

BARRIERS TO INVESTMENT ABROAD AS TOOLS OF PAYMENTS POLICY

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For the past four years, the United States has used restrictions on the outflow of capital for the purpose of correcting the deficit in the U.S. payments balance. Clearly, such restrictions violate the principle of freedom for international commerce—including investment—on which U.S. international economic policies are generally based. Hence, their application can be explained—and justified—only by assuming that, in the specific situations in which the United States found itself in the 1960s, such restrictions were a lesser evil than other available tools of payments policy.

This paper discusses, first, the conditions under which barriers to investment abroad may be considered to be efficient policy tools; second, the effects such barriers are likely to have on the payments balance and on the domestic economies of the investing country and of the rest of the world; third, some political and administrative problems posed by such barriers; and finally, the conclusions to be drawn from the analysis for the payments policies of the United States and of other countries.

I

BARRIERS TO INVESTMENT AS EFFICIENT POLICY TOOLS

As Mr. Solomon's paper in this symposium points out,¹ there are two, and only two, ways in which a country can reduce its payments deficit: first, by increasing receipts more than expenditures; and, second, by reducing expenditures more than receipts. Whenever applicable, the first method is clearly preferable to the second since the first involves an expansion and the second a contraction of economic activity. Unfortunately, however, the first method is applicable by itself only when the economy of the deficit country has unemployed resources; in the absence of unemployment, any attempt at expansion leads to inflationary pressures rather than to a rise in "real" economic activity, and thus to an aggravation rather than to a correction of the payments deficit.

The "classical" method of correcting a payments deficit the expansionary way is currency depreciation. This method makes domestic goods cheaper abroad and foreign goods more expensive at home; hence, the exports of the deficit country tend to be stimulated and its imports reduced. But if the deficit country has no unemployed resources available, its export industries cannot expand to meet the

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¹ Solomon, *Foreign Investment Controls: Policy and Response*, in this symposium, p. 118.

increased demand of foreigners, and its import-competing industries cannot expand to meet the increased demand from domestic residents, except by trying to bid away factors of production already employed in the rest of the economy. These bids inevitably raise prices and costs throughout the economy and therefore counteract the effect of depreciation on the international competitive position of export and import-competing industries. In this case, depreciation alone cannot solve the country's payments problem but needs to be either replaced by, or at least combined with, restrictive domestic fiscal and monetary policies: a reduction in domestic purchasing power is necessary to permit the transfer of resources from the rest of the economy to the export and import-competing industries without a rise in prices and costs.

In contrast, the restrictive method alone is applicable only when the economy of the deficit country is at least fully employed. In this case, a reduction in domestic disposable income and/or liquidity, say, by means of an increase in taxes and/or a reduction in the availability of credit, will not only reduce the demand for imports along with the demand for domestic products but will also set free resources hitherto employed in production for domestic use so that they become available for increased production for export. But if domestic resources already are unemployed, the very existence of the payments deficit indicates that idle resources are not being shifted to export or to import-competing industries—apparently because these industries are not internationally competitive at existing exchange rates. Hence, further reductions in domestic demand would merely aggravate domestic unemployment but fail to correct the payments deficit. In this case, the appropriate policy is currency depreciation, which would simultaneously lead to an improvement in the payments balance and to fuller domestic employment.

Hence, the two basic types of payments policies are not alternatives that may be used in all possible situations according to the subjective preference of the policy maker; instead, each of them is applicable only in a specific situation. Whenever the payments deficit coexists with full or overfull employment, restrictive fiscal and monetary policies are inescapable—although they may need to be associated with currency depreciation if it appears, when domestic excess demand is removed, that domestic industries are internationally noncompetitive at existing exchange rates. Whenever the payments deficit coexists with underemployment, currency depreciation is the appropriate remedy—although again it may need to be associated with restrictive monetary and fiscal policies if the additional foreign and domestic demand stimulated by the depreciation exceeds the availability of previously unemployed resources. Thus, if the domestic economy of the deficit country is in precarious equilibrium—so that restrictive fiscal and monetary policies alone would lead to domestic unemployment but depreciation alone to domestic overfull employment—the simultaneous use of restrictive fiscal and monetary measures and of currency depreciation will generally be unavoidable. A good example of such a situation has been provided by the plight of Britain during the recent sterling crisis.

This clear-cut scheme cannot, unfortunately, be applied to the United States without modification. As long as the U.S. dollar is the world's main (if not only) international currency, the United States must forego the use of currency depreciation even though it finds itself in a situation in which this tool would be appropriate for any other country.

As some eminent experts still fail to realize the difference between a depreciation of the dollar (by whatever name—flexibility of exchange rates, widening of exchange rate margins, or institution of a “sliding par”—it may be called) and the depreciation of any other currency (including the pound sterling), the three reasons for the unique position of the dollar need to be briefly reviewed.

First, depreciation of the dollar would transfer purchasing power from dollar creditors to dollar debtors in amounts so much larger than those involved in the depreciation of any other currency that the difference becomes one of kind rather than degree. Foreigners hold not only more than \$40 billion in dollar claims on U.S. residents (short- and long-term claims reported by banks and other concerns as well as dollar-denominated bonds) but also dollar claims on other foreigners including perhaps \$20 billion in Euro-dollar balances and uncounted billions in dollar-denominated credits and securities. U.S. residents in turn hold about \$25 billion in claims on foreigners (claims reported by banks and other concerns as well as dollar bonds, *not* counting the claims of the U.S. Government resulting from credit assistance to foreign countries). Altogether, therefore, international obligations denominated in dollars may not be far from the \$100 billion mark. Even a “small” depreciation would thus lead to a sudden shift in purchasing power equivalent to billions of dollars not merely between U.S. and foreign residents but also, in view of the large amount of third-country dollar obligations, among foreign individuals and nations.

