that movements of short-term funds might be viewed as an equilibrating factor in international payments." Investor optimism is not boundless, however, and such a pattern could not continue indefinitely. When the countries failed to

168. See LEAGUE OF NATIONS, INTERNATIONAL CURRENCY EXPERIENCE 113 (1944), and Chapters V and VII therein. Another factor likely to have contributed to the post-war trend of exchange depreciation was widespread inflation due to inadequate taxation, administrative weakness, and political upheavals.

169. "Destabilizing" capital movements are believed to be self-justifying to some extent. A depreciation in the exchange value of a currency is likely to generate a fear of further depreciation and, consequently, an exit of capital from the depreciating country; such an exit of capital will accelerate, in fact, the advent of the feared further depreciation. Although this cycle clearly cannot continue forever, its limits seem as likely to be found in mass psychology as in the science of economics.


171. IMF, ANNUAL REPORT 12 (1965).
curb inflation and when depreciations persisted, even after large inflows of investment capital, it became apparent that the devaluations were not merely temporary aberrations from the higher norm, but part of a trend to a lower equilibrium exchange rate. A loss of confidence and withdrawal of capital soon followed which accelerated the depreciations.\textsuperscript{172}

Individual countries undertook stabilization policies, but in a "piecemeal" and "uncoordinated manner."\textsuperscript{173} In the 1920's several countries expressed the value of their currencies in gold, with little or no regard to the level of any single currency relative to that of other currencies. The resulting melange of over- and under-valued currencies disintegrated in the 1930's.\textsuperscript{174}

Characteristic of this period of economic and monetary disintegration were large and sudden changes in exchange rates, sometimes designed to stimulate export production and real income.\textsuperscript{175} Such deliberate devaluation has been aptly termed "competitive" devaluation. Occasionally, monetary stability was disrupted when investors, seeking to avoid anticipated devaluations, moved "hot" money rapidly between countries on the slightest provocation,\textsuperscript{176} precipitating changes in exchange rates.\textsuperscript{177} Such speculative activity, psychologically induced, was unresponsive to discount policies designed to slow or reverse the capital outflows.\textsuperscript{178}

\textsuperscript{172} THE LEAGUE OF NATIONS, INTERNATIONAL CURRENCY EXPERIENCE, supra note 168, at 114-15.
\textsuperscript{173} Id. at 116.
\textsuperscript{174} Id. at 117-31.
\textsuperscript{175} See id. especially at 127-29; see also J. J. Polak, International Coordination of Economic Policy, 9 IMF STAFF PAPERS 149, 169 (1962).
\textsuperscript{176} LEAGUE OF NATIONS, INTERNATIONAL CURRENCY EXPERIENCE, supra note 168, at 123.
\textsuperscript{177} Id. at 133-34, 162. The speculative capital flight from some countries (Hungary, Bulgaria, Greece) was not regarded as the predominant cause of depreciation there in the early 1930's. For other countries, however, the capital flight was clearly the major factor precipitating devaluation; Argentina, Austria, Czechoslovakia, Denmark, Estonia, Germany and Latvia experienced depletion of gold and foreign exchange resources that were far greater than any deficits in their current account balances.
\textsuperscript{178} Id. at 162-63.
Consequently, many countries attempted to prevent abnormal or disruptive capital movements through the imposition of controls on capital movements.179 Some controls required the repatriation of funds held abroad by residents and others curtailed the flight of domestically-owned funds. However, later observers have contended that the imposition of such controls had further adverse effects on investor confidence. If so, the controls actually inhibited the repatriation of funds and, perhaps, even encouraged outflows wherever these were possible.180 Additionally, most of the countries that imposed capital controls during this period experienced a worsening in their current balances, due to the effect of the controls on the exchange rate (increasing the rate or slowing its decline), or to inflation, or to a combination of factors.181 Although the benefits from a reduced level of speculation and greater monetary stability may have offset the self-aggravating aspects of capital controls to some degree, the imposition of controls during this period, even where needed, clearly did not produce uniformly corrective results. So it was that the delegates from many countries convened at Bretton Woods to draft the original Articles of the IMF, having experienced recent competitive and self-perpetuating devaluations and capital movements that had been both stabilizing and destabilizing. The product of their efforts established a system of fixed but (rarely) adjustable par values and imposed obligations on the part of members to maintain these values. The Articles were a reform of monetary relationships that reflected the world-wide concern for a stable system of exchange rates.182 The provisions that preserve to members the capacity to control capital movements indicate the conviction of the delegates that such controls helped to maintain an orderly monetary system.

The British Proposals for an International Clearing Union, authored largely by John Meynard Keynes, stated that "control of capital movements, both inward and outward, should be a permanent part of the post-war..."
system. The British planners believed that there was no country which can, in future, safely allow the flight of funds for political reasons, or to avoid domestic taxation or in anticipation of the owner turning refugee. Equally, there is no country that can safely receive fugitive funds ... [which] cannot safely be used for fixed investment.

The plan eschewed cumbersome international regulation of capital movements and proposed instead unilateral, nationally administered controls. Despite its broad grant of national control of capital movements, the plan, as enacted, adhered to its overriding purpose to promote trade, employment, and income, and to reduce the level of exchange restrictions. The plan therefore cautioned against the use of "drastic measures," and advised that regulation of inward flows of capital would be less onerous than regulation of outward flows.

A closely related concern was that, with fixed "stable" exchange rates, national regulation of capital movements was necessary to maintain domestic control over interest rates. Assume that under fixed rates a country undertakes a restrictive monetary policy, perhaps to quell inflationary pressures. An increase in that country's interest rate relative to the rate in other countries would tend to attract foreign capital, which in turn would lower or moderate the rise in interest rates and frustrate the restrictive policies. Conversely, a country undergoing monetary expansion would experience a capital outflow, as the expansion would cause its interest rates to fall (see generally, part V, infra).

This concern is based not on the transient psychology of speculation, but on the fundamental economic premises that interest-sensitive capital, if not inhibited, will move internationally and that, under fixed

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184. Id. at para. 32.
185. See Article I, Second Amendment, supra note 3.
186. See IMF, INTERNATIONAL MONETARY REFORM: DOCUMENTS OF THE COMMITTEE OF TWENTY 80, para. 9 (1974), acknowledging the importance of interest-rate differentials as a factor motivating capital flows.
exchange rates, international payments on both the capital and the current accounts must finally balance. As Lord Keynes reminded the Parliament, "Unless the aggregate of the new investments which individuals are free to make overseas is kept within the amount which our favorable trade balance is capable of looking after, we lose control over the domestic rate of interest." 187

Nationalist sentiment, too, contributes to the interest in preserving members' control of capital movements. No participating country relished the notion of relinquishing sovereignty in economic policy. In an address before the House of Lords on May 23, 1944, Keynes assured his peers:

We are determined that, in future, the external value of sterling shall conform to its internal value as set by our own domestic policies, and not the other way round.... We intend to retain control of our domestic rate of interest, so that we can keep it as low as suits our purposes, without interference from the ebb and flow of international capital movements or flights of hot money.... [and] whilst we intend to prevent inflation at home, we will not accept deflation at the dictate of influences from outside. 188

Keynes commented further that the proposed system secured, "on firmer foundations than ever before," the explicit right to control all capital movements and the domestic capital market. Yet the importance of the nationalist sentiment should not overshadow the desire of the planners to enhance stability, trade, and economic welfare. Keynes was careful to note that the

187. Lord Keynes' address to the House of Lords, May 18, 1943, reprinted in THE NEW ECONOMICS, supra note 183, at 364. The view that capital movements under fixed exchange rates could reduce the scope of national interest rate policy has been widely accepted. See H.G. JOHNSON, The Case for Flexible Exchange Rates, 1969 in FURTHER ESSAYS IN MONETARY ECONOMICS 199 (1973); Aliber, Monetary Independence Under Floating Exchange Rates, 30 J. FINANCE 365, 367 (1975); J.J. Polak, supra note 175, at 171. See generally part V infra.

188. Lord Keynes' address to the House of Lords, May 23, 1944, reprinted in THE NEW ECONOMICS, supra note 183, at 374.
capital controls should not prevent the conduct of "innocent current transactions." 189

The United States originally took a less restrictive approach toward the regulation of capital movements. In the April 1942 version of the White Plan for a Preliminary Draft Proposal for a United Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations, a condition of membership was that a country agree "to abandon, not later than one year after joining the Fund, all restrictions and controls over foreign exchange transactions with member countries, except with the approval of the Fund." 190 Although this proposal assumed that the International Monetary Fund would approve necessary regulation, its clear objective was "foreign exchange trading in an open, free and legal market." 191 A later version of the White Plan did not take so permissive a view of capital movements. The revised plan acknowledged the purposes of the IMF to foster "the smooth flow of foreign trade and of productive capital among member countries" and to "reduce the use of such foreign exchange restrictions ... and discriminatory foreign exchange practices as hamper world trade and the international flow of productive capital." 192 This revision, however, did not require members to refrain from imposing restrictions on capital transfers. Rather, it proposed that members undertake to "abandon, as soon as ... conditions permit, all restrictions (other than those involving capital transfers) over foreign exchange transactions with other member countries, and not to impose any additional restrictions (except on capital transfers) without the approval of the Fund." 193

The Congress and several influential Americans expressed concerns similar to those of Lord Keynes in his proposals and speeches to Parliament. A House Report on the proposed U.S. participation in the International Monetary Fund distinguished between payments for current and capital transactions. Restrictions on the former diverted trade and investment into "uneconomic channels" and were therefore correctly proscribed

189. Id. at 375.
190. 3 THE INTERNATIONAL MONETARY FUND 1945-65, supra note 183, at 63.
191. Id.
192. Id. at 86.
193. Id. at 95.
by the proposed Articles. However, the Report assumed the necessity of some control over payments for capital transactions: "To avoid capital flights, member countries are authorized to control international capital movements, and the Fund may require a member to exercise controls to prevent use of the Fund's resources for large or sustained outflows of capital." At the time of the Conference, interest rates and inflation in the United States were more likely to affect than to be affected by economic events in other countries. The relative monetary independence of the United States during the inter-war period explains much of the readiness of the House Committee to value capital controls primarily as a curb on the disruptive effects of speculation rather than as a tool for the maintenance of domestic monetary autonomy.

The Senate Committee on Banking and Currency heard witnesses who placed control of current transactions "in a different category" from control of capital movements. Some speakers stressed the necessity of the capacity to control capital movements as a means to temper or avoid speculative flows. Others, however, feared that the Article VI, Section 3 provision allowing controls might become an undesirable complication which, by encouraging the exercise of national capital controls, would institutionalize the controls and frustrate the purposes of the IMF.


195. SENATE COMM. ON BANKING AND CURRENCY, HEARINGS ON THE BRETON WOODS AGREEMENT ACT, H.R. 3314, 79th Cong., 1st Sess. 327 (1945) [hereinafter referred to as SENATE HEARINGS] (Statement of J.H. Williams, Dean of the Graduate School of Public Administration, Harvard University).

196. Id., at 207-08 (Statement of Harry D. White, Assistant Secretary of the Treasury).

197. Id., at 276-77 (Statement of M. Palyi, Lecturer at Oxford, University of Chicago, Northwestern University, and the University of Wisconsin, and consulting economist).

See also HOUSE COMM. ON BANKING AND CURRENCY, HEARINGS ON H.R. 2211, 79th Cong., 1st Sess. 839 (1945) (Statement of E. Kemmerer, Emeritus Professor of International Finance, Princeton University) [hereinafter referred to as HOUSE HEARINGS].

