

Boeck, Klaus

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The Supply of International Liquidity to Developing Countries

by Klaus Boeck, Hamburg *

The gravamen of the comments by the developing countries on the problem of the supply of international liquidity is that since 1970 they have been at a great disadvantage as far as the distribution of the newly created international liquidity is concerned. At the annual IMF meeting in Manila in early October 1976 they therefore put forth a demand for a fresh allocation of SDRs¹. The question that has to be asked in this connection is whether the developing countries are justified in their criticism concerning the supply of liquidity and whether another SDR allocation is needed in order to solve their liquidity problems if any exist.

A discussion of problems of the supply and distribution of international liquidity calls, even more definitely than many other economic subjects, for an incontrovertible delimitation of the object of investigation, for the number of liquidity concepts in vogue is too large².

The Monetary Reserve Concept

The developing countries appear to base their line of argument on the currency reserve concept, for in their critique of the supply of international liquidity they are referring explicitly to the regression of international reserves relative to world imports³. The monetary reserves — also known as unconditional liquidity — consist of the gold, foreign currencies and SDRs held by the monetary authorities plus their drawing rights on the so-called gold tranche with the International Monetary Fund (IMF).

A comparison of the changes in the monetary reserves of the developing countries with those of the total world reserves does not bear out the assertion that there has been a permanent deterioration in the position of the developing countries. After a distinct decline in 1971 compared with 1970 the developing countries' share of the

total monetary reserves showed between 1971 and 1973 an equally distinct increase which in turn was followed by a substantial downturn due to the oil crisis up to the end of 1975. In the first half of 1976 however the developing countries' reserves rose again much faster than the total reserves, so that by August 1976 they were back to 15.3 p.c. of all reserves — a figure surpassed only once before in the seventies, namely by that for 1973.

The actual changes in the monetary reserves and their distribution thus do not show the developing countries to have been at a disadvantage. It is questionable however whether these figures can be quoted at all as sufficient evidence for the equitableness or adequacy of the supply of international liquidity.

Value Changes

The movements of the monetary reserves as recorded by the IMF indicate either value or volume changes in the reserve-stocks. As the reserves are valued in SDR, value changes cannot occur in the SDR accounts or the reserves with the IMF. The value of the gold holdings of monetary authorities could not change either as long as the gold-SDR ratio was prescribed by the official gold price⁴. The impending second amendment to the IMF's Articles of Agreement however will abolish the official gold price⁵ and thus open the possibility in principle of gold holdings changing in value.

World Total and LDCs' Share of Monetary Reserves in 1970–1975 and in August 1976

	1970	1971	1972	1973	1974	1975	August 1976
	in SDR bn						
Total	93.2	123.2	146.5	152.2	180.1	194.2	210.7
Developing Countries	13.9	14.5	19.7	24.5	26.5	26.5	32.2
	in p.c.						
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Developing Countries	14.9	11.8	13.4	16.1	14.7	13.6	15.3

Source: International Financial Statistics, Vol. XXIX (1976), No. 11, p. 18.

* HWWA-Institut für Wirtschaftsforschung-Hamburg.

¹ Cf. Press Communiqué of the Ministers of the Group of 24, issued following their meeting in Manila on Oct. 2, 1976, in: IMF Survey, Vol. 5 (1976), No. 20, p. 313.

² Cf. John Williamson, International Liquidity, in: The Economic Journal, Vol. 83 (1973), No. 331, p. 686 ff.

³ Cf. Press Communiqué, *ibid.*, p. 313.

⁴ 35 SDR = one ounce of pure gold.

⁵ Cf. International Monetary Fund, Proposed Second Amendment to the Articles of Agreement of the International Monetary Fund, Washington D.C., 1976, p. 40.

Value changes in the reserves held in foreign currencies on the other hand have long been common occurrences. This reserve component is regularly revalued whenever the rate of the reserve currency in question to the SDR changes. About four-fifths of all foreign currency reserves in 1975 were held in dollars, according to IMF estimates. As the dollar was revalued by 4.6 p.c. against the SDR in that year, the total monetary reserves increased by about SDR 4.2 bn in consequence of this parity change ⁶.

If all monetary authorities held identical reserve portfolios, value changes in the monetary reserves would be neutral in their effect on the reserve distribution. In actual fact however gold and foreign currencies carry widely differing weights in the reserve portfolios of the industrialized and developing countries. At the end of the first half of 1976 gold accounted for 6 p.c. of all monetary reserves of developing countries but for as much as 27 p.c. of those of the industrialized countries. If the gold holdings are revalued, as is to be expected in view of the present world market price for gold if for no other reason, the reserve position of the developing countries will therefore clearly worsen.