Second, depreciation of the dollar would inevitably cause deep uncertainty in the financial and commercial community throughout the world—a state of mind that would induce many if not most holders of dollar assets to try to dispose of them as fast as possible. Even if foreign central banks were willing to undertake unprecedented stabilization operations, they would risk not only serious inflation by converting up to \$20 billion of privately held dollar assets into their domestic liquid funds; but also, in spite of their efforts, chaos on exchange as well as on securities markets all over the world.

And, third, even if these blows were successfully parried, there would remain the obvious risk lest foreigners decide no longer to accept dollars in settlement of international transactions. Such a decision would threaten the collapse of international commerce—much, if not most, of which is invoiced and financed in dollars—even more certainly than the devaluation of sterling did in 1931; then, the dollar was, after all, ready to take over the international function of sterling; today, no other currency could possibly fulfill the international function of the dollar.

True, these consequences would—at least initially—hit foreign countries harder than the United States, which is less dependent on international commerce than any other major nation. But exactly for this reason foreign countries are extremely unlikely to permit the United States to act in such a way. Most if not all of them would try to maintain the dollar exchange relationship of their currency at the present rate; and if the United States acted to thwart such moves—which obviously would prevent the attempted dollar depreciation from correcting the U.S. payments deficit—by letting the dollar rate freely fluctuate in exchange markets, the additional uncertainty created by the resulting fluctuations could well give the *coup de grace* to international commerce and especially to long-term international investment.

Those experts who insist that the probability of such catastrophic consequences is not as high as the author believes should realize that even if the odds were slightly against a complete collapse of the world economy, the risk would be out of proportion to the benefit to be derived from the potential reduction in the U.S. payments deficit. And those experts who recommend that the risk of collapse be minimized by a gold value guarantee of foreign-held dollar balances should remember that in this case a depreciation of the dollar by as little as five per cent would reduce the net international liquidity of the United States by \$2 billion, or about as much as the average annual U.S. payments deficit over the past few years.

This digression is necessary because the risk involved in any dollar depreciation is the rationale of U.S. restrictions on capital outflows. If it were not for that risk, the United States—like all other countries—should let its currency depreciate whenever a large and persistent payments deficit coexists with domestic unemployment; only if the risk is conceded does it become necessary for the United States to seek a substitute for depreciation.

Like depreciation, barriers to capital outflow are an expansionary tool of payments policy. Like depreciation, they switch expenditures from foreign to domestic recipients—the only difference being that these expenditures are connected with international capital rather than current transactions.

Effective barriers to capital outflow mean that capital owners are induced or compelled to reduce the placement of their funds in foreign investments. It is extremely unlikely that the owners will let these funds lie idle if they cannot place them abroad; it seems far more likely that they will instead make the funds available for domestic investments, thus adding to total effective domestic demand.² Hence, like depreciation, effective barriers to capital outflow tend initially both to reduce the country's payments deficit and to stimulate its domestic economy. And therefore, like depreciation, the method is applicable only when the payments deficit coexists with domestic unemployment and the added effective demand can therefore be met by putting idle resources to work.

² Needless to say, the same result would obtain in the unlikely case of capital owners using those funds instead for additional consumption.

If there is no domestic unemployment, such barriers, again like depreciation, would merely mean that the additional demand competes for resources already employed and therefore tends to raise prices and costs. Hence, the improvement in the payments balance on capital account would be offset, in part or entirely or more than entirely, by a deterioration on current account, due to the impaired international competitiveness of domestic export and import-competing industries.

This expansionary character makes barriers to capital outflow as unsuitable as depreciation for a country suffering simultaneously from payments deficit and overfull employment. And it means that in all cases in which depreciation would be effective only in association with restrictive domestic monetary and fiscal policies, barriers to capital outflow also will need to be associated with such restrictive domestic policies.

Finally, the tool is obviously applicable only in a country whose capital outflow is large enough to influence decisively its payments balance. This fact alone makes the tool useless for most countries other than the United States—even apart from the fact that it would be unnecessary for any country that is at liberty to let its currency depreciate.

II

ECONOMIC EFFECTS OF BARRIERS TO INVESTMENT

Even when barriers to the outflow of investment funds are in principle appropriate tools of the payments policy of a reserve center that suffers simultaneously from a payments deficit and from domestic underemployment, they have—like all restrictions on economic freedom—adverse effects on the payments balance and on the economies of the reserve center itself and of the rest of the world.

A. Effects on the Payments Balance of the Deficit Country

Since all items of a country's payments balance are interrelated, a change in any one item will bring about changes in others, and at least some of these changes will have effects opposite to those of the original change. For this reason, a curtailment of the outflow of investment funds is unlikely to reduce the payments deficit by the full amount of the curtailment. Even if all possible precautions are taken to exempt from the restrictions those capital flows that are directly financing exports of goods and services, it will be impossible to prevent the restrictions from indirectly affecting the country's exports.

The inflow of capital funds generally raises total purchasing power in the recipient country, both in the short and in the long run, and to some varying but never completely negligible degree this rise will be reflected in an increased demand for imports, including imports from the investing country. This effect is likely to be the greater the larger the share of the capital inflow in the recipient country's total purchasing power; and the impact on the exports of the investing country is

likely to be the greater the larger the share of purchases from the investing country in the recipient country's total imports. For this reason, curtailing the outflow of U.S. capital to capital-poor, less developed nations, or to countries with large imports from the United States (such as Canada), will result in a sharper decline in U.S. exports than curtailing the outflow to capital-rich, fully developed countries with small proportions of imports from the United States (such as the industrial countries of continental Western Europe, which purchase barely ten per cent of their imports from the United States).