198. See SENATE HEARINGS, supra note 195, at 306 (Statement of Allan Sproul, President, Federal Reserve Bank of New York); see also SENATE HEARINGS, supra note 195, at 368-69 (Statement of M.K. Hart, President, National Economic Council, New York).

199. M. Palyi alludes to those consequences in his Statement at the SENATE HEARINGS, supra note 195, especially at 275, 277.
The acceptance by the United States and other countries of the IMF Articles of Agreement, which contained the familiar distinction between payments for current and capital transactions, represents the resolution of many, sometimes conflicting, interests and concerns. In allowing member countries to retain control of international capital movements, the drafters acceded to the demands for domestic autonomy and monetary stability. The resulting agreement compromised the goals of increased trade, increased real income, and lower levels of exchange restriction. Nevertheless, the Articles provided the greatest degree of stability possible, considering the domestic economic necessities perceived by the countries involved.

This compromise, however, has been called into question by recent research on international monetary reform by the Committee of Twenty. National capi-

200. See Press Release, Document No. 508 of the U.N. Monetary and Financial Conference at Bretton Woods (July 21, 1944), reprinted in PROCEEDINGS AND DOCUMENTS, supra note 167, at 1209, 1213. See also Address by Secretary of State Morgenthau, Closing Plenary Session of the Bretton Woods Conference (July 21, 1944), Document No. 522, reprinted in PROCEEDINGS AND DOCUMENTS, supra note 167, at 1224, 1226, declaring that "[t]here must be a reasonably stable standard of international exchange to which all countries can adhere without sacrificing the freedom of action necessary to meet their internal economic problems." The Secretary's later reference to the IMF as a remedy for "unnecessary exchange restrictions" presupposes that, for certain (presumably internal) reasons, some exchange restrictions are necessary.

201. The Committee of Twenty is formally titled: Committee of the Board of Governors on Reform of the International Monetary System and Related Issues. It was established in 1971 to examine alternatives for reform. See M. GARRITSEN DE VRIES, THE INTERNATIONAL MONETARY FUND 1966-1971, at 68, 556, 634 (1976). The Committee included representatives of the major industrial countries and representatives of nine developing countries (each of which, in turn, represented several other developing countries): Argentina, Australia, Belgium, Brazil, Canada, Ethiopia, France, West Germany, India, Indonesia, Iraq, Italy, Japan, Morocco, the Netherlands, Sweden, the United States, the United Kingdom, Venezuela, and Zaire.
tal restrictions, while perhaps effective in curbing smaller disequilibrating flows, do not withstand massive capital flows. Moreover, they may have deleterious side effects on trade,\textsuperscript{202} and thus cause problems for developing countries (see part V, infra).\textsuperscript{203} Therefore the Committee recommended that members not use capital controls, except infrequently and in cooperation with other countries.\textsuperscript{204} Thus the amendment to Article IV declares it an essential purpose of the IMF to "provide a framework that facilitates the exchange of goods, services, and capital among countries...."\textsuperscript{205}

In 1965, the Joint Economic Committee of the United States Congress implicitly acknowledged the counter-productive effects of controls on capital movements. The Committee declared that "[i]t is one of the many ironies and inconsistencies of modern life that, to protect fixed exchange rates—the means—we have compromised freedom of capital movements and, to some extent, the ends which fixed rates were intended to serve."\textsuperscript{206} Recognizing these effects, the United States' negotiators of the Second Amendment stressed the importance of capital mobility,\textsuperscript{207} as did the legislative history to the Congressional approval of the Amendment.\textsuperscript{208}

But, despite the recognition of potential disadvantages to controls on capital movements, many of the...
concerns that influenced the delegates to Bretton Woods still prevail. A study group of the Committee of Twenty, the Technical Group on Disequilibrium Capital Flows, noted in its May 1973 report that

"[t]he Group were confirmed in the view that the possibility of disequilibrium capital flows continuing in future could not be neglected, and that countries should be able to use a variety of measures, including controls, to influence them."

This view derives from the common perception that capital flows had caused members' recent difficulties with both international payment imbalances and disturbances in their domestic economies. Although some economists regard "disequilibrium" capital flows as a persistent problem in the international monetary system, others dispute the view that capital movements are a causal element in international instability and contend, instead, that such movements often are the product of underlying instability.

The concern for disequilibrium flows of capital and the desire for national capital controls predominated among the European countries during the negotiation of the Second Amendment. Thomas D. Willett, a prominent economist and former director of international monetary research at the U.S. Treasury Department, observed that "most major countries are not going to be willing, within the foreseeable future, to give up a great deal of autonomy in macroeconomic policy, whatever might be optimal in strictly economic terms."

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209. IMF, supra note 202, at 84-85.
210. Id. at 78, 79.
211. See, e.g., Cooper, Monetary Theory and Policy in an Open Economy, 78 SCANDINAVIAN J. ECON. 146, 162 (1976); but cf. S.W. Black, Discussant, 78 SCANDINAVIAN J. ECON. 166, 168 (1976) (viewing capital flows not as a source of difficulty but, rather, as essential to the proper functioning of the exchange market).
212. See part V infra.
213. See R. SOLOMON, supra note 4, at 240. Cf. J. GOLD, INTERNATIONAL CAPITAL MOVEMENTS, supra note 22, at 44.
These concerns prevailed and, contrary to the posture of the United States, the Second Amendment preserves the provisions of Articles VII and VI that relate to the differential treatment of current payments and capital movements.

V. An Economic Analysis of Capital Mobility under Fixed and Flexible Exchange Rates: The Major Issues

It is very usual, in nations ignorant of the nature of commerce, to prohibit the exportation of commodities, and to preserve among themselves whatever they think valuable and useful. They do not consider, that, in this prohibition, they act directly contrary to their intention; and that the more is exported of any commodity, the more will be raised at home, of which they themselves will always have the first offer .... The same jealous fear, with regard to money, has also prevailed among several nations; and it required both reason and experience to convince any people, that those prohibitions serve no other purpose than to raise the exchange against them and produce a still greater exportation.

David Hume, Of the Balance of Trade (1752)

That free commerce—in finance as well as in trade—is generally of mutual benefit to the parties involved is a lesson hard-learned. Even the Second Amendment, while affirming a system of flexible exchange rates, which system should eliminate or greatly reduce the need for nationally administered capital controls, permits members to control capital movements. Under flexible exchange rates, freely mobile capital is at least as beneficial as restrictions are costly.

Part V of this article will examine the role of capital mobility in the international economy. Economic analysis not only will elucidate why, under fixed exchange rates, capital mobility limits national monetary

autonomy, but also how capital movements enhance rather than inhibit the effectiveness of monetary policy. Further, the implications of capital mobility for the promotion of world economic welfare will be discussed.

A. The Impact of the International Mobility of Capital on Domestic Economic Policies under Fixed and Flexible Exchange Rates

1. The Exchange Rate Systems and the Model

Adoption of the two exchange rate systems in their pure forms avoids the complications of "limited" flexibility, which is the result of government intervention. Flexible exchange rates, as the term is used in this paper, are determined exclusively by supply and demand in the foreign exchange market. Such a system is free from restrictions on exchange rates and other forms of intervention by national monetary authorities. The international demand and supply for a country's currency is determined by the amount of the currency sought elsewhere for the purchase of that country's exports and for investment in it, and by the amount of the currency provided by its residents through their purchase of imports and through their investment abroad. External changes in the supply and demand


218. The supply and demand for currencies on the international exchange markets is affected by noneconomic as well as economic factors. Political instability, politically motivated trade sanctions (e.g., the oil embargo), and military activities might influence exchange rates. Yet the fundamental determinants continue to be the export, import, and investment demands and the corresponding supplies of goods and capital in the participating economies.
for a country's currency, and incipient trade and capital imbalances, do not result in external disequilibrium (net payments deficits or surpluses) under purely flexible rates, because the rate appreciates or depreciates according to the change. The current exchange rate, by definition, is the equilibrium exchange rate.

In a fixed exchange-rate system such as that established at Bretton Woods, monetary authorities of the participating countries determine "par" values for each currency vis-a-vis the U.S. dollar or gold, and each country binds itself to maintain the foreign value of its currency within a narrow margin of the par value. The governments therefore act as residual buyers and sellers in the foreign exchange market, using gold, other international reserves, and their credit with the IMF to support the par values when trade and capital imbalances bring about external disequilibrium. According to the original Articles, a country could alter the par value of its currency only in the event of a "fundamental disequilibrium" and then only after consultation with the IMF. This limitation compelled countries to favor means other than changes in their exchange rates to compensate for

219. See generally Article IV, First Amendment, supra note 2.
221. See generally Article IV, § 8, and Article V, §§ 3,6,7, First Amendment, supra note 2.
222. External disequilibrium occurs when the foreign disbursements of a country (e.g., payments for imported goods, the transfer of funds abroad for foreign investments, foreign aid and military expenditures) do not equal foreign receipts (e.g., payments for exports, investments by foreigners, repatriation of foreign earnings) at a given exchange rate. The resulting imbalance (net surplus where receipts exceed disbursements, net deficit where disbursements exceed receipts) must be "financed" by inter-country loans, by loans from the IMF, by the depletion of exchange reserves or gold, or by the generation of new international reserves, if the exchange rate is to be held constant, at "par."
223. See Article IV, § 5, First Amendment, supra note 2. Compare Article IV, Second Amendment, supra note 3, in which a variety of exchange arrangements is authorized (both fixed and flexible).
external disequilibria.\textsuperscript{224} Therefore, changes in par
values occurred rarely in the period before 1971.\textsuperscript{225}

The following analysis of the impact of capital
mobility on domestic economic policies relies heavily
on the widely-accepted Mundell-Fleming approach to in-
ternational economics.\textsuperscript{226} This approach assumes a
simple Keynesian model, free of trade barriers. Private
after-tax income and taxes vary directly with national
income; private expenditure varies directly with after-

\textsuperscript{224} See Crockett and Goldstein, Inflation under Fixed and
Such other means of adjustment may include: deflation by deficit
countries, to lower the prices of exported goods and to dampen im-
port demand; "tight" money, to attract foreign capital via higher
interest rates; and controls on capital exports, to curb the out-
flow of capital into various forms of foreign investments. Sur-
plus countries might be encouraged by deficit countries to inflate
their economies so that the price of their exports might be less
competitive and that their demand for imports might increase.

\textsuperscript{225} See generally M. GARRITSEN DE VRIES, THE INTERNATIONAL
MONETARY FUND 1966-1971, Part Five (1976); IMF, ANNUAL REPORTS for
the period 1945-1971; R. SOLOMON, THE INTERNATIONAL MONETARY SYSTEM,
1945-1976, supra note 4, at 30, 166-75, and 339-49.

\textsuperscript{226} See R. MUNDELL, INTERNATIONAL ECONOMICS (1968); Fleming,
Domestic Financial Policies Under Fixed and Floating Exchange
Rates, 9 IMF STAFF PAPERS 369 (1962); Mundell, Capital Mobility and
Stabilization Policy Under Fixed and Flexible Exchange Rates, 29

For a sampling of the articles that have acknowledged ex-
pressly or implicitly the wide acceptance of the Mundell-Fleming
approach, albeit with occasional modification or criticisms, see
S. BLACK, FLOATING EXCHANGE RATES AND NATIONAL ECONOMIC POLICY 27
(1977); E. SCHMIDT, FLEXIBLE EXCHANGE RATES 141 (1969); Argy and
Porter, The Forward Exchange Market and the Effects of Domestic and
External Disturbances Under Alternative Exchange-Rate Systems, 19
IMF STAFF PAPERS 503 (1972); Cooper, Monetary Theory and Policy in
an Open Economy, 78 SCANDINAVIAN J. ECON. 146 (1976); Dornbusch,
Exchange Rate Expectations and Monetary Policy, 6 J. INT'L ECON.
231 (1976).