At the same time 89 p.c. of the monetary reserves of the developing countries were held in the form of foreign currencies — a much higher percentage than the corresponding 58 p.c. of the industrialized states. As a result the developing countries benefited from the mentioned revaluation of the US dollar much more than the industrialized states. The opposite of course happens in the case of a dollar devaluation as was seen in 1973 and 1974.

As the gold value changes have not yet shown up in the books and the value changes in foreign currency reserves apparently did not follow a uniform trend, they do not allow any definite statements about advantages or disadvantages for the developing countries in regard to the supply of international liquidity in the past.

Reserve-Stock Changes

Quantitative changes, i.e. movements in the monetary reserve-stocks, are the outcome of balance of payments disequilibria or IMF decisions on the allocation of extra SDR. So far such allocations have been made only in the triannual period from 1970 to 1972. They are thus playing no part in the current supply of liquidity and may be disregarded for the following observations.

As regards the role of balance of payments surpluses and deficits for the supply of liquidity, a distinction must be made between those in re-

serve currency countries and those in non-reserve currency countries. The surpluses and deficits of the former affect both the total amount of the world monetary reserves and their distribution. States with a balance of payments surplus vis-à-vis the reserve currency country for instance will accumulate additional foreign currency reserves equal to the deficit of the reserve currency country. Their reserve position vis-à-vis all other participants in this reserve system will improve coincidentally.

Balance of payments disequilibria between non-reserve currency countries on the other hand affect only the distribution but not the total amount of the world's monetary reserves. This however holds good only if deficits are financed from their own reserve-stocks and not by foreign loans.

Foreign currency loans from another monetary authority, the Euro-markets or the IMF on the other hand increase the total world monetary reserve-stock. They also alter the distribution of the reserves in favour of the states with a balance of payments surplus vis-à-vis the borrower. If the borrower's balance of payments before acceptance of the loan was in equilibrium, his own monetary reserves will increase by the amount of the additional indebtedness incurred.

The distribution effects of the creation of additional foreign currency reserves are the only relevant factor as regards the question whether a country or group of countries is put at a disadvantage in respect of the supply of liquidity. These effects can only be calculated from the total of the bilateral balances of payments of all the participants in the reserve system and not from the statistics of monetary reserve changes which are published by the IMF, for the IMF figures aggregate the distribution effects of the creation of additional reserves with those of drawings on existing reserves.

There are no adequate statistical data available yet for the necessary analysis of the bilateral balances of payments however, and quantitative statements about the distribution of the additional foreign currency reserves created in recent years cannot therefore be made, at least not at present. But even if the required information on the distribution of new foreign currency reserves could be culled from currently available statistics, it could not either prove or disprove the developing countries' thesis of a handicap in regard to the supply of international liquidity.

Functional Liquidity Concept

The distribution of the newly created monetary reserves may for instance conceivably shift over

⁶ Cf. International Monetary Fund, Annual Report 1976, p. 34 f.

a certain period in favour of the industrialized states because they needed larger reserves during this time than the developing countries and therefore made correspondingly greater efforts to increase their reserves. The existence of a disadvantage can therefore be proved only if the access to new reserves is made relatively more difficult for developing countries while the reserve requirements of both groups of countries, industrialized and developing, are assumed to be changing at the same rate. This line of argument rests no longer on the largely formal interpretation of the concept of reserve liquidity. International liquidity is now understood in a functional sense⁷ as the ability to obtain international means of payment.

Possibilities for at least a nominal increase in the supply of liquidity are inherent in the mere possession of monetary reserves — in the case of gold reserves through higher prices and in regard to foreign currency accounts through the earning of interest. With a reserve increase in this form neither group of countries is discriminated against if the rise of the gold price matches the interest earned on foreign currency accounts. But if the gold price rises more strongly than the interest earned on foreign currency accounts, the industrialized countries will profit more. Conversely, the developing countries will be the ones to profit more if the gold price rises less than the interest income from foreign currency accounts. It is certainly not possible to predict which of these conjunctures will predominate in future, but disregarding the non-recurrent adjustment effects of the freeing of the official gold price, it is quite feasible that the interest earnings on foreign currency accounts and the increase of the gold price will be kept more or less in balance by a yield-oriented investment policy of the monetary authorities.