Moreover, the curtailment of U.S. capital outflows would lead to a particularly large reduction in U.S. exports if the government of the recipient country were compelled actively to restrict imports—by financial measures or “direct” controls—because of the decline in its dollar receipts. Many less developed countries are permanently in a precarious dollar position: hence, this consideration, too, makes U.S. exports particularly sensitive to a curtailment of U.S. capital flows to such countries. In fact, the situation could become grotesque if the curtailment of private capital outflows were to induce the U.S. Government to increase the outflow of public assistance funds in order to save the recipient country from a disastrous dollar shortage.

In the longer run, further adverse side effects are likely to be felt; but these side effects may in turn be offset, in part or completely, by some long-run beneficial effects of a curtailment of capital outflows.

Lower outflows of investment funds necessarily mean lower future inflows of capital income. The magnitude of these offsets probably varies greatly from industry to industry and from country to country. In view of the uncertain economic and political conditions in most less developed countries, U.S. concerns will try to recoup their investments in such countries faster than those in developed countries.

Generally, however, the discounted value of future receipts will, on balance, be lower than the present value of the outflow giving rise to those receipts: the present value of outflowing investment funds is rationally based on the expected *total* return from the investment in question; the discounted value of future receipts, however, must be based only on those sums that will actually be remitted to the investing concern, excluding those parts of the earnings that are to be reinvested in the recipient country (or in third countries). Here again there is a great difference between returns on investments in less developed and in fully developed countries. In 1967, for instance, U.S. investors reinvested abroad \$1,106 million out of \$2,760 million earned in foreign fully developed countries (Europe, Canada, Japan, Oceania), or forty per cent; but reinvested only \$304 million out of \$3,041 million earned in less developed countries, or ten per cent.

Moreover, the rate of return is (for obvious reasons) much lower for direct investments in foreign fully developed than in less developed countries. At the end

of 1967, U.S. direct investments in Canada and Western Europe³ were valued at \$36 billion; those in the rest of the world (excluding ships under flags of convenience) at \$21 billion. But total earnings from direct investments in Canada and Western Europe amounted to \$2,466 million or less than seven per cent; from those in the rest of the world amounted to \$3,334 million or nearly sixteen per cent.

Almost needless to say, the often-heard argument that remitted earnings from U.S. direct investments abroad have recently been larger than net outflows of new investment funds has no bearing on the matter. Investment income would usually continue even in the absence of new investments; and the rise in such income is only a small fraction of outflows (either in the year under consideration or in the previous year): in 1967, U.S. net income from direct investment was only \$473 million larger than in 1966, as compared with an outflow of investment funds amounting to \$3,623 million in 1966 and to \$3,020 million in 1967.⁴

But in contrast to the adverse effects so far discussed, curtailment of outflows of investment funds may also have long-run beneficial effects on the payments balance of the investing country. The trade balance of that country will be spared some deterioration whenever investment funds, if not prevented from flowing out, would have financed the establishment of a plant abroad the output of which would have competed with exports from the investing country. Such an effect is practically inevitable in the usual case in which the direct investment has the purpose of making available to the foreign country new products, or new techniques for producing old products, previously available only through imports from the investing country. But the effect becomes particularly strong if the newly established foreign subsidiary becomes able to compete with U.S. products not only in the markets of the recipient country but also in third markets and even in the United States itself.

It is extremely difficult to make quantitative assessments of these effects. We can never know for sure whether a plant newly established abroad by a U.S. concern might merely have taken the place of a plant owned and financed by foreigners that would have been established in the absence of the U.S. investment. Would some German (or other foreign) concern have produced, and exported to the United States, the cars actually produced and exported by the German subsidiaries of General Motors and Ford, or would the U.S. public instead have purchased more U.S. made cars? No statistical wizardry can give reliable answers to these questions.

But again, the adverse effect on U.S. exports to third countries and on U.S. imports seems likely to be far greater in the case of the establishment of U.S. subsidiaries in foreign fully developed than in less developed countries. And in view of the irrational but almost universal practice of less developed countries to impede

³No breakdown is available for Japan and Oceania.

⁴All the figures are taken from U.S. DEP'T OF COMMERCE, SURVEY OF CURRENT BUSINESS, Oct. 1968, at 22, 25.

the importation of consumer goods other than necessities in favor of domestic production, no matter how uneconomical, the substitution of locally produced goods for imports from the United States, too, is probably more important in foreign developed than in less developed countries—which would often prohibit the importation even if U.S. concerns were not willing to produce the goods locally.

Thus, despite the absence of reliable statistical data, it seems clear that in general curtailment of capital flows from the United States to foreign developed countries is more likely to reduce the U.S. payments deficit than the curtailment of such flows to less developed countries.

B. Effects on Domestic Economies

The domestic economic effects of barriers to investment abroad are usually more adverse in the prospective recipient countries than in the investing country. Capital tends to flow generally from a country in which it is less productive to one in which it is more productive. Hence, while barriers to such outflow merely reduce the profitability of investment for capital owners in the investing country, they reduce the total level of investment and hence of economic activity in the prospective recipient country. The adverse effect will clearly be the greater the smaller the supply of capital in the recipient country. Hence, the effect will again be greater in a less developed than in a fully developed country.

There are instances, however, in which—as mentioned in Mr. Solomon's paper⁵—the flow of capital does not correspond to a productivity differential. This may happen, for instance, if capital flows from a country with low tariffs to one with high tariffs; or from a country enforcing competition to one permitting monopolistic practices; or from a country with an equitable system of taxation to one in which regressive taxes favor capital at the expense of the rest of the economy. In all these cases, capital may actually flow from a country in which its contribution to an increase in real output would be greater than in the recipient country: investment in the recipient country is more profitable for the individual investor only because there the share of capital income in the value of the output is greater than in the investing country.