The writer has relied heavily on the model developed by
J.M. Fleming, and is indebted to him. Any errors in the interpreta-
tion herein are those of the writer.
tax income and inversely with the interest rate. The interest rate varies directly with the ratio of national income to the stock of money (i.e., other things constant, an increase in the money stock or a decrease in national income lowers interest rates and, conversely, a decrease in the money stock or an increase in the national income raises interest rates). The balance of payments comprises both the trade and capital accounts. The balance of trade, equal to exports minus imports, varies directly with the domestic value of foreign exchange (i.e., an appreciation of the domestic currency lowers the domestic value of foreign currency, increases imports relative to exports, and causes the trade balance to decline), and inversely with domestic expenditure, private and public. The capital account balance varies inversely with the interest rate. Unless otherwise noted, capital moves freely in response to interest-rate differentials.

2. The Role of Capital Mobility in Domestic Monetary Policy

Expansionary monetary policy, with a corresponding increase in the domestic stock of money, drives down the interest rate, reduces the velocity of money and stimulates private expenditure. Increased consumption and investment generate increased income, output, and employment. Accordingly, imports increase relative to exports, causing a deterioration in the trade balance. Although the rise in domestic income and investment may moderate the decline in the interest rate, they will not offset it completely (for, otherwise, there would

227. In slightly more technical terms: the interest rate varies directly with the income-velocity of circulation of money. See Fleming, supra note 226, at 369.

228. See id., at 374-76, for a discussion of the effects of capital mobility on certain aspects of the Fleming model.

229. Refer generally to Fleming, supra note 226, from whose article this analysis is in large part adopted.
be no real increase in investment or income). To the extent that the domestic interest rate, as expressed through the medium of the exchange rate, declines relative to the interest rates abroad, capital will flow out of the expanding economy toward higher rates abroad. Thus, a monetary expansion initially tends to cause a deterioration in the balance of payments as a whole, in both the trade and capital accounts, and an increase in domestic expenditure and income.

Under fixed exchange rates, the outflow of capital would continue until the decline of the domestic interest rate were reversed and/or foreign interest rates were forced down, or until the expanding country exhausted its reserves and embarked on other policies.

230. This statement appears tautological. However, it must be true for more than definitional reasons. If, initially, monetary expansion gives rise to investment and income growth, it must be supposed that this new investment will result in efficiencies and, likely, in greater output and employment. The increased economic activity will doubtless exert pressure on the financial capital markets and, in the absence of further expansion, tend to push the interest rate upwards. Yet the real gains in efficiency and employment will be retained, and a portion of the return to labor and capital will flow back into the money market (since the marginal propensity to save increases with income and with the interest rate) to dampen the pressures thereon. See also id. at 373.

231. The outflow of capital that is predicted by the Mundell-Fleming model as a consequence of monetary expansion under fixed exchange rates has been observed and analyzed empirically. See generally Porter, Capital Flows as an Offset to Monetary Policy: The German Experience, 19 IMF STAFF PAPERS 395 (1972); L. Rhomberg, A Model of the Canadian Economy under Fixed and Fluctuating Exchange Rates, 72 J. POL. ECON. 1 (1972).


233. Fleming, supra note 226, at 375, notes that under fixed rates, monetary expansion—with the attendant deterioration in the balance of payments—could not be financed or sustained indefinitely.
The consequent decline in the stock of money, or the decline in its rate of growth, and the upward pressure on domestic interest rates, would tend to offset the gains in income and output contemplated above and frustrate the original expansionary policy. If capital is infinitely mobile and sensitive to interest differentials and foreign and domestic bonds are perfect substitutes, then monetary expansion under fixed exchange rates would result in the importation of foreign bonds in an amount equal to that which investors would have placed in domestic bonds, were capital not mobile. The result would frustrate the intended increase in domestic expenditure and domestic employment; prices and income would remain unchanged. Thus, the greater the mobility of capital under fixed exchange rates, the smaller the impact of monetary policy on domestic real variables, such as income and employment.

This result not unreasonably contributed to the desire for monetary autonomy already described. Thus, while fixed exchange rates prevailed, restrictions on capital movements, permitted by Article VI, Section 3, were regarded as "less harmful" than other measures to attain balance-of-payments equilibrium. And member countries resorted to them with increasing frequency in the mid-to-late 1960's. The United States, for example, enacted the Interest Equalization Tax and the Foreign Credit Restraint Program, discussed below, to control capital outflows and free domestic monetary

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234. See Aliber, Monetary Independence under Floating Exchange Rates, supra note 187, at 369.
235. IMF, SEVENTH ANNUAL REPORT ON EXCHANGE RESTRICTIONS 5 (1956).
237. See pp. 87-96 infra.
In contrast, under flexible exchange rates capital mobility does not limit the effectiveness of domestic monetary policies. Instead, the impact of monetary expansion on income, output, and employment must always be greater where capital is mobile than where it is immobile. To demonstrate this proposition, it is useful to distinguish among the potential effects of an increase in the stock of money on the basis of whether those effects are generated internally or externally.

Now, assume that capital is immobile; an increase in the stock of money does not affect the capital account. Monetary expansion will induce the increase in income and expenditure through the internal media of the interest rate, velocity, and investment expenditure, described at p. 67, supra. Although the increase in expenditure stimulates import demand and causes an incipient deterioration in the trade balance, the expanding country's currency will depreciate to a level at which the trade balance will be maintained. By diminishing the domestic demand for goods and services

238. Cf. G.M. Meier, The Bretton Woods Agreement--25 Years After, 23 STAN. L. REV. 235, 250-55 (1971). Meier explains that the loss of domestic monetary autonomy, through the continued free mobility of capital under fixed exchange rates, was most serious for the United States in the early 1960's. The country then had to restrain the rate of domestic expansion in order to curb the growth of its balance-of-payments deficit. The rate of interest was often maintained at a level higher than that which would have been appropriate for domestic expansion, in an effort to generate an influx of foreign capital and to avoid growth in import demand.

Cf. S. REP, NO. 1267, REASONS FOR THE BILL, 88 Cong., 2d Sess. (1964). See also JOIN ECONOMIC COMMITTEE, SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS, INTERNATIONAL PAYMENTS IMBALANCES, 87th Cong., 1st Sess. 113 (May 16, June 19-21, 1961) (Statement of Mr. E.M. Bernstein) suggesting that, if interest rates "appropriate to the needs of each country induce large capital movements, the way to deal with them is through ..., a reserve settlement account." Mr. Bernstein perceived the potentially complex problems that might arise when countries seek to avoid the impact of capital movements and yet are precluded, by Article IV, supra note 1, from using the Fund Resources to meet a large, sustained outflow of capital. Id. at 110.

See also Polak, International Coordination of Economic Policy, supra note 175, at 171, noting that the greater freedom and willingness of capital to move has reduced the scope of interest-rate policy and of monetary policy in general.

from other countries and by increasing the world demand for the products of the expanding country, this depreciation will shift world demand from imports to the expanding country, toward its exports to such an extent as to exactly offset the initial expansion of import demands that had been generated by the increase in domestic income and expenditure.  

The results of monetary expansion are quite different when the model incorporates the assumptions of the mobility and interest-sensitivity of capital. An increase in the money supply depresses the interest rate and increases domestic income and expenditure through the internal media, as described above. But now, in addition to the increase in import demand and incipient trade deficit, the falling interest rate triggers an incipient outflow of capital and a deterioration of the capital account balance. The capital outflow exerts pressure on the exchange rate beyond that exerted by the incipient trade deficit. Therefore, the currency of the expanding country depreciates to a level below that which would be required to restore the trade balance alone. Further depreciation more than offsets the incipient trade deficit and generates a net trade surplus through an increase in the demand for exports. This increase in demand, generated externally, stimulates domestic output, income, and employment to levels higher than those which a similar expansionary policy would attain under the condition of immobile capital.

Therefore, under flexible exchange rates, the impact of monetary policy on output, income, and employment will increase with the mobility and interest-sensitivity of capital. Indeed, if capital were infinitely mobile and highly sensitive to the interest rate, the outflow of capital would be so great as to cause the exchange rate to depreciate to a level at which the trade balance became so favorable, and income and output so much increased, that the domestic economic activity would raise the interest rate to its pre-expansion level. Domestic income would then increase at the same rate as the stock of money, and not merely at a fraction thereof.  

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240. See Fleming, supra note 226, at 374.
241. Id. at 373-74.
242. Id.
A depreciation caused by an outflow of capital during monetary expansion, though rendering exports more competitive abroad, will not generate a subsequent capital inflow under the Mundell-Fleming analysis. This limitation results from the fact that it is a decline in the interest rate, making domestic financial assets less attractive for investment, that motivates the initial outflow of capital. Therefore, the depreciation will continue until the pressure toward an unfavorable interest differential is effectively eliminated by the exchange rate. Foreign financial assets, then, will cost more per unit of return. At this point, there is no further impetus for the exit of domestic capital, and the depreciation ceases without producing an interest differential that encourages foreign investment in domestic financial assets.

Some recent theoretical studies of the interaction between monetary policy and the exchange markets have suggested that the Mundell-Fleming model might overstate the impact of monetary policy under flexible exchange rates where capital is perfectly mobile.243 Argy and Porter244 incorporate into the model the concept of the expectation of a future or "normal" exchange rate. If monetary expansion were to cause the exchange rate to depreciate to a level below the expected future or "normal" rate, investors would be unlikely to dispose of their capital assets denominated in the depreciating currency, or to invest in capital assets denominated in foreign currencies, for they would anticipate a subsequent appreciation in the exchange rate to its expected or "normal" level. On similar expectations, foreign investors would be likely to invest in financial assets denominated in the depreciating currency, despite a possibly unfavorable interest differential, for they would hope to benefit from the contemplated subsequent appreciation.245 Thus, a country undergoing monetary expansion might experience inflows of capital if its currency were expected to appreciate. Such inflows would moderate, or perhaps offset, the initial depreciation, and thus inhibit the

244. Id., at 512-13.
external stimulus to domestic output, income, and employment and to export demand. This perverse effect could continue only until expectations adjust downward or until the exchange rate appreciates, removing the gap between the actual and expected exchange rate, rendering this phenomenon short-term.

3. The Role of Capital Mobility in Domestic Fiscal Policy

Unlike monetary policy, the mobility of capital does not enhance effects of fiscal policy under flexible exchange rates. Rather, such mobility tends to mute the effectiveness of fiscal policy.

An increase in public expenditure or a reduction in tax rates will result in increased income, consumption, and employment, and tend to increase imports relative to exports. Under fixed exchange rates, the expansion will cause a deficit in the trade balance. Assuming a constant money stock, an increase in national income results in an increase in the interest rate; this, in turn, reduces capital outflows or increases capital inflows, and develops a surplus on the capital account.

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248. This analysis of domestic fiscal policy, like the previous analysis of monetary policy, follows closely the theoretical exposition of J.M. Fleming, supra note 226. Other discussions of the macroeconomic effects of flexible rates may be found in Argy and Porter, supra note 243, at 516; Dornbusch and Krugman, Flexible Exchange Rates in the Short Run, 1976 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 537, 542-51; Laursen and Metzler, Flexible Exchange Rates and the Theory of Employment, 32 REV. ECON. & STATISTICS 281 (1950).