The industrialized states will of course derive especially large profits from the adjustment of the price of monetary gold to the world market price following the parting with the official gold price. Since however monetary gold, unlike the reserves held in foreign currencies, did not earn interest, the gold price adjustment is to be interpreted as compensation for interest forgone rather than as an advantage or disadvantage bestowed on a particular group of countries.

As well as by a higher gold price and interest income from foreign currency accounts, the supply of liquidity can be improved by intervention of monetary authorities in the foreign exchange markets or by the raising of loans in foreign currencies. Exchange market intervention for the purpose of increasing the foreign currency reserves offers little prospect of success unless there is

relatively flexible exchange rate management and the country's own currency can be expected to be alternatively subject to upward and downward tendencies. Most developing countries meet neither of these conditions.

The IMF Interim Committee legalized the floating of exchange rates at its meeting in Jamaica in January 1976 and thereby put the monetary authorities in a position to pursue a flexible exchange rate policy. Most developing countries however have made no use of this possibility. They continue to keep their currencies firmly linked to one or several other currencies⁸. This linkage is often maintained exclusively by foreign exchange controls. Exchange controls make it possible to raise the monetary reserve, e.g. by tightening the foreign currency allocations to importers, i.e. by curtailing imports and/or undervaluing the national currency so as to promote exports, but the developing countries are for both these measures less favourably placed than the industrialized states.

Disadvantages to the Developing Countries

Undervaluation of its currency is unlikely to provide a significantly larger foreign currency income for a developing country. Obviously it will not increase the foreign currency income if the exporters do not pass on the benefit from the lower exchange rate in their prices. If they do reduce their prices in foreign currencies on the other hand, the foreign currency income will increase only in consequence of a more than proportionate rise of demand and supply. The price elasticity of demand cannot be expected to be high for the kind of goods which developing countries supply except perhaps for semi-manufactures and finished products. Extra capacity would be needed to cope with a more than proportionate rise in the foreign demand for these. In this sector however the developing countries are even worse off for spare capacity and the resources for capacity extensions than in the raw materials sector.

With floating exchange rates industrialized countries achieve an undervaluation of their currency if the latter is exposed to revaluation pressure which is neutralized by corresponding intervention. In this case price concessions by the exporters of the industrialized country are much more likely to result in an increase of the foreign currency income because their supply flexibility will probably enable them to make an adequate response to a more than proportionate rise of the demand from abroad.

⁷ Cf. John Williamson, *ibid.*, p. 687.

⁸ On the reasons for this measure cf. Barbara Erhardt, *Floating Exchange Rates and their Problems for the Developing Countries*, in: *Intereconomics*, 12th year (1977), No. 1/2, p. 29 f.

An increase of the monetary reserves may however, as mentioned, follow from curtailment of imports as well as from additional exports. Recourse to import restrictions on the part of developing countries can however in certain circumstances interfere with the realization of their development aims or result in an immediate noticeable worsening of goods supplies.

The imports of an industrialized state with a depreciation-prone currency are also apt to be affected if the authorities do not intervene at all or only on a relatively moderate scale in order to preserve their reserves, but the advanced state of development and high level of supplies in industrialized countries mitigate the impact of such import reductions.

The advantage accruing to industrialized states from their more advanced development, which is reflected by the diversity and flexibility of their exports, explains in great measure why their currencies can be expected to show alternative upward and downward tendencies. In the developing countries this cannot be expected, at least not in like measure. Developing countries have more reason to expect permanent downward pressure; hence a more flexible exchange rate policy would probably do nothing for their liquidity.

Finally, developing countries are also at a disadvantage compared with the industrialized states in the raising of balance of payments loans. They are rarely in a position to tap such bilateral lines of credit with other monetary authorities as the USA in particular has opened to the central banks of the other industrialized states. Besides, most developing countries have no or only very limited access to the international credit and capital markets⁹. An approach to the IMF is thus the only possible remedy left to them.

Compensation through IMF Loans

Until the outbreak of the oil crisis approximately, IMF loans were obtainable in the framework of the so-called credit tranches, the compensatory financing facility and the buffer stock financing facility. While resort to the credit tranches is open to industrialized and developing countries alike, the compensatory and buffer stock facilities are primarily intended to cover the requirements of the developing countries. Drawings on these credit lines are in any case subject to quite definite conditions.