Even in these cases the recipient country suffers a loss from the reduction in capital inflows. But this loss may well be smaller than the gain accruing to the investing country from the additional investment of the funds that, without the barriers, would have gone to the recipient country. Hence, from the point of view of the world as a whole, total output and real income will be greater if this type of international investment is averted than if there is complete freedom of international capital flows.

Some part of the inflow of investment funds from the United States to continental Europe is based on the—correct or incorrect—belief that continental Europe

⁵ Solomon, *supra* note 1, at 121.

is protected by higher tariff walls, is more lenient towards monopolistic practices, and has a more regressive tax system than the United States. The need to breach the protective tariff walls of the Common Market is regularly cited as a reason for investments of U.S. concerns in continental Europe; and the repeated complaints of European concerns about strict enforcement of antitrust laws and about an allegedly excessive tax burden on capital in the United States indicate that the two other points are also practically relevant. Insofar as these motives are decisive for capital movements, impediments to U.S. investment in Europe, while painful for capital owners in the United States, actually promote optimal international utilization of resources.

The prospective recipient country may in fact benefit from barriers to the inflow of foreign investment funds, *viz.*, if it is suffering from inflationary pressures. In this case, the inflow of funds from abroad would increase such pressures to the extent that the inflow is not fully and immediately associated with additional importation of goods or services. Since the disassociation between "monetary" and "real" transfers is more likely to happen in the case of flows among fully developed countries than of flows from developed to less developed countries, this problem again is relevant mainly in the case of capital flows among developed countries. In fact, the alleged inflationary impact of flows of U.S. capital to continental Europe has been a frequent complaint of European governments—although it is difficult to decide whether these complaints were based on fact or were rather made to excuse inappropriate domestic policies of the European authorities and to divert criticism from these authorities to the United States.

Finally, even if the international flow of investment funds is consistent with optimal international utilization of resources, it invariably benefits some groups more than others, and may actually harm some groups to the benefit of others. Thus, flows of capital tend to raise the rate of return on capital in the investing country and to lower that rate in the recipient country; simultaneously, they tend to lower the share of other factors of production (primarily labor) in the investing country and to raise that share in the recipient country.

True, in the investing country, these effects are usually so small as to be almost negligible: in 1967, the outflow of long-term U.S. capital was equal to only four per cent of domestic gross private investment. Only if the outflow of capital occurs in a period of domestic unemployment so that it actually—if ever so slightly—lowers the level of domestic economic activity, would the depressive effect on wages, superimposed on the generally contractive impact of the outflow, do significant harm to the recipients of labor income in the investing country.

In the recipient country, the effect will be larger since generally the inflowing capital will represent a larger proportion of total investment funds there than in the investing (capital-richer) country. The beneficial effect of capital inflows on labor will be particularly important because it will be superimposed on the generally

expansionary effect of the investment on total economic activity. For the same reason, the downward pressure on the rate and share of return on capital will usually be overshadowed by the increase in total capital returns due to the expansion of the economy. Clearly, the rate of return will be lower only in comparison with a rate that would be obtained without the capital inflow but at the same level of economic activity as that induced by the capital inflow: hence, the actual rate of return will often be higher than it had been before the inflow—even though the proportion of capital income to other income may have been very slightly reduced.

On balance, the effects of capital flows—and, hence, also of barriers to capital flows—on income distribution will usually be minor not only in the investing but also in the recipient country. Nevertheless, even a very slight impact may help to explain why in the capital exporting countries, such as the United States, capital owners are unanimously and totally opposed to curbs on international capital flows while at least in some recipient countries—fully developed as well as less developed ones—their opposition seems to be less vocal: after all, in the investing country the flow lessens domestic competition among capital owners but in the recipient country it increases such competition—and while everybody favors competition among other groups, hardly anybody likes it within his own group.

III

POLITICAL AND ADMINISTRATIVE PROBLEMS

Even in those cases in which a good theoretical case can be made for using barriers to investment as a tool of payments policy, such use will be advisable in practice only if the political and administrative problems posed by such restrictions can be solved. Actually, political considerations seem to speak for rather than against such barriers while the administrative difficulties are indeed formidable.

A. Political Problems

The political case for barriers to investment abroad is based not only on the probably irrational but nevertheless—as Mr. Solomon's paper points out⁶—very real rationalistic opposition to large inflows of foreign capital in the recipient countries but primarily—in this observer's opinion—on the political risks for the investing country.

Experience in most (though not all) foreign countries proves conclusively that large inflows of foreign capital tend to create resentment, and especially fears of excessive foreign influence on the domestic economy. In a country such as Canada, where U.S. credits and investments at the end of 1967 amounted to about \$30 billion (equal to nearly one-half of the country's gross national product), such resentment and such fears, however, unwarranted on rational grounds, are easily understood:

⁶ *Id.* at 121-22.

the public in the United States would probably react with open hostility if a foreign nation held some \$400-odd billion worth of assets in this country.

Actually, foreign creditors and investors today are hardly in a privileged position. If any foreign-owned corporation should try to pursue policies or conduct operations contrary to the laws, or merely to the policies or reputed interests, of the host country, the host country would, under present international law, have every right to prevent such policies or operations from being executed, and perhaps to "nationalize" the foreign enterprise. Even in the United States—a country that respects foreign as well as domestic property probably as deeply as any foreign nation, and more deeply than most of them—the Trading with the Enemy Act of 1917 enables the President during any period of national emergency (not just in wartime) to "regulate, . . . prevent or prohibit any acquisition [of], . . . or exercising any right, power, or privilege with respect to, or transactions involving, any property in which any foreign country or a national thereof has any interest" (to be sure: any foreign national, not just, as the title of the act would seem to indicate, an enemy alien); he is also empowered to vest "any property or interest of any foreign country or national thereof . . . , when, as, and upon the terms, directed by the President, in such agency or person as may be designated . . . by the President."⁷

Hence, there is little merit to the idea that a foreign country, by letting its nationals invest abroad, might gain some unholy power over the domestic economy if not the domestic political scene of the recipient country. This is not to deny that a rich and powerful foreign country may indeed exert pressures on a poor nation: but not through the process of investing but instead through its power to prevent its nationals from investing in an economy requiring the inflow of capital. Once the investment is made, that power is exhausted—except insofar as future additional investments can be withheld.