249. Fleming, supra note 226, at 370. To hold the money stock constant in a period of budgetary expansion will require enforced economy in the use of money, which likely will be achieved through higher interest rates.
As the budgetary expansion generates divergent pressures on the current and capital accounts, the net impact on the balance of payments will depend, of course, upon which account is most affected by the expansion.\(^{250}\) A high propensity to import—as, for example, where an increase in income would lead to an increase in energy consumption and to large petroleum imports—would tend to cause a net payments deficit. Conversely, a highly mobile and interest-sensitive supply of capital would tend to cause a net payments surplus.\(^{251}\) Less mobile capital, or the imposition of capital controls, could reduce the need both to hold the money stock constant and to raise the interest rate, depending on the type of control and on the economic circumstances at the time of imposition.\(^{252}\) In theory, at least, when an expansion results in chronic net deficits, the expanding country is constrained to discontinue its fiscal expansion when its foreign exchange reserves approach depletion. But despite this potential constraint imposed by the external balance, the expanding country would realize an increase in national income, consumption, and employment under fixed exchange rates.

However, under flexible exchange rates the initial increases in such variables which fiscal expansion yields might dissipate if capital were highly mobile.

\(^{250}\) Id. at 371.

\(^{251}\) Id.

\(^{252}\) Although controls on the outflow of capital might eliminate or forestall the need for restraint in the money markets, they might also provide a disincentive for the needed inflow of foreign investment in the country imposing the controls. Foreign investors could view the imposition of controls as indicating weakness in the controlled currency and as a factor likely to complicate the expatriation of the proceeds of their investments. Additionally, lack of restraint in the money markets, which would otherwise be limited by international movements of capital, could have inflationary consequences in the expanding economy. (However, there appears to be a very fine line between the monetary liberality necessary to the optimum rate of economic expansion and that which is generative of inflation; cf. E. DESPRES, INTERNATIONAL ECONOMIC REFORM 210 (G. Meier ed. 1973). Another important consideration in the imposition of capital controls is the welfare effect of such a policy, which is likely to be adverse. See part V infra.)
Increased income and consumption produce an increase in import demand, which in turn exerts deficit pressures on the trade balance. If capital is immobile, the exchange rate depreciates to maintain equilibrium in the trade balance; the depreciation shifts demand from imports toward exports until the two are equal, and the expansionary policy operates on income, consumption, and output as though the economy were closed.253 But, if capital is both mobile and interest-sensitive, the increase in interest rates causes an incipient surplus on the capital account. This incipient surplus tends to drive the exchange rate upward and shifts demand from domestic goods (exports) to foreign goods (imports), thereby reducing the initial increases in income, consumption, and employment.254 The greater the mobility and interest-sensitivity of capital the more pronounced the incipient surplus in the capital account, the exchange appreciation, and the consequent muting of the domestic expansion. If capital were infinitely mobile, then the exchange appreciation would be sufficiently large to offset completely the original, and presumably intended, expansion.255

Mr. J.M. Fleming, a leading economist whose approach to international economics is followed closely in this article, has suggested that monetary restraint of sufficient stringency to cause an increase in the interest rate and significant pressures for exchange appreciation seldom accompanies fiscal expansion.256 Normally, fiscal expansion is funded in part by an increase in the stock of money, and capital flows do not interfere (or interfere less) with the desired objectives of increased income, consumption, and employment. Other economists, however, have observed expansionary fiscal policy and monetary restraint to produce the frustrating capital flows in some countries.257 Thus, though it is possible that capital

253. See Dornbusch and Krugman, supra note 248, at 543; Fleming, supra note 226, at 372.
255. Id., at 372.
256. Id., at 372.
257. See id., citing Mr. R. Rhomberg's econometric model of the postwar Canadian economy. supra note 231.
mobility might reduce the effectiveness of domestic fiscal policy under flexible exchange rates, such a result is improbable.

4. The Monetary Model

The recent formulations of a "monetary" or asset-market approach to exchange-rate determination suggest further refinements of the traditional Mundell-Fleming model. A fundamental point distinguishing the Mundell-Fleming and the monetary models is the characterization of capital flows. The traditional model views such flows as responsive to differentials in interest rates or effective yields, without balance-sheet constraints; such flows may continue for the duration of the interest-rate differential. As has been shown, this model utilizes a concept of flow equilibrium, in which the exchange rate moves to balance receipts from exports and capital inflows with payments for exports and capital outflows.

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258. This "monetary" approach, which has been much discussed in the recent economic literature, is to be distinguished from a monetaristic approach, which treats output as given. It is also to be distinguished from the monetary approach which, though dealing with domestic and foreign monetary equilibria, and with the determinants of money demand, does not entertain the concept of asset substitutability. See M.G. Porter, Monetary Versus Portfolio Balance Models of International Economic Adjustment, (unpublished notes for Economics 535 workshop at Yale University, October 31, 1978) (explaining this distinction among "monetary" approaches).

259. See R.N. Cooper, Monetary Theory and Policy in an Open Economy, 78 SCANDINAVIAN J. ECON. 146, 150-51 (1976). "Balance-sheet constraint" refers to the portfolio limitation, in the monetary approach, on the question of capital that is free to flow at any given level of income, interest, wealth, and expectations. That such a limitation is assumed in the monetary model constrains the flow whereas under the more traditional view, no such limitation is imposed: capital is assumed to flow so long as an interest differential endures to stimulate the flow.

260. Id. at 150; see also S.W. BLACK, FLOATING EXCHANGE RATES AND NATIONAL ECONOMIC POLICY 10 (1977).
In contrast, the monetary model defines capital movements as the product of changes in portfolio holdings, which holdings are affected by asset yields and wealth. Capital flows cease when portfolio equilibrium is attained at a given level of wealth and interest rates. The exchange rate, as the relative price of monies, is also the price that equilibrates the international market for financial assets. Therefore, the monetary model not only takes into account the behavior of imports and exports, but also the behavior of the supplies and demands of money and financial assets.

A simple model for demonstrative purposes must disregard some of the assumptions that give rise to interesting, but complex, analyses in the current literature. Consider the basic model of one country in a many-country world. There are three assets available in that country: money, which is a non-earning asset; domestically-issued assets, which are denominated in the home currency; and foreign-issued assets, which are denominated in foreign currency. Wealth consists of the stock of money and the holdings of domestic and foreign assets (the domestic value of which is adjusted by the exchange rate). The portfolio demand for these assets depends on wealth and the rates of return on domestic and foreign assets. An increase in wealth increases the demand for all three assets. The demands for domestic and foreign assets rise as their respective rates of return increase. Demands for domestic and foreign assets, however, respond negatively to changes in the rate of return of the other asset. And the demand for money responds negatively to changes in the rate of return on either domestic or foreign assets. As domestic or effective foreign interest rates grow, investors will shift their portfolio holdings from

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261. R.N. Cooper, supra note 259, at 150.
263. Id.
264. The model used here draws heavily from that which is developed in greater detail in W.H. Branson, Asset Markets and Relative Prices in Exchange Rate Determination (Seminar Paper No. 66, Institute for International Economic Studies, University of Stockholm 1976). Any errors or omissions herein are the responsibility of the writer.
money into the asset on which the return has increased.

With these assumptions, and under a system of flexible exchange rates, an expansionary monetary policy will affect domestic real variables in a fashion similar, but not identical, to that described by the Mundell-Fleming model. An increase in the stock of money, by expanding wealth and depressing the return on domestic assets, will create a portfolio disequilibrium. As domestic investors shift their holdings from money to foreign assets, the domestic currency will depreciate. This initial depreciation will generate a trade surplus and, thus, will stimulate domestic output; if the interest-response of money demand is lower than the interest-response of demand for earning assets, this initial depreciation will be proportionately greater than the increase in the money supply. However, the capital outflow will diminish and cease as domestic investors accumulate stocks of foreign assets and approach the desired equilibrium at the new levels of wealth and interest rates. This temporary trade surplus will decline over time, because the rising demand for domestic assets, generated by increased wealth, will cause the currency to be bid up, though it is not likely to appreciate to its pre-expansion level. Repatriation of the earnings that accrue to the newly accumulated foreign assets may well cause a further, slight appreciation in the currency and a trade deficit equal to the amount of the repatriated flow of earnings.

Thus, the monetary model predicts that monetary policy will have real impact on domestic output and income under flexible rates. However, the portfolio constraint on capital flows, and the long-term appreciation, will reduce the strength and duration of the externally generated demand to a level below that which the traditional model anticipates.


266. See W.H. Branson, supra note 264, at 26-27.

267. Id. at 25 (noting that the extent of the initial depreciation will depend, in a complicated fashion, on the initial proportions of assets in portfolios and on the relative substitutability of the assets).

268. Id. at 27.
Where fixed exchange rates and capital mobility are assumed, however, both models predict similar results from monetary expansion. An increase in the supply of money will have no real impact domestically. This is so in the monetary model because any attempt to increase the money supply over that which is required for portfolio balance will induce offsetting adjustments. Corresponding outflows of capital, though of limited duration, will occur in the amount of the monetary expansion, and frustrate its intended effect.

Some formulations of the monetary model incorporate investor expectations of future exchange rate levels as determinants of the prevailing or "spot" rate. This modification closely resembles that suggested by Argy and Porter (see p. 72 supra). If a depreciation, caused by monetary expansion, generates expectations of a subsequent appreciation in the exchange rate, the real domestic effects of the expansion will be dampened. At the point of a depreciation, such expectations will place a premium on the future exchange which, despite the declining interest rate, will enhance the effective return on domestic assets. Therefore, the portfolio adjustment in favor of foreign assets and the related depreciation will be smaller than would have occurred in the absence of such expectations. Of course, the opposite result would follow if expectations of further depreciation prevailed.

The proposition that an increase in the money stock would raise the domestic price level may complicate further these formulations of the monetary model. The speed and magnitude of the domestic price adjustment may affect the duration of the trade surplus. Clearly, an economy at full employment will experience a more rapid increase in its domestic price level than one in which there is substantial unemployment. But

269. See R.N. Cooper, supra note 259, at 151-52 (citing several studies in support of this proposition).
270. See generally S.W. BLACK, supra note 260; Dornbusch, supra note 226; P.J. Kouri, supra note 262.
271. See S.W. BLACK, supra note 260, at 31-33; Dornbusch, supra note 226, at 268.
273. Id.
a determination of the nature of price adjustment in any particular case would depend on a great variety of factors, the consideration of which is beyond the scope of this paper. Nevertheless, some increase in domestic prices would render the trade surplus generated by monetary expansion smaller and of shorter duration than would be the case were prices held constant. If, over the long term, prices rise in equal proportion to the stock of money, the internal effect of monetary expansion will be nominal, but if the currency initially depreciates proportionately more than the money supply increases (see page 72, supra), it will diminish but not eliminate the trade surplus.274

The monetary model differs most from the Mundell-Fleming model in its treatment of fiscal policy. Assume that expectations of future exchange-rate changes are neutral: investors expect the current rate to prevail indefinitely. A tax-financed increase in government expenditure will raise money income and the interest rate, causing an increase in the demand for imports and a portfolio adjustment in favor of domestic assets. Portfolio-holders will sell off foreign assets, producing an inflow of capital. Due to the portfolio constraints assumed by the model, this inflow must terminate. Therefore the pressure toward appreciation which it generates will endure only in the short term. But, since the portfolio model does not constrain the increased demand for imports, such demand, as well as the consequent pressure toward depreciation, will persist.