⁹ Cf. Jacob A. Frenkel, The Demand for International Reserves by Developed and Less-Developed Countries, in: *Economica*, February 1974, p. 21.

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V E R L A G W E L T A R C H I V G M B H - H A M B U R G

The general prerequisite for them is an acute balance of payments need. Drawings on the credit tranches involve, besides, economic policy impositions designed to help to restore the balance of payments. The compensatory financing facility on the other hand is available for the bridging of short-term shortfalls in export earnings due to external causes outside the control of the deficitary country. Loans from the buffer stock facility are provided for payments arising from membership of international commodity agreements.

This traditional arsenal of IMF credit instruments is intended as stop-gap aid against cyclical or seasonal balance of payments deficits. As means of disposing of the balance of payments problems thrown up by the oil crisis they have proved largely inadequate. It has also been realized that, especially in developing countries, balance of payments deficits may be the result of mistakes in the structural and growth policy which take much more time to correct than for instance adjustments to compensate for cyclical oversteer.

The IMF responded to these additional demands by offering new lines of credit. In June 1974 the oil facility was created; it could only be used for balance of payments deficits caused by the increased cost of imported oil¹⁰. In August 1975 the IMF supplemented it by an Interest Subsidy account for the purpose of lowering the interest burden of drawings from the oil facility – by about 5 p.c. – on the most severely affected developing countries (the MSAC)¹¹. The oil facility was at first provided for one year only as its main purpose was to avoid the material overreactions to which, it was feared, the oil price explosion would give rise, but it was later extended until the spring of 1976. The Interest Subsidy account has been opened for a correspondingly limited period only; it will be closed on the last interest date.

No closing date has been set for the extended IMF facility which was created in September 1974 or for the Trust Fund set up in May 1976. Both these measures were taken with the particular balance of payments problems of the developing countries in mind. The extended facility allows drawings for much longer periods and appreciably larger sums than are common with other credit lines. The Trust Fund provides balance of payments loans on concessional terms for developing countries in special need. The grant of a credit is however in both cases conditional upon initiation of an IMF-approved programme to restore the balance of payments.

Besides providing new credit facilities, the IMF at the beginning of 1976 raised the credit limit for the compensatory financing facility and the

buffer stock financing facility. These measures together resulted in a considerably larger expansion of drawing rights for developing countries than for the industrialized states. At the end of the IMF year of 1973/74 the drawing rights of the developing countries amounted to SDR 12.7 bn and were thus markedly smaller than the credit facilities of SDR 18.1 bn available to the industrialized states. Two years later a total of SDR 24.2 bn was at the disposal of the developing countries compared with an amount of SDR 28.0 bn for the industrialized states¹². When the IMF members have given their assent to the sixth general review of quotas, the ratio will change further in favour of the developing countries: the countries in this group will be able to dispose of SDR 28.7 bn and the industrialized states only of SDR 21.7 bn.

This review of the IMF's recent credit measures warrants the conclusion that the IMF has shown adequate flexibility, especially in respect of the particular concerns of the developing countries. It has proved its flexibility by its ability to create new instruments to cope with new situations typical of developing countries, but also by the substantial additions to the total volume of finance – about SDR 12 bn in no more than two years. The credit policy of the IMF may thus be considered to have provided an adequate equivalent for the handicap from which the developing countries are undeniably suffering in regard to the supply of international liquidity from other sources.

No New SDR Allocation

In view of the available financing facilities and their impending increase by another SDR 4.5 bn there is no manifest need for an immediate new SDR allocation, especially bearing in mind that SDR drawings differ from IMF loans only in one respect, namely in that their use is not contingent on any economic stipulations whatsoever and may in certain circumstances be allowed for longer periods. The individual developing country may consider the resulting greater scope of action an advantage but it only creates a possibility of deferring necessary adjustment measures. For the viability of the world monetary system it is if anything a drawback. The economic impositions by the IMF on the other hand are aimed at perfecting the adjustment process. It follows that, from the point of view of monetary policy, an enlargement of liquidity subject to "conditionality" within the IMF framework is clearly preferable to any new SDR allocation.

¹⁰ Cf. IMF, Annual Report 1975, p. 53.

¹¹ Cf. IMF, Annual Report 1976, p. 58 f.

¹² These figures are based on the assumption that the extended facility is used exclusively by developing countries. Moreover, the drawing rights against the gold tranche were not taken into account because they are counted as official monetary reserves.