On the contrary, the balance of bargaining power now has shifted to the recipient country. Just as the U.S. Government can for all practical purposes at any time "nationalize" any foreign-owned enterprise (or other assets and claims) by "vesting" them in a domestic agency or person (for surely a state of national emergency could have rightly been proclaimed in any postwar year, and has in fact been declared from time to time), so any foreign government can at any time "nationalize" any U.S.-owned enterprise or other claim or asset. True, it has to grant just compensation to the expropriated U.S. investor—but if it refuses to do so, and refuses to submit to the judgment of an international tribunal (or to abide by that judgment), the United States has practically no redress except protests or threats of retaliation—which are likely to be in vain because the foreign country presumably will see to it that, at the crucial time, it has no assets left in the United States which the U.S. Government or the U.S. investor could seize.

And this is not all: even if the foreign country has indeed no intention to

⁷ 50 U.S.C. app. § 5(b) (1964).

“nationalize” the U.S. property, it can use the threat of such “nationalization” as a bargaining weapon, explicitly or implicitly, whenever it so desires. The U.S. authorities seem to be aware of this situation: the astonishing leniency with which the U.S. Government treats so many foreign countries that act contrary to U.S. interests can be most simply explained by the fact that these countries hold hostages in the form of large U.S. investments.

This is true not only of countries in the Middle East and in Latin America but in principle also of European nations. And, in fact, European countries are in a far stronger position than those in the rest of the world. A less developed country knows that, while it has little to fear from other forms of reprisals, it can hardly count on future U.S. Government aid or private investment once it has “nationalized” existing U.S. assets—and the example of Cuba shows that the windfall “profit” from “nationalizing” U.S.-owned enterprises is soon dissipated if the further inflow of U.S. capital is stopped. But continental Europe can do very well without future inflows of U.S. capital. Hence, any U.S. investment there (even more so than such investment in a less developed country) is a political hostage given to fortune—no matter how profitable the investment may seem on purely economic grounds.

For these reasons, barriers to U.S. investment in continental Europe would seem not only to remove important potential sources of friction but also to strengthen rather than to weaken the international political position of the United States.

B. Administrative Problems

But the situation is different in respect to administrative problems. There are at least six reasons for believing that the execution of measures restricting the outflow of investment funds is extremely difficult, and especially so if these restrictions are meant to be permanent rather than temporary tools of policy.

First, in order to have a corrective effect on the payments balance, any restriction of investment abroad must avoid curtailing capital flows that are directly financing exports. It is often very difficult, however, to determine whether or not any individual capital transaction is directly financing exports—especially since the necessary information will inevitably be provided primarily by the parties interested in having the transaction exempted from the restrictions.

Second, in order to avoid unnecessary hardship for recipient countries, any restriction must avoid curtailing capital flows to less developed countries or to countries whose economic health is otherwise dependent upon the inflow of funds from the restricting country; in the case of the United States, the second point applies primarily to Canada but to a lesser extent also to Britain and Japan. It is often very difficult, however, to determine whether an investment formally undertaken in an exempted country is actually benefiting that country or whether the exempted country acts as an intermediary between the restricting country and the rest of the world. Such intermediation is impossible to avert except with the fullest coopera-

tion of the exempted countries—a cooperation that is increasingly difficult to maintain without friction if the restrictions become permanent.

Third, the largest international investors are giant concerns that are in fact if not in law supranational rather than national institutions. They have virtually unlimited ability to shift funds internationally without any formal capital transactions. An international oil concern, for instance, can probably transfer very large sums from one country to another merely by changing the distribution of overhead costs, the computation of transportation charges, or the relative prices of crude and refined products among its various subsidiaries.

Fourth, the recent development of supranational capital and money markets, such as the Euro-dollar markets, further reduces the power of any individual government to enforce restrictions on international movements of funds. It would take a more courageous person than this observer to state categorically whether or not such activities as the extension of long-term credits to foreigners by the foreign branches of U.S. banks, the issue of bonds in the Euro-dollar market by foreign subsidiaries of U.S. concerns under the guarantee of their parents, and the operations of the so-called Delaware subsidiaries of U.S. concerns in financing direct investments abroad, in the final analysis do or do not result in some transfer of capital funds from the United States to foreign countries (or on the contrary, in some transfer of capital funds from foreign countries to the United States).

Fifth, in a country such as the United States, where foreign investments in U.S. markets, although much smaller than U.S. investments abroad, still represent very large sums (more than \$20 billion at the end of 1967, excluding foreign liquid assets and holdings of U.S. Government securities), any effect on the payments balance of a restriction of outflows of domestic funds would be counteracted if the restriction resulted in a corresponding withdrawal of, or even in a corresponding decline in the inflow of, foreign funds.

Finally, any interference with market processes makes necessary the issuance of detailed regulations and the creation of a cumbersome bureaucratic apparatus to deal with statistical reporting, to decide doubtful cases, to detect and prosecute violators. Thus, the interference not only burdens the taxpayer (*i.e.*, the economy) but also decreases the efficiency of business management; in both ways, it reduces the international competitiveness of the export and import-competing industries of the restricting nation, and therefore has an adverse effect on its current account balance.