Of course, the predominance of either of these divergent pressures in the short term depends on their relative magnitudes and, thus, on the response of import demand to fiscal expansion and on the sensitivity of portfolio-holders to changes in wealth and interest rates. The resolution of these pressures may result in short-term appreciation or depreciation. Then, too, the pressures may cancel, leaving the exchange rate unchanged at a temporary equilibrium level; indeed, the expanding country may experience a trade deficit at this temporary equilibrium rate.275 Even after the portfolio adjustment is completed, however, the increased import demand will probably continue


275. See P.J. Kouri, supra note 262, at 298.
over the long term. Due to this demand, the exchange rate will depreciate gradually and, thereby, restore the trade balance of the expanding country.276

The result here differs significantly from the traditional model, which envisions an appreciation of the currency during fiscal expansion where capital is highly mobile. Here, there is no possibility for currency appreciation,277 for the constraint on the capital inflow, and the simultaneous activity of the trade account, stabilize the exchange rate in the short run. Both the trade deficit that endures until the subsequent depreciation, and its inhibiting effect on the real impact of the fiscal expansion, necessarily must be smaller than that which an initial appreciation of the currency would generate.

An assumption that expectations of future exchange-rate changes are rational further enhances the effectiveness of fiscal policy.278 Under this variation of the model, speculators anticipate the long-run depreciation of the currency. Overcoming their desire to invest in the higher-yield domestic assets, they will adjust their portfolios immediately in favor of foreign assets. This adjustment will cause the currency to depreciate, generating a trade surplus and further stimulating domestic output. The surplus will gradually decrease as the foreign purchasers of goods bid up the currency to its long-run equilibrium level, and the trade account will balance.279

5. Summary

The traditional Mundell-Fleming model yields results that have intuitive appeal for their clarity and for the direct procedure of their derivation. The newer monetary approach does not dispute many of these results.280 Yet the portfolio constraints of the

276. Id. See also S.W. BLACK, supra 260, at 32.
277. Cf. S.W. BLACK, supra note 260, at 32.
279. S.W. BLACK, supra note 260, at 32; cf. P.J. Kouri, supra note 262, at 298.
280. See S.W. BLACK, supra note 260, at 30. See generally R.N. Cooper, supra note 259.
monetary model, and its recognition of the role of expectations, qualify the traditional results. Monetary policy has real effects under flexible exchange rates where capital is mobile, but the real impact of monetary expansion exceeds that which is predicted by the traditional model. And, somewhat contrary to the Mundell-Fleming result, the mobility of capital with appropriate expectations will not hinder fiscal policy at all.

These results strongly favor the free mobility of capital under flexible exchange rates. Whereas under the traditional model the attainment of greater monetary effectiveness, through increased capital mobility, would require forfeiture of fiscal potency, the modified results of the monetary model would not necessitate this sacrifice.

B. The Foreign Impact of Domestic Policies Affected by Capital Mobility

As shown in the preceding subpart A, the efficacy of monetary expansion under flexible exchange rates derives, in large part, from an outflow of capital from the expanding country and a depreciation of its currency. Through the consequent shift in demand, from foreign to domestic goods, capital movements and the related depreciation transmit certain effects of monetary expansion to foreign markets.

However, the foreign impact of monetary expansion contrasts with its domestic impact. A net shift in demand from foreign to domestic goods, other things being equal, requires that foreign output and income must fall. In a two-country model, where one country expands its money supply and becomes a net exporter of goods, the other country must become a net importer, whose purchases of foreign goods are financed by the capital outflow from the expanding country. In short, "Income will rise in the country where the money supply increases and ... income will fall abroad."281 This effect might be mitigated to the extent that the goods imported by the foreign country are productive goods (e.g., capital goods, such as heavy machinery) that are likely to generate a future stream of income

at a relatively lower cost than if the exchange de-precipitation had not occurred. Such mitigation, however, is marginal and cannot offset fully the adverse impact of unilateral monetary expansion on foreign output and income.

In contrast, fiscal expansion, where exchange rates are flexible and capital is mobile, will benefit foreign markets. Such an expansion generates increased import demand which stimulates foreign output and income. When monetary restraint accompanies a fiscal expansion, interest rates rise and a capital surplus develops causing the currency of the expanding country to appreciate. This appreciation will further increase import demand and foreign output and income. Therefore, "under perfect capital mobility, fiscal expansion raises equilibrium income everywhere in the world."²⁸²

A means for the international coordination of economic policy may be necessary if any country is to realize the full benefits of capital mobility and avoid the possibly harmful repercussions from the enforced sharing of the burdens introduced by ill-advised changes in domestic policies.²⁸³ Simultaneous monetary expansion in several countries would enable those countries to enjoy increasing income, output, and employment, without imposing on trading partners reductions in income.²⁸⁴ Ideally, internationally coordinated fiscal and monetary policies would raise world income to a higher level than either policy alone could achieve.²⁸⁵

The United States and most other countries are independent in their choice of domestic economic goals and policies. Yet, if countries were to engage in informal policy negotiations to achieve commonly desired objectives, the world could witness considerable de facto coordination of national policies without its being imposed de jure. The free mobility of capital, by contributing to international financial integration, might also stimulate a coordination of national policies to "manage" the distribution of benefits

²⁸². Id. at 545.
²⁸³. Id. at 547.
²⁸⁴. See id. at 547, 574-75.
²⁸⁵. Id. at 546-47.
C. The Welfare Argument for the Free Mobility of Capital

The welfare argument is perhaps the strongest argument in favor of the free international mobility of capital. Stated simply, the welfare theory holds that, under perfect competition and absent "market failures," freedom of movement of the factors of production yields the most efficient distribution of the world's productive resources. Such a distribution leads to the welfare optimum or the maximization of "gross social return." To avoid the problem of assessing subjective values which may inhere in the concept of gross social return, the welfare optimum is assumed to be identical to the maximization of world income. Much like the theory of international trade, the welfare argument asserts that the free movement of capital is superior to the restricted movement of this

286. For analyses of the phenomenon of international financial integration and coordination of economic policies, see Dornbusch and Krugman, supra note 248; Lutz, Foreign Exchange Rate Policy and European Economic Integration in INTERNATIONAL MONETARY PROBLEMS 107 (F. Machlup, A. Gutowski, & F.A. Lutz, eds. 1972); Polak, International Coordination of Economic Policy, 9 IMF STAFF PAPERS 149 (1962).

287. See Bator, The Anatomy of Market Failure, 72 Q. J. ECON. 351 (1958). "Market failure" is described as "the failure of a more or less ideal system of price-market institutions to sustain 'desirable' activities or to estop 'undesirable' activities." The desirability of an activity is determined by its impact on maximum welfare. Id.


289. C.P. KINDLEBERGER, supra note 288, at 230.

290. Johnson, Theoretical Problems of the International Monetary System, 7 PAKISTAN DEV. REV. 1, reprinted in INTERNATIONAL FINANCE 304, 315 (R.N. Cooper ed. 1969) [hereinafter page references in this article are cited to the reprint]. See also N. FIELDKES, supra note 288, at 5-6.

291. See Bator, supra note 287, at 351 n.2 (explaining the welfare optimum as Paretian efficiency).
For the purpose of this paper, capital is a factor of production. Capital attains its most efficient distribution when the marginal efficiency of investment (the return to capital, or the interest rate) is equal everywhere. To approach the optimally efficient distribution of capital, it must flow to where the return on its application will be greatest until the rate of return on each marginal increment of investment (or disinvestment) converges on a uniform rate. The world economy, however, is not perfectly competitive, and market failures do occur. Additionally, many other factors affect the international movement of capital, such as political and military uncertainty, taxes, and divergent government policies regarding employment, inflation, and other economic variables.

292. The goal in free trade theory is, in the terms of welfare economics, to maximize real income, nationally and internationally. To that end, restricted trade is regarded as superior to no trade, and free trade is regarded as superior to restricted trade. Only the anomalous "optimum" tariff or subsidy, which improves a country's terms of trade without causing a reduction in trade, is superior to free trade. In most circumstances free trade is the objective of international trade negotiation.


293. See N. FIELEKE, supra note 288, at 5. Real capital is one of the factors of production. Financial capital might be viewed as the sublimation of real capital into a more liquid form and as a medium by which real capital is made mobile. Therefore, it is appropriate to regard financial capital as within the meaning of "factor of production."

294. Id.

295. See generally Johnson, supra note 290, especially at 314-19.
The question arises whether the movement of capital in response to these institutional factors necessarily will result in the optimally efficient distribution of capital. For example, where capital movements are motivated by tax considerations, it may be that capital flows from jurisdictions where it is scarce to those where it is abundant, contrary to its most efficient distribution. And, although capital movements in response to monetary expansion tend to equalize interest rates internationally, as described earlier in part V, the market rates may vary from the real returns on the application of capital. Therefore, one must conclude that the free movement of capital, in response either to various institutional factors or to the interest rate, will not always result in the maximization of welfare.

This conclusion alone does not support the imposition of controls or restrictions on capital movements. Such controls must justify themselves by their remedial effects. If it is accepted that certain national policies and their related capital movements create "a serious distortion of the allocation of new real investment resources, and a consequent welfare loss for the countries concerned and the world economy," the best solution would be to alter or suspend the distorting policies. Nevertheless, where this solution is impossible or politically undesirable, other policies, such as capital controls designed to correct the observed distortions, may have to serve. Thus the argument for controlling capital movements rests on the theory of the "second-best."

A further and vitally important question thus arises as to whether controls on capital movements are likely to be remedial in their effects and, hence,

296. See Johnson, supra note 290, at 315.
298. Id. at 231. Kindleberger notes that many economists consider the probability of divergence between market and real returns to be so high as to warrant a presumption against their convergence.
299. See Johnson, supra note 290, at 314.
successful as second-best measures. The impact of the
distorting gloss that various national policies and
other institutional factors cast on the world’s capital
markets is difficult to measure.\footnote{301} While it is true
that policy-makers may attempt to identify the sources
of the distortions of capital distributions, there is
nothing to assure the accuracy of their estimates.
Moreover, there can be no guarantee that they would
discern all—or even most—of the contributing factors
and the interrelationships among them. Nor is there
any certainty that the corrective policies undertaken
would operate as intended. Indeed, there is consider-
able risk that such policies might magnify indirectly
the existing distortions. Or such policies may have
unexpected ramifications and simply alter the locus or
form of the target distortion. A leading economist,
Mr. Harry G. Johnson, has suggested that a fundamental
problem with all second-best arguments is that

...determination of the conditions under
which a second-best policy actually leads
to an improvement of social welfare re-
quires detailed theoretical and empirical
investigation by a first-best economist.
Unfortunately, policy is generally formu-
lated by fourth-best economists and ad-
ministered by third-best economists; it
is therefore very unlikely that a second-
best welfare optimum will result from
policies based on second-best arguments.\footnote{302}

Statements in the legislative history of the
Interest Equalization Tax (IET)\footnote{303} offered a variation
of the second-best argument. Supporters viewed it as
a sort of "optimum tariff" which would improve the
balance of payments (presumably in the amount of the

\footnote{301} See C.P, Kindleberger, supra note 288, at 230-33.
\footnote{302} Johnson, The Efficiency and Welfare Implications of
the International Corporation, in THE INTERNATIONAL CORPORATION,
\footnote{303} Interest Equalization Tax Act, Pub. L. No. 88-563, 78
Stat. 809 (1964) (repealed 1976). Though the IET was not a direct
control on capital movements, the subsequent Foreign Credit Res-
traint Program and Foreign Direct Investment Program did directly
inhibit capital flows from the United States. For the purpose of
illustrating the welfare implications of capital controls, the
tax and these programs are regarded as integral parts of a larger
policy of capital control.
tax) without hindering capital movements. Some might have regarded it as a means to compensate for the divergence between the real and market returns to capital. It would be inaccurate, however, to ascribe such a limited economic purpose to the tax, for the testimony in support of the IET indicates that the legislators' chief concern was to curb capital outflow from the United States. The tax was "designed to aid our balance-of-payments position by restraining the heavy and accelerated demand on our capital market from other industrialized countries." Not only was the second-best argument subordinate to the predominant concern for the capital account deficit, but it was ill-applied. For the IET supported the exchange rate and

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308. The theoretical analysis of the Interest Equalization Tax by Norman Fieleke concludes somewhat tentatively that the tax did not successfully remedy the market imperfections to which some had attributed the heavy outflow of capital from the United States and, hence, that it did not constitute the "second-best" alternative. See N. FIELEKE, supra note 288, at 20. If the high cost of borrowing abroad were due largely to institutional factors, such as issue taxes or "tight" monetary policies, and if the IET had equalized the costs of borrowing and offset the institutional distortions, then the tax might have been a "second-best" measure, actually improving the world distribution of capital. However, if the differences between the United States and Europe in the cost of borrowing were due primarily to differences in efficiency in the respective capital markets and to a higher European demand for capital relative to supply, then the imposition of the tax would disrupt these efficiencies and impose greater costs in both markets; it then would not be justifiable as a second-best alternative. See id. at 9-12.
the domestic policies that allowed the capital outflow
to continue, and it has had adverse welfare effects in
the United States and abroad.