These effects can be mitigated (though not completely eliminated) if the restrictions take the form of fiscal measures (such as the U.S. interest equalization tax), which—like tariffs—still leave room for business decisions based on the principle of maximizing revenues and minimizing costs. They are aggravated if the restrictions take the form of “direct” controls, and especially if such controls are not confined to general directives but reserve to the authorities the right and duty to decide individual cases (as in the case of quotas or licenses). In such instances, the restric-

tions do not only become intrinsically arbitrary (*i.e.*, dissociated from the principle of maximum profitability) but also involve the serious risk of graft—not necessarily in the crude form of financial bribes but under the more subtle and effective appearance of political pressures, collusion among the interested parties, and friendly “deals” and “compromises” between government and business.

This risk in turn may be reduced by making the restrictions “voluntary” (as in the case of the current U.S. foreign credit restraint programs for banks and other financial institutions, administered by the Federal Reserve System). Such “voluntary” measures can be effective, however, only when they are supported by a nearly unanimous consensus of the parties involved, or when the parties are so dependent on the good will of the administering authority that they refrain from exercising their formal right of withdrawing from the program, or when the program leaves such wide loopholes that it does not materially hurt the parties.

IV

POLICY CONCLUSIONS

The preceding analysis yields the following conclusions:

(i) By themselves, barriers to investment abroad are effective tools of policies designed to correct a country's payments deficit only in those situations in which currency depreciation would be effective by itself, *viz.*, when the payments deficit coexists with domestic underemployment or deflation.

(ii) In association with restrictive domestic fiscal and monetary measures, they are effective tools in those situations in which currency depreciation would be effective in association with restrictive domestic policies, *viz.*, when the payments deficit coexists with such precarious domestic equilibrium that depreciation alone would produce inflationary disturbances and restrictive domestic policies alone deflationary disturbances.⁸

(iii) Moreover, such barriers are effective tools only when outflows of domestic capital from the deficit country are so large that a reduction in outflows would substantially affect the payments balance.

(iv) Finally, such barriers are preferable to currency depreciation only when the currency involved is generally used as an international means of payments, reserve asset, and standard of value, so that depreciation would risk very serious damage to international trade and investment.

(v) Points (iii) and (iv) indicate that, under the present international payments system, such barriers should be considered as potentially effective policy tools only by the United States; and points (i) and (ii) indicate that they should be so con-

⁸ Needless to say, barriers to investment abroad cannot be used as a substitute for currency depreciation once the price level in the deficit country has risen hopelessly out of line with prices abroad. But the great difficulty of calculating international price differentials makes this limitation easier to perceive in theory than to apply in practice.

sidered even in the United States only when the country simultaneously experiences a large payments deficit and either substantial unemployment or such a precarious state of reasonably full employment that restrictive domestic policies alone would generate serious unemployment.

(vi) Adverse side effects of such barriers on the payments balance of the deficit country as well as on the domestic economies of all countries affected are minimized if investments used directly to finance exports as well as investments in less developed countries and in other countries depending for their economic health on inflows of capital from, or on trade with, the deficit country are exempted from the restrictions; in the case of the United States, this means that the barriers should apply exclusively or at least mainly to the developed countries of continental Western Europe.

(vii) The political effects of such barriers are more likely to be beneficial than adverse.

(viii) The administrative problems associated with the execution of such policies, however, are extremely difficult, especially in view of the necessary loopholes (point vi), the existence of *de facto* supranational business concerns and capital markets, the possibility of offsetting movements of foreign capital, and the adverse effects of bureaucratic interference with business activity in general; these problems become particularly troublesome if the barriers take the form of compulsory "direct" controls rather than that of fiscal measures or—in very special circumstances—"voluntary" programs.

A. Possible Alternative Policy Tools

In view of the probability of adverse side effects (point vi) and of the administrative difficulties (point viii) it would seem advisable to explore other possibilities of correcting the payments deficit of an international reserve center that suffers from unemployment or precarious full employment.

Four such alternatives present themselves: first, appropriate action of nonreserve surplus countries; second, stimulating the inflow of foreign (instead of restricting the outflow of domestic) investment funds; third, changing the relation between domestic and foreign price levels by means other than currency depreciation; and, fourth, restricting imports of goods and services (instead of restricting the outflow of capital).

I. *Action of Nonreserve Surplus Countries*

In view of the precarious payments position of most less developed countries, it is virtually inevitable that a large deficit of a reserve center be matched by corresponding surpluses of other fully developed countries. In this case, the payments deficit of the reserve center could probably be most efficiently corrected with least adverse side effects on any of the parties concerned if the surplus countries could be induced to take appropriate action.

Obviously, if the surplus countries are themselves suffering from unemployment, expansionary domestic policies are indicated; if they are suffering from overfull employment, appreciation of their currencies is indicated; and if they are in a position of precarious domestic balance, a combination of mildly expansionary domestic policies and mild appreciation is indicated.

Obstacles to such an optimal pattern of policies are largely political rather than economic. This is particularly true for the refusal of surplus countries to appreciate their currencies: the burden of such adjustment will fall on the export and import-competing industries, which are as a rule economically and politically very powerful and understandably want the burden to be borne by other groups or, preferably, by other countries.⁹ The only economic drawback of appreciation is the probability of speculative capital movements, both before and after appreciation, viz., if the financial community believes that the appreciation will need to be repeated. Obviously, the risk of speculation will be minimized if the authorities act quickly—not, as the German authorities in 1961, after many months of public discussion—and see to it that the appreciation is immediately so substantial that doubts as to its sufficiency cannot arise.

The often-heard objection that surplus countries ought not to be “penalized” for inflationary excesses of a deficit country is irrelevant in this connection. If the reserve center suffers from both inflation and payments deficit, its appropriate policy tools are restrictive domestic measures rather than barriers to investment abroad (or currency depreciation); in this case, the deficit country must indeed take corrective action of its own, whether or not it is an international reserve center. But when domestic restrictive policies of the deficit country are not (or not alone) appropriate, this fact itself indicates that “inflation” in the deficit country is not (or not alone) to blame; and in this case surplus countries have no reason to refuse cooperation in the adjustment process.

2. *Stimulating Inflows of Foreign Investment Funds*

As expansionary measures usually are both more advantageous and more pleasant than restrictions, it is tempting to recommend measures stimulating the inflow of foreign funds as a preferable substitute for measures restricting the outflow of domestic funds. Actually, however, such an alternative would be neither effective nor economically beneficial.

The only type of country that can appropriately consider the use of barriers to

⁹ This is the reason why any talk of depreciation of the dollar would seem futile even if the advocates of depreciation were right. If the few large surplus countries were willing to permit the dollar to depreciate, they could more easily and with less adverse effects on the world as a whole (including their own economies) restore international financial equilibrium by permitting their own currencies to appreciate. If the proponents of flexible exchange rates were to concentrate their efforts on the monetary authorities of these few countries rather than on U.S. authorities, their arguments would be theoretically more valid and practically more useful.

investment abroad as an effective policy tool is a country that is so rich in capital as to supply large amounts of investment funds to the rest of the world (point iii, above). Such a country cannot expect to be the recipient of foreign investment funds in amounts sufficient to correct a large payments deficit. And if it were to receive such funds, the inflow would probably be at the expense of flows to capital-poor countries and thus far worse, from the point of view of an optimal international allocation of capital, than a reduction in the outflow of capital from a reserve center to foreign *developed* countries.

The U.S. experience with a large inflow of capital from continental Europe in 1968 cannot be considered a refutation of this statement. Although the funds involved were formally long-term equity funds (not direct investments but purchases of corporate securities), they were in substance mainly short-term money-market funds, temporarily shifted from Europe to the United States because of political and financial uncertainties in European centers. Ordinarily, these funds would have been placed in U.S. money-market assets; but because of doubts as to the stable value of the dollar, based on the steady rise in inflationary pressures in the United States during the year, foreign capital owners (like their U.S. counterparts) preferred to place their funds in the New York stock market. This market is so broad and resilient that even large inflows and outflows can be absorbed without major price fluctuations; and the generally accepted assumption of continued inflationary pressure permitted owners to expect a continuation of the stock market boom, which not only would maintain the "real" value of the placements but even make for windfall profits. Hence, a major part of the inflow should be treated as "liquid" rather than as "investment" funds, if not in the statistics (since the exact amount cannot be calculated) so at least in economic analysis.

3. *Change in Price Level Relationships Without Change in Exchange Rates*

The German authorities decided in November 1968 to substitute a reduction in their "border taxes" (value-added taxes on imports and tax rebates on exports) for an appreciation of the German mark, which was recommended by most economists as a cure for the chronic German payments surplus. This decision makes it tempting to envisage the possibility of a world-wide system of "border taxes," the rates of which could be changed by the participating countries, in accordance with their payments position and under supervision of the International Monetary Fund, so as to maintain the "purchasing power parity" of their currencies in the face of large payments surpluses or deficits.

This method would be available to reserve centers as well as to nonreserve countries since it would not affect the par value of currencies and therefore could not give rise to speculative capital movements.¹⁰ Its only drawbacks seem to be these:

¹⁰ The problem has been briefly but brilliantly discussed by Robert Solomon, *Reflections on the International Monetary Crisis*, FEDERAL RESERVE BANK OF ST. LOUIS MONTHLY REVIEW, Dec. 1968, at 20-21.

first, objections to normally high rates of value-added taxes from the point of view of an equitable and progressive tax system (if the tax rates were normally low, there would be no sufficient room for reductions in case of a payments surplus); second, doubts as to the effectiveness of changes that the market would probably consider as temporary; third, the risk (apparently present in the actual German case) lest the measure were considered merely a half-way station on the road to a change in exchange rates (in which case currency speculation would be stimulated rather than averted); and, fourth, the possibility of using increases in rates as protectionist measures rather than exclusively for the purpose of restoring payments balance—a practice analogous to the “competitive exchange depreciation” of the 1930s that gave rise to the stress on exchange rate stability in the Articles of Agreement of the International Monetary Fund.¹¹

4. *Restrictions on Current-Account Transactions*

Such restrictions have been outlawed, in principle, as tools of payments policies both in the Articles of Agreement of the International Monetary Fund¹² and in the General Agreement on Tariffs and Trade.¹³ And rightly so: such restrictions are much more likely to be harmful to all parties involved than restrictions on the flow of capital.

Such restrictions are by their very nature discriminatory among commodities. This means that they distort the price relationships that would obtain in a competitive market. In contrast, restrictions on capital outflow not only have a much smaller effect on the price of capital (interest rates and equity yields) but also affect all industries in a broadly similar way and thus do not substantially distort relationships among industries.

Moreover, import barriers (to take the type of restrictions that is most likely to be used to correct a payments deficit) generally protect the most inefficient industries within the restricting country—*viz.*, import-competing industries that are less efficient than either export industries or those import-competing industries that are viable without such protection. And in the foreign countries affected by the restriction, they hurt the most efficient industries, *viz.*, the export industries.

In contrast, barriers on capital outflows have very little if any protective effect in the restricting country; and, if anything, they benefit the most capital-intensive and thus presumably the most efficient industries. In the foreign countries affected by the restrictions, the barriers tend to reduce investment largely in highly protected import-competing industries, which are generally most attractive to foreign con-

¹¹ Articles of Agreement of the International Monetary Fund, art. I(iii), 60 Stat. 1401 (1946), 2 U.N.T.S. 39.