The Interest Equalization Tax applied to certain
securities acquisitions made after July 18, 1963,309
and ceased to apply after June 30, 1974,310 following
several extensions and amendments. It imposed a tax
on "each acquisition by a United States person ... of
stock of a foreign issuer, or of a debt obligation of
a foreign obligor... ."311 The tax was computed on a
sliding scale, increasing with the length of the period
to maturity from 1.05% to 15%, and the legislation as
amended provided the President with authority to adjust
the tax within the range of 0% to 22.5%.312 The IET
excluded several types of securities and debt obliga-
tions that might be construed as current international 
transactions,313 thus avoiding the possible violation
of Article VI, Section 3 and Article VIII, Section
2(a).314 The most important exemptions from the wel-
fare standpoint were the securities of corporations of
less-developed countries, the obligations of less-
developed countries, and the direct investments in
corporations or partnerships 10% or more of which were

310. See Pub. L. No. 93-17, § 2, 87 Stat. 12 (1973);
(codified, as amended, at I.R.C. § 4911(a) (1970)) (repealed
1976).
(codified, as amended, at I.R.C. § 4911(b)(1)(B)(1970)) (repealed
1976); Pub. L. No. 90-59, § 3(a), 81 Stat. 145 (1967) (codified,
(add ed by Pub. L. No. 88-563, 78 Stat. 809 (1964), and repealed by
314. Such exclusion of apparently current transactions was
probably not required by Article VIII, § 2(a), supra note 1, for
the tax was indirect and did not regulate the use of foreign ex-
change as such. See Decision No. 1034--(60/27), supra note 58.
However, the exclusion might indicate a policy preference that
favors free trade over the free movement of capital.
owned by a U.S. investor.\textsuperscript{315}

The Voluntary Foreign Credit Restraint Program augmented the IET when, in 1967, President Johnson announced a set of "guidelines" for banks and nonbank financial business. In 1968 the Foreign Direct Investment Program (FDIP), imposed a more stringent mandatory version of these guidelines.\textsuperscript{316} Under the FDIP, (1) capital outflow plus reinvested earnings were subject to annual limits, (2) a prescribed share of total earnings abroad was required to be repatriated, and (3) a limitation was imposed on the short-term financial assets held abroad by residents, requiring repatriation of the excess.\textsuperscript{317}

Few have attempted to measure the welfare effects of controls on capital movements and interest-equalization taxes.\textsuperscript{318} But those studies that exist provide insight into the effects of such controls on the welfare of the countries involved.


\textsuperscript{317} IMF, \textit{supra} note 316, at 462-63. The IMF Report notes that many other countries maintained or imposed various capital controls during this period; some were designed to discourage the influx of capital and others were to prevent the exit of capital, as appropriate to the countries' respective balance-of-payments positions. Consider especially the controls imposed by Germany, Switzerland, the United Kingdom, and the Netherlands. \textit{See also} IMF, \textit{SEVENTEENTH ANNUAL REPORT ON EXCHANGE RESTRICTIONS} 6, 396, 399, 581-82, 594-95 (1966).

The IET and other successful controls were noted with some approval by the IMF. \textit{See IMF, ANNUAL REPORT} 53-55 (1966).

\textsuperscript{318} Analyses of capital controls and their effects include: A. Cairncross, \textit{CONTROL OF LONG-TERM INTERNATIONAL CAPITAL MOVEMENTS} (1973); N. Fieleke, \textit{supra} note 288; Johnson, \textit{supra} note 290.
From the perspective of the investing, capital-rich country, an enforced limitation on foreign investment, when the return on investment is higher abroad, imposes the obvious loss of the difference between the domestic and foreign rates of return. If the average rate of return on direct investment abroad is relatively high, as it was for U.S. investors in the 1960's, then a steady, non-accelerating outflow of investment capital would not long keep pace with the mounting income from investments. Therefore, although a short-term benefit might result from curbing the outflow of capital and, under fixed exchange rates, deficit pressures would lessen, the long-term loss of income could well outweigh this immediate benefit. The reduced outflow of capital, which would slow economic activity and growth abroad, might have a further adverse impact on the capital-exporting country by restraining the demand for its exported goods. In addition to the real economic loss of investment and trade income, the country that imposes controls on the export of capital may lose the accounting benefit of receiving such income in foreign denominated currencies. Although the IET and the FDIP did not contemplate a serious drop in gross investment abroad (U.S. investors were expected to finance foreign investments in foreign capital markets), there is no way to determine


320. Pisar, supra note 319, at 95. Prior to 1962, direct investment abroad was the type of foreign investment that was most significant as a deficit factor. See Note, The Interest Equalization Tax, 17 STAN. L. REV. 710, 714 (1965). However, somewhat surprisingly, direct investment was expressly exempted from the IET (see I.R.C. § 4915 (1970) (repealed 1976)) but was subsequently included in the Foreign Credit Restraint Program and in the Foreign Direct Investment Program see Pisar, Capital Restraint Programs, supra note 319, at 93.

321. Pisar, supra note 319, at 91.

322. See Office of Foreign Direct Investment, Dep't of Commerce, Regulation of Foreign Direct Investment, in 1 U.S. COMMISSION ON INTERNATIONAL TRADE AND INVESTMENT POLICY, supra note 319, at 114.
to what extent the inconvenience and potentially higher cost of borrowing abroad actually did reduce the gross foreign investment of U.S. residents.323

From the perspective of other capital markets and of borrowing countries, the imposition of controls by capital-exporting countries may have adverse consequences. Prior to the enactment of the IET, Treasury Secretary Dillon acknowledged that the European capital market was less efficient than that of the U.S. and possibly incapable of providing funds in the amounts which would be required by imposition of the capital restraint program.324 Later observers have suggested that the IET might have benefited the European capital market in the long run, both by reducing competition from the highly developed U.S. market, and by forcing it to become more efficient.325 Other economists, however, have held the U.S. capital restraint program largely responsible for the slackening in 1966 of European industrial capital formation and economic growth, and for the narrowing of profit margins.326 The slackening of economic growth follows where the foreign demand for capital, comprised of both U.S. investors forced to borrow abroad and of foreign investors excluded from the U.S. market, combines with the domestic demand to exceed supply of the European market. Such excess demand necessarily results in less domestic investment, and greater exports, of capital. These observations lead to the inference that the European economy could have expanded further had more capital remained available for its domestic use at lower inter-

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323. Even if gross foreign investment were not reduced, the proportion of foreign income available for repatriation to the U.S. would be diminished by the return which must accrue to foreign lenders.


326. E. DESPRES, supra note 319, at 259–60.
est rates. But Europe suffered small discomfort when compared to less-developed countries.

Capital occupies a central position in the theory of economic development. Moreover, those developing

327. Id. Despite a "protected" capital market, high interest rates, and prosperous financiers, it is likely that Europe would have experienced greater real gains in investment, output, and income, had the U.S. not imposed its capital restraint program. The countervailing consideration is, of course, that Europe was enabled to develop a more efficient capital market and to avoid the burden (if indeed a burden it should be) of an even more rapidly growing quantum of "Eurodollars." This in turn helped to strengthen the dollar and to forestall the termination of the "gold standard"; as the dollar was the major reserve currency, its strengthening was of indirect benefit to all participants in the international monetary system. See Note, supra note 320, at 723.

328. In light of the perceived deleterious effects of the IET and the FDIP on the European economy, it is interesting to note the persistent doubt among some European economists that the potential benefit of international integration is as great in the capital market as it is in the goods market. See M. WHITMAN, SUSTAINING THE INTERNATIONAL ECONOMICS SYSTEM: ISSUES FOR U.S. POLICY 36 (1977). This doubt may account in part for the continued distinction, in the Second Amendment to the Articles, supra note 3, between payments for current transactions and capital transfers.

329. The need for foreign capital in developing countries is clear. See generally W.R. CLINE, INTERNATIONAL MONETARY REFORM AND THE DEVELOPING COUNTRIES 20 (1976); C. DIAZ-ALEJANDRO, LESS-DEVELOPED COUNTRIES AND THE POST-1971 INTERNATIONAL FINANCIAL SYSTEM (1975); S.H. KIM, FOREIGN CAPITAL FOR ECONOMIC DEVELOPMENT (1970), especially Chapters 1 and 2; C.P. KINDLEBERGER, ECONOMIC DEVELOPMENT, Chapter 5 (2d ed. 1965); R.F. MIDESELL, PROMOTING UNITED STATES PRIVATE INVESTMENT ABROAD (1957); Kindleberger, U.S. Policy toward Direct Investment with Special Reference to the Less Developed Countries, in 2 U.S. COMMISSION ON INTERNATIONAL TRADE AND INVESTMENT POLICY, supra note 319, at 329-51.

However, the net benefit accruing to the capital-importing (less-developed) country seems to be contingent upon the propriety of the investment and the sensitivity to local economic conditions with which it is administered. See C.P. KINDLEBERGER, supra; WHITMAN, SUSTAINING THE INTERNATIONAL ECONOMIC SYSTEM: ISSUES AND POLICIES, supra note 328, regarding the investment policies and techniques of multinational corporate investors. As to the political and social ill-effects that attend improper negotiations,
countries that are incapable of generating internally the capital which a reasonable rate of economic growth requires need investment capital urgently. The exclusion of less-developed countries from any single capital market shifts the capital demands of such countries to markets that remain open to them. Increased demands upon these markets will raise their interest rates. Consequently the countries will be forced to forgo or curtail economic growth to the extent that they do not obtain needed capital. Any premium paid to foreign lenders in higher interest rates may reduce the portion of earnings that is available for reinvestment in the developing country. 330

Similar consequences, though of lesser magnitude, result from programs like the IET and the FDIP which, while not excluding developing countries from a capital market, do restrict the access of other, developed countries to a particular market. Such restrictive programs cause heavy demand in the unrestricted markets, as described above, and increase the cost of capital.

329. (Continued)

bribes, and mismanagement, see G.P. VERBIT, INTERNATIONAL MONETARY REFORM AND THE DEVELOPING COUNTRIES 19-44 (1975). For a discussion of the less-developed countries' needs for foreign capital for accounting (balance-of-payments) purposes, see generally id. at Chapter 2; C. MICHAPOULOS, FINANCING NEEDS OF DEVELOPING COUNTRIES (1975).