¹² *Id.*, art. VIII, § 2.

¹³ General Agreement on Tariffs and Trade, arts. II, III, 55 U.N.T.S. 187 (1950); *but see* art. XII permitting certain temporary restrictions.

cerns; hence, they are more likely to hurt relatively inefficient than efficient industries.

For these reasons, barriers on imports are far more likely than barriers on capital outflows to distort significantly the international division of labor; and in contrast to barriers on capital outflows they are also likely to distort the allocation of resources both within the restricting country and in the rest of the world.

B. Historical Experience

It might be objected to the analysis presented in this paper that experience has proved investment barriers to be ineffective as tools of payments policy: such barriers have been applied in the United States since the beginning of 1965, and they have hardly been instrumental in restoring the U.S. payments balance to equilibrium.

Actually, however, the U.S. experiments with the interest equalization tax and with the voluntary foreign credit restraint programs of 1965 and the compulsory program of January 1968 have been conducted under conditions different from those envisaged in this paper as being required for an effective use of such methods.

At the beginning of 1965, the basic conditions of effective use were indeed present: the United States suffered simultaneously from a payments deficit and from domestic unemployment. Hence, the use of barriers to the outflow of investment funds was justified—although it would have been even more justified in the years 1961-64, when unemployment was still larger. Unfortunately, however, the most important type of long-term capital outflows, direct investments of U.S. concerns in foreign developed countries, was expressly exempted from the interest equalization tax and subject only to a “voluntary” program administered by the Department of Commerce. Perhaps because the Secretary of Commerce at that time was the former head of a large U.S. corporation who in that capacity had been active in establishing a network of foreign subsidiaries and therefore had understandably little sympathy for barriers to investment abroad, the program was administered so leniently that the outflow of direct investments, which had alarmingly increased between 1961 and 1964 from \$1,599 million to \$2,435 million, rose in 1965 to \$3,418 million (or by more than in the entire preceding three-year period)¹⁴ and remained above the \$3 billion mark in 1966 and 1967.

This very development presumably was a main reason for the President's Executive Order 11387 of January 1, 1968,¹⁵ which transformed the “voluntary” into a “compulsory” restraint program for direct investments of U.S. corporations. Unfortunately, by that time the basic conditions for effective use of such restraint had changed: the United States not only had achieved reasonably full employment—the unemployment ratio dropped from 6.7 per cent in 1961 and 5.2 per cent in 1964 to 3.6 percent in 1968—but also had replaced reasonable price stability by inflationary price increases—the wholesale price index, which remained virtually stationary be-

¹⁴ U.S. DEP'T OF COMMERCE, SURVEY OF CURRENT BUSINESS, June 1967, at 23.

¹⁵ 33 Fed. Reg. 47 (1968).

tween 1958 and 1964 at around 100.5, rose between 1967 and 1968 from 106.1 to 108.7. Hence, the use of barriers to investment as the major tool of payments policy was no longer justified—quite apart from the fact that it apparently took a good while to implement the new restraint policy: over the first three quarters of 1968, the outflow of direct investments continued at a seasonally adjusted annual rate of \$3,348 million, ten per cent *higher* than in 1967!¹⁶

Hence, the U.S. experience tells us little or nothing about the impact on the payments balance of *effectively administered* barriers to investment abroad.

C. Concluding Remarks

One final conclusion should be drawn from our analysis: if we want to apply barriers to investment abroad as an effective tool of payments policy, we should not only be aware of the limitations indicated by theoretical reasoning but also gather more information, especially on the magnitude of side effects, on the problems of administration, and on potential alternative tools.

Despite some discussion of side effects in Britain as well as in this country,¹⁷ it is far from certain whether these effects are either as adverse as the opponents, or as harmless as the advocates, of investment barriers want to believe. While the question is not vital when restrictions are imposed as a temporary emergency measure, it becomes decisive whenever they are considered as permanent methods of adjustment.

The files of the Treasury, the Federal Reserve, and the Commerce Department contain invaluable material for an assessment of the problems of administering investment barriers. This material has apparently not yet been utilized.

And the study of alternative adjustment methods, such as the generalized use of variations in border taxes—in contrast to the use of such taxes as a method of “protection”—as a substitute for changes in exchange rates and hence also for investment barriers, has hardly begun.

The analysis presented in this paper does not claim to resolve the problem of investment barriers. But it will serve its purpose if it gives direction and impetus to further research and to more soundly based policy advice.

¹⁶ In contrast, the “voluntary” restraint program for banks, administered by the Federal Reserve System, was outstandingly effective, presumably because all or most of the preconditions for the success of a “voluntary” program were fulfilled (*see pp. 77 supra*): the rise in outstanding bank-reported claims on foreigners, which had increased from \$469 million in 1962 to \$1,403 million in 1963 and \$2,435 million in 1969, was replaced by declines averaging about \$200 million in each of the years 1965, 1966, and 1968, only interrupted by an increase of \$475 million in 1967. 53 FEDERAL RESERVE BULL. 2151-53 (1967); 55 FEDERAL RESERVE BULL. A 81 (1969). If it had not been for adverse changes in other items (some of which were, however, in line with our analysis related to the decline in claims), the program would thus have corrected the annual decline in U.S. international liquidity experienced in 1964 by an average of about \$2.5 billion!

¹⁷ *See* G. HUFBAUER & F. ADLER, OVERSEAS MANUFACTURING INVESTMENT AND THE BALANCE OF PAYMENTS (1968); the analysis presented in that study has been criticized by the National Foreign Trade Council, Inc., in a pamphlet, DIRECT MANUFACTURING INVESTMENT, EXPORTS AND THE BALANCE OF PAYMENTS (1968).