330. The excess of the market interest rate over the rate that would have obtained had the exclusion not occurred might have been reinvested in the developing country or expatriated—according to the business plans of the foreign lenders—if the higher rate were not paid into the foreign capital markets. This, of course, assumes that the developing country has not engaged in retaliatory or compensatory controls on capital outflow. Europe is about 2.5 per cent of the total issue. See N. FIELEKE, supra note 288, at 10. If the investment is in the form of government or private bonds or loans, then not only the interest but also the principal must eventually be expatriated to the foreign bondholder/lender. If the investment is direct (e.g., in physical manufacturing facilities), then the principal is permanently, or nearly permanently, located in the host country, though title may be held abroad. Earnings, or a portion of them, are likely to be expatriated to the foreign owner/investor, but the principal is likely to remain in the host country.
that developing countries can obtain in those markets. Additionally, if the restricted participation of developed countries increases the risk level of the pool of available investments, then the interest rate is likely to rise. The developing countries, though not excluded from the market, would then face a higher cost of capital or more burdensome terms than theretofore. The exemption from the IET of the securities of less-developed countries and the very liberal quotas on direct investments in such countries provided in the FDIP did not offset fully the costs which these programs imposed on some developing countries.

The case of Malaysia illustrates the adverse impact of these capital control measures on the very countries that the exclusions and liberal quotas were designed to protect. In a 1967 memorandum to the Malaysian Economic Planning Unit, Mr. Emile Despres, a prominent international economist, found a serious shortcoming in the external borrowing of the country. Mr. Despres felt that the shortcoming would result in a "marked retardation" of economic growth and per capita real income, and would possibly worsen Malaysia's balance of payments irremediably. These circumstances are "an instructive case study of the injury inflicted on innocent bystanders by the measures, many of them both futile and pernicious, taken by the United States and Britain for balance-of-payments reasons."

In view of the welfare benefits that accrue to all parties from the optimum distribution of capital, and the special importance of foreign capital to developing countries, only the most thorough theoretical and empirical analyses should justify the imposition of controls on capital movements. Such controls should have

331. See Office of Foreign Investment, Dep't of Commerce, Regulation of Foreign Direct Investment, in 1 U.S. COMMISSION ON INTERNATIONAL TRADE AND INVESTMENT POLICY, supra note 319, at 116. The less-developed countries were subject to the "Schedule A" quotas, which from 1968 to 1971 limited the allowable annual investment to 110% of the base period (1965-66) investment.
332. E. DESPRES, supra note 319, at 154.
333. Id. These rather unattractive prospects arose, despite Malaysia's generally well-developed economic infrastructure and other strengths, as a consequence of its need for development capital. See id. at 154-71.
334. Id. at 179.
to meet the presumption that they are distortive of the market and harmful to the world welfare. Where this presumption is overcome and where the suggested analyses are sanctioned by international scrutiny, policies of control might be justified as second-best measures.

D. Capital Mobility and the Transmission and Generation of Inflation

The problem of inflation pervades the economies of the world. Due to the direct link between changes in exchange rates and the international prices of traded goods, much of the recent discussion of the inflation problem has focused on the character of exchange-rate systems. Capital mobility, however, receives only occasional reference, for its influence on price levels is less direct. Capital movements respond to interest rates and wealth, and thus operate first upon the exchange rate and national income, and only indirectly upon price levels. Therefore an analysis of the role of capital mobility in the inflation problem relies upon discussions of the exchange-rate systems.

Many have regarded flexible exchange rates as a means to "bottle up" inflation in the country where it is generated and to insulate the rest of the world from its transmission.335 Other things remaining unchanged, the currency of a country which experiences a higher rate of inflation than the rest of the world depreciates.336 This depreciation offsets the incipient increase in demand for imports and the probable decrease in demand in foreign countries for exports from the inflating country. The relatively higher domestic prices therefore will not affect the price indices of foreign


trading partners, and the inflated currency will not command an inflated purchasing power abroad.337

However, flexible exchange rates may insulate inflation imperfectly in the short run. Some countries may face the transmission of monetary disturbances via capital movements resulting from changes in interest rates.338 Where a country experiencing inflation has an interest rate that is lower or decreasing relative to interest rates elsewhere, capital may flow out of that country and into foreign markets as portfolios adjust. The foreign country, in turn, may experience the symptoms of monetary expansion until the portfolio equilibrium is reached at the new levels of interest and exchange rates. Both the speed of the exchange-rate adjustment and the particular conditions that determine the trade-off between unemployment and inflation in the recipient countries limit the inflationary potential of the capital inflow. But it is important to note that neither the mobility of capital nor the exchange-rate adjustment are the causal factors here. Rather, they are endogenous variables that respond, like the price level, to monetary policy.339 The absence of a causal relationship afflicts most studies that attribute an inflationary bias to a particular exchange-rate regime.

337. Some economists have noted a distinction between "monetary" and "real" disturbances in price levels. They point out that, where disturbances are primarily monetary phenomena (which price disturbances frequently are understood to be—see G. Haberler, Some Currently Suggested Explanations and Cures for Inflation, in INSTITUTIONAL ARRANGEMENTS AND THE INFLATION PROBLEM (K. Brunner & A. Meltzer eds. 1976)), changes in relative price levels can be fully offset by exchange-rate movements. However, where the disturbances are mainly real, such as divergent trends in productivity or consumption of non-renewable resources, relative changes in price levels cannot be offset by exchange-rate changes. See generally Dornbusch, Managed Floating: An Appraisal of the Post Bretton Woods International Financial System, supra note 336; B. Balassa, The Purchasing-Power Parity Doctrine: A Reappraisal, 72 J. POL. ECON. 584 (1964); P. Samuelson, Theoretical Notes on Trade Problems, 46 REV. ECON. & STATISTICS 145 (1964).


This limited potential of flexible rates to transmit inflation in the short run contrasts with the tendency of fixed exchange rates to enforce a "sharing" of the inflation of one country with the rest of the world.\(^{340}\) The capacity of fixed rates to transmit inflation is similar in operation to, but more extended and of greater quantitative impact than, the short-term transmission that flexible rates may effect. Under the system of fixed rates, there is no adjustment in the exchange rate to curb imports or to lower the foreign price of exports. Consequently, inflation spreads to foreign goods markets through the increased import demand of the inflating country and the higher prices of its exported goods. If the inflating country does engage in restrictive monetary policy, thereby raising its interest rates relative to those abroad, an inflow of foreign capital is likely to frustrate its restrictive policy.\(^{341}\) And, if it does not engage in monetary restraint, the interest rate may decline relative to those abroad. Foreign governments will seek to avoid the inflationary impact of the increased import demand by raising their rates and causing a capital outflow from the less-restrained economies. This outflow will aggravate the inflationary demand conditions in the recipient countries.

Flexible exchange rates not only inhibit the transmission of inflation from one country to another (except in the short term), but they also may tend to generate inflation.\(^{342}\) One means by which flexible rates may generate inflation is by increasing uncertainty and instability in the exchange market. Such uncertainty raises the cost to exchange dealers or international traders of "hedging" in the forward exchange market to protect against sudden fluctuations in the exchange rates. These costs, added to the costs of production and distribution,\(^{343}\) cause the prices of consumer goods to increase. Professor Milton Friedman, having anticipated this criticism in his classic essay, The Case For Flexible Exchange Rates, pointed out that


\(^{341}\) See generally part V, A, 2 of this article.

\(^{342}\) See Crockett and Goldstein, *supra* note 224.

\(^{343}\) See id. at 512-13.
"the substitution of flexible for rigid exchange rates changes the form in which uncertainty is manifested; it may not change the extent of uncertainty at all, and, indeed, may even decrease uncertainty."\textsuperscript{344} Thus, even if a system of flexible exchange rates were to increase uncertainty in the foreign exchange markets, it might well decrease uncertainty in the use of fiscal, monetary, and income policies. A flexible system would also discourage the use of large, discrete, and unexpected changes in "par" values of currencies. Whether flexible rates generate inflationary trends therefore will depend, in part, on the net change in the level of certainty which the system affects.\textsuperscript{345}

If, as Professor Friedman has suggested, speculative capital movements under flexible exchange rates are stabilizing rather than destabilizing,\textsuperscript{346} then the high mobility of capital would tend to reduce uncertainty and minimize the inflationary potential of the flexible exchange-rate system. Stabilizing speculation will result because speculators who wrongly anticipate the equilibrium exchange rate will either disappear from the market, or bear a large portion of the costs of traders' "hedging" in the forward market.\textsuperscript{347}

Recent data show some movements in exchange rates which are, by historical standards, large.\textsuperscript{348} However,

\begin{itemize}
  \item \textsuperscript{344} M. Friedman, supra note 217, at 174.
  \item \textsuperscript{345} Crockett and Goldstein, supra note 224, at 513-15. See generally Euromarkets and the International Monetary System (D. Logue, J. Makin & C. Stem eds. 1976).
  \item Alexandre Kafka notes that frequent small changes in exchange rates would probably generate expectations of further frequent changes, and that large infrequent changes in exchange rates would probably generate expectations of further large and infrequent changes. A Kafka, The IMF: The Second Coming? 12 (Princeton Essays in International Finance No. 94, 1977). It seems reasonable to assume that the quantum of uncertainty in the system might actually be greater under the second posited circumstance than under the first.
  \item \textsuperscript{346} M. Friedman, supra note 217, at 175.
  \item \textsuperscript{347} Id.,
\end{itemize}
longer-term studies of flexible exchange rates reveal that the major foreign exchange markets have not been subject to persistent, poorly-behaved speculation.\footnote{349} There is no \textit{a priori} reason to expect the size of exchange-rate changes, in net, to be significantly greater under flexible rates,\footnote{350} nor is there reason to expect capital movements to be more destabilizing under flexible rates. The volatility that does exist in the exchange markets may result from the instability of the underlying international economic environment and the intervention of central banks to "manage" exchange rates.\footnote{351}

Exchange-rate changes that persist long enough to be reflected in price indices result from either underlying conditions (e.g., scarcity of resources) or speculative movements of capital that correctly anticipated such changes.\footnote{352} There is no consensus that speculative movements of capital have been destabilizing,\footnote{353} and much of the evidence indicates that they have not been so. In fact the inflationary consequence of speculative capital movements is likely to be very small relative to the pressures that are generated by underlying economic conditions. Nevertheless, to the extent that speculative capital flows contribute to uncertainty or are destabilizing under flexible exchange rates, they contribute to the generation of inflation.

Flexible rates exert their clearest inflationary impact on the price-level of a depreciating country. Assuming that prices and costs of imported goods are fixed in terms of the supplier's currency, then

depreciation of the importing country's currency will raise the domestic price of imports.\textsuperscript{354} The sale or use of the imported goods in domestic production will affect domestic wholesale and consumer prices as well.\textsuperscript{355} Where monetary expansion accounts for the depreciation, no immediate rise in the price of exports takes place, despite the import price inflation, for the supply prices are determined on the basis of pre-expansion cost\textsuperscript{356} and many are set in commercial contracts and understandings. Although inflexible in the short term, over time the higher supply prices and production costs generated by the import price inflation affect the prices of exports.\textsuperscript{357} This lag in the adjustment of export prices to exchange-rate changes has a dual impact on the deprecating country. It effects an inflationary "squeeze" by raising the price of imports more rapidly than the price of exports and it gives the country a competitive advantage on foreign markets for the duration of the lag in export price inflation.\textsuperscript{358}

Where currency depreciations are frequent, the deprecating country may face an upward-ratcheting price index.\textsuperscript{359} Some economists have suggested that the deprecating country will bear the \textit{full burden} of the price adjustment. Their prediction rests on the assumption that the prices in countries with stable or appreciating currencies will not decline in response to the relatively lower prices of imports to those countries.\textsuperscript{360} However, this assumption conflicts with re-

\begin{itemize}
\item \textsuperscript{354} Dornbusch and Krugman, \textit{supra} note 248, at 558-60.
\item \textsuperscript{355} \textit{See id.} at 568-75; R. Dornbusch, \textit{supra} note 336, at 24.
\item \textsuperscript{356} R. Dornbusch, \textit{supra} note 336, at 11.
\item \textsuperscript{357} \textit{Id.} at 14-16. Dornbusch notes that the lag time in price adjustment for currency depreciation may be as much as two years, though the long-term elasticity of prices with respect to exchange-rate changes is quite high.
\item \textsuperscript{358} \textit{See id.}
\item \textsuperscript{359} \textit{See generally id.}; Crockett and Goldstein, \textit{supra} note 224, at 525-30. As to world inflation, however, the size and frequency of exchange-rate changes, though generating an upward bias in prices, does not correlate with the magnitude of price increases. Perhaps a more important element in world inflation is the size of the \textit{economy} most affected by a particular change in exchange rates, and the random occurrence of shortage and surplus.
\item \textsuperscript{360} Crockett and Goldstein, \textit{supra} note 224, at 523-24.
\end{itemize}
cent data which show that appreciation does reduce im-
port price inflation and, indeed, may render it nega-
tive.361 Such data would indicate that the lower
prices in the appreciating countries affect the price
of imports to the devaluing countries, and partially
help to offset the inflationary impact of deprecia-
tion.362 Therefore, although the depreciating country
experiences inflation of domestic prices, downward price
adjustments in other countries will moderate the infla-
tion.

In summary, it appears that the inflationary impact
of increased capital mobility under flexible exchange
rates is small, if it exists at all. There is no
causal relationship between capital mobility and in-
flation, except to the extent that such mobility
generates destabilizing speculation or exchange-rate
volatility and, thus, increases the cost of market un-
certainty, but even this relationship may be doubted.
Flexible rates tend to insulate countries from foreign
inflation, though countries with a depreciating curren-
cy will experience an increase in the price of imports,
to which capital mobility may contribute indirectly.
Nevertheless, most inflationary pressures flow from
underlying economic conditions that are independent of
the mobility of capital.

VI. Conclusion

The Articles of Agreement of the International
Monetary Fund prohibit members from restricting or un-
duly delaying payments and transfers for current inter-
national transactions. This provision is meant to
further the purposes of the IMF: to facilitate the ex-
pansion and balanced growth of international trade, to
promote high levels of employment and real income, and
to develop the productive resources of all members.

The Articles give great latitude to members to
restrict and control capital movements for any purpose.
In providing this latitude the original drafters
responded to the desire for domestic monetary autonomy
under fixed exchange rates, the fear of destabilizing
speculative movements of capital, and the need to

362. See Crocket and Goldstein, supra note 224, at 524.
preserve a tool for regulating the external balance of the capital account.

The concerns of the drafters at Bretton Woods prevail today. As a consequence, although the Second Amendment to the Articles affirms a system of flexible exchange rates, it retains the distinction between current payments and capital movements. Hortatory terms remind members of an "essential purpose" of the IMF: to facilitate the free exchange of capital. But countries remain free to use any means to control capital movements that does not unduly restrict current payments or the settlement of commitments. Private parties have brought members' restrictions on capital and/or current payments before the courts of various countries. These private actions are based on a provision of the Articles that requires the courts of any member to hold unenforceable exchange contracts that are contrary to the exchange regulations of any other member when those regulations are consistent with the Articles. Generally, courts are not to recognize other members' regulations which either restrict payments for current transactions or unduly delay the settlement of commitments. However, regulations restricting or controlling payments for purely capital transactions are to be recognized and contracts contrary to such regulations are to be held unenforceable.

Occasionally, where the capital nature of a transaction was evident, the courts have upheld members' controls affecting the transaction and correctly refused to enforce contracts that contravened the members' controls. These cases involved agreements for the exchange of currencies or the assignment of equity interests. However, in numerous cases where a transaction possessed both current and capital characteristics, the courts have failed to analyze these economic attributes to determine the consistency of exchange controls that affect the transaction. Rather, the courts have assumed incorrectly that the controls were consistent with the Articles. The finding of a consistent exchange control would seem to compel the courts to hold unenforceable those exchange contracts that are contrary to the controls. But, in their desire to avoid unjust results, the courts have fashioned remedies on other grounds, such as territorial limitation of the control, quasi-delictual liability, and a narrow reading of "exchange contract."
These cases reveal that the courts frequently have arrived at the "right" result by the "wrong" reasoning. Judicial reluctance to apply economic analyses has perhaps prevented diplomatic affront to the countries whose arguably inconsistent controls were litigated. However, the noneconomic approach has produced an incoherent body of case law and it has failed, in the difficult cases, to provide adequate protection to payments that are in substance current transactions. Clearly, the courts should find such regulations, which restrict what are actually current payments, to be inconsistent with the Articles. Where exchange contracts contravene such inconsistent regulations, the courts of members need not hold these contracts unenforceable under the Articles. In upholding the contracts the courts then could provide the desired relief more directly, and by disregarding the inconsistent regulations they would call attention to members' failures to abide by the Articles.

To be sure, the economic consequence of a more rigorous economic analysis in the cases would be slight indeed. Many of the significant exchange controls are indisputably within the present power of members to impose, and parties seldom undertake transactions involving payments that contravene these controls.

A more effective measure would be to afford capital movements the same degree of protection from which payments for current international transactions now benefit. This would relieve the courts of a distinction which they are ill-equipped to make, avoid the possibility of diplomatic affront, and free the economically significant payments and capital movements from restrictive controls.

This proposition is well-founded in economics. The recent advent of flexible exchange rates has negated or diluted the validity of the historical concerns upon

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which the original distinction between current and capital payments rested. No longer should the mobility of capital limit the effectiveness of domestic monetary policy. To the contrary, capital movements in response to changes in the interest rate enhance the impact of monetary expansion on domestic income, output, and employment; the greater and mobility of capital, the greater the effectiveness of monetary policy under flexible exchange rates.

Increased mobility of capital, however, and the consequently greater monetary effectiveness, entails some costs. The traditional Mundell-Fleming model predicts that the high mobility of capital under flexible exchange rates will cause fiscal policy to be less effective on domestic real variables, where fiscal expansion is accompanied by monetary restraint. This phenomenon would tend to shift the locus of economic control from fiscal policy-makers toward monetary policy-makers. However, a newly developed "monetary" model indicates that capital mobility will not greatly inhibit the effectiveness of fiscal policy, especially where expectations of future exchange-rate changes are rational. The improbability that greater capital mobility would seriously curb fiscal effectiveness, and the potential benefit of stronger monetary policy, are considerations that warrant a reduction in national restrictions on capital movements. Even if fiscal effectiveness were compromised, a shift in the locus of economic control toward monetary policy-makers would not be wholly disadvantageous. For monetary policy is the more flexible economic tool and--to the extent that it is the Governors of the Federal Reserve who formulate policy--it is less likely to be affected by transient changes in the political temperament than is fiscal policy developed largely by the Congress and the Executive Branch.

Another cost of flexible exchange rates and increased capital mobility lies in their potentially inflationary impact. If flexible rates and speculative movements of capital tend to destabilize the exchange markets and to increase market uncertainty, the commercial costs of such uncertainty would emerge in inflated consumer prices. However, there is no evidence that speculative capital movements are destabilizing; nor is there evidence to show that flexible rates and exchange uncertainty result in a net increase in uncertainty. On the contrary, speculation may have a stabilizing effect, and
flexible rates may reduce the exchange dealers' fear of large, sudden rate adjustments and disadvantageous national economic policies designed to remedy payments imbalances. Flexible rates and capital mobility may actually decrease the level of uncertainty in international commerce, with the remaining uncertainty due in part to heavy governmental intervention in the exchange markets and instability in the underlying economic environment. Therefore, inflation from the costs of increased uncertainty cannot conclusively be attributed to flexible rates or to capital mobility.

Depreciation of a country's currency generates a once-and-for-all increase in the price of imports. To the extent that imports are not reduced, consumer prices in that country rise. Over time, the price levels in other countries adjust downward, reflecting the less expensive exports purchased from the depreciating country. Because the depreciation operates directly on the price level, speculative and other movements of capital have no immediate impact on this sort of inflation. Yet capital flows are implicated, for under flexible exchange rates the most effective expansionary monetary policy is that which causes the largest outflow of capital and, thereby, the greatest exchange depreciation. This depreciation stimulates export demand and domestic income, output, and employment. Hence, the benefit of more effective monetary policy must be weighed against the cost of occasional increases in the domestic price level that accompany exchange depreciation and movements of capital.

Exchange depreciation almost certainly curbs imports and shifts world demand toward the relatively cheaper domestic goods. It is unlikely, therefore, that the impact on the domestic price level of a depreciation will be so great as to offset completely the gains in income and output that are obtained through the expansion and attendant depreciation. However, where an economy depends heavily on imports for which there is no adequate domestic substitute—e.g., the U.S. demand for foreign oil—depreciation may have more serious inflationary consequences.

The most compelling argument for increased mobility of capital is the welfare argument. The encouragement of world economic growth calls for the most efficient distribution of the factors of production. Capital, one such factor, should be applied where the return on its
application is greatest. Failure to achieve such a
distribution retards economic development in capital-
poor countries, and lowers return on capital invest-
ments by capital-rich countries. Various economic
policies, tax laws, concern for national security, and
other factors on which investment decisions often de-
pend may create distortions in domestic and interna-
tional markets for capital. Such distortions, how-
ever, cannot be so accurately perceived as to permit
much success in compensating policies. The Interest
Equalization Tax and the Foreign Direct Investment
Program were considered by some to be remedial measures
to equalize the costs of borrowing in the U.S. and
abroad, yet these measures might well have had the
effect of further aggravating the inefficient distri-
bution of capital, especially for capital-importing
countries.

The predominant considerations, then, favor greater
capital mobility. To this end, the Articles of Agree-
ment of the International Monetary Fund should be amend-
ed to remove the present distinction between current
payments and capital movements. This would prohibit
members from restricting capital movements, as they are
prohibited from restricting current payments, except
where the Fund approves such restrictions. Such an
amendment would reduce the incidence of restrictions on
capital movements while retaining a means to control
such movements should they genuinely disrupt the inter-
national monetary system. Necessary controls would be
subject to the scrutiny and approval of the IMF, all of
whose members have an interest in assuring the proper
administration of such controls. Additionally, this
limitation on the capacity of members to restrict
capital movements, and the international scrutiny to
which permitted controls would be subject, might pro-
vide an incentive for greater coordination of national
economic policies and the realization of the full bene-
fits of capital mobility.

The proposed amendment thus would relieve the courts
of the necessity to rationalize economic distinctions
between current transactions and capital movements. By
affording the same protections to capital movements as
are currently applied in aid of current transactions,
the amendment would greatly enhance the mobility of
capital among member nations. This would result in a
more efficient world allocation of capital, increasing
capital flow to capital-importing countries and raising
returns on capital to capital-exporting countries,
thereby significantly enhancing world economic welfare. Finally, the increased mobility of capital that would result from the amendment would make capital flows more responsive to domestic monetary policy and contribute to greater economic self-determination for member nations.