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An Appropriate International Monetary Order for Developing Countries?

by Gabriele Ullrich, Berlin*

The mounting balance of payments difficulties of most developing countries raise the question whether they are not aggravated by an international monetary system which is tailored to the requirements of industrialized countries and how the existing system could possibly be adapted to the needs of the developing countries. Dr. Ullrich is examining this question, using Black Africa as an example. The countries there are very similar in their historical and economic development and are all integrated in the western monetary system.

A study of the implications of the international monetary system for the economic policies of Black African states has to start with an examination of their economic policy objectives and the choice of objectives required by the international monetary system. Even if developing countries are aiming at the objectives of the international monetary system, the question remains whether the elementary preconditions are met and the necessary infrastructure is established in developing countries. Only if this is assured – at least partly – the transmission mechanism in the sense of monetary theory can be analysed. Taking Black African countries as an example these questions will be tackled upon in the following. Furthermore the possibilities of an international monetary system will be elaborated which takes into account the difficulties of monetary policy in the Third World as much as the interests of the industrialized countries.

Conflicting Objectives of Monetary Policy

Furtherance of economic development is seen as the foremost aim of economic policy in the Black African countries. It goes beyond the promotion of growth pure and simple and includes the establishment of the required infrastructure and removal of regional and sectoral imbalances among the early targets. For Black Africa the objective can be stated more precisely as “overcoming the dualism in the economy”, and this holds good also for countries

like Nigeria and Gabon whose payments balances benefit from profitable raw material exports. The central banks are also pledged to the objective of mitigating the dualism. This means in terms of monetary policy that they must go ahead with the monetization of their whole economy and help to create the institutional infrastructure for this purpose.

The preservation of stable money is rather subordinate to this aim, as is clear from the formulation of the central banks' tasks and reflected even more clearly by their monetary policies. In very few cases only is there any evidence of a restrictive monetary policy being pursued even though there is no assurance of stable money values. One need not go any further to notice a gap between the tasks which the African central banks have set themselves and the expectation of the international monetary system which is to pursue restrictive monetary policies in this situation so as to activate the appropriate mechanisms. However, the African developing countries do not consider this a priority task of economic policy. Hence they resort only in the most extreme emergency to solutions of this kind. The francophone countries of Black Africa are under a relatively greater compulsion to take such measures because their currencies are tied to the French franc. A restrictive policy becomes an absolute necessity when the integration of the country with the international monetary system is in jeopardy. In such a situation – and it arises quite often – developing countries are, like others, ready to compromise with their own set of objectives. Situations of this kind are likely to arise in

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Black Africa because most of the national currencies are – at least over the medium term – firmly tied to a European currency or else to the US dollar. In isolated instances national currencies have only been tied recently to a basket of other currencies. Flexible exchange rates do not yet exist in Black Africa.

If the African central banks are thus willing to practise monetary policy conforming to the western monetary system, it has to be asked whether they are making successful use of the available instruments. They have all the monetary policy instruments of western coinage at their disposal. Some of these instruments – e. g. the open market policy – cannot be used because money and capital markets are as yet virtually non-existing, however, progress has been made with others – all of a rather dirigiste character.

Prerequisites of the International Monetary System

A certain level of monetization – not only in a few salient regions or sectors but throughout the economy – is an elementary prerequisite for the deployment of monetary policy instruments. Below it monetary impulses cannot make themselves felt in the economy as a whole. An economy cannot be regarded as monetized as long as the money cannot be used to perform several – generally recognized – prime functions at the same time, amongst them its well-known functions of accounting unit, means of payment or exchange and store of value. As an accounting unit money can certainly be replaced by other objects – e. g. by gold or Units of Account – without any lessening of the degree of monetization in the particular national economy. The situation is however different if the money is not universally recognized as a means of exchange or store of value and other articles take on these roles. Of crucial importance is in this context that such developments do not occur only on a small scale but debar large parts of certain sectors or the population at large from participation in an advanced money economy.

The experience in the developing countries used here to illustrate the point shows that among the rural population, i. e. in the traditional sector of the economy, money exists only on a limited scale because labour is used mainly for self-supply purposes and remunerated in kind. Money is being used exclusively as a means of exchange for a few exchange transactions outside the scope of self-supply which do not take the form which is still the common one, namely that of barter. Another significant fact is that in the economic processes in the modern sector – which is largely dominated by foreign

enterprises – other units than the national currency are being used as a means of exchange.

In the traditional sector the store of value function of money is usually also performed by other objects many of which have traditional prestige value or offer a better guarantee of retaining their value. Precious metals and trading goods are used mostly for this purpose, for other financial assets are difficult to obtain. With the risk of rapid loss of purchasing power in mind, enterprises in the modern sector fight shy of using the native currency as a store of value.

It has to be noted then that in the traditional sector, in particular, monetization has not yet gone very far: money exists and serves as a means of exchange but, as experience shows, by no means for all economic activities in this sector. Worth noting is also that the relative shares of money economy and natural self-supply tend to vary, probably in relation to cyclical movements in the world markets.

Institutional Infrastructure and Monetary Policy

A major cause of the low monetization of the traditional sector is the inadequacy of the institutional infrastructure. Money and credit for economic processes are provided in part through the organized market of the banks and savings banks and otherwise by the unorganized market of moneylenders and merchants which also includes supply through hoarded money. It is well-nigh impossible to ascertain the relative importance of these two markets although the unorganized market is known to have the lion's share of the traditional rural sector. The moneylenders charge openly much higher rates of interest but their methods are more flexible and more easily understood by the farmers and they are in any case usually the only available source of money. The essential point for the central banks' monetary policies is that moneylenders and merchants cannot be regarded as financial intermediaries who gather together financial resources and allocate them in the form of investments. They do not specialize in the performance of financial functions as the institutions of the organized market, and they are not likely to be swayed by actions of the central bank through monetary impulses, the less so as they hardly ever draw on refinancing facilities in the banking sector.

As regards the modern sector, one of the problems of influencing the economic processes by the means of monetary policy is that the numerous foreign enterprises rely only in small measure on finance through indigenous banks; most of them are able to

draw on other internal or foreign sources of finance. Besides, the commercial banks in these developing countries, having formerly been subsidiaries of large foreign banks, still tend to pay more attention to short-term results and interests than to the long-term development objectives of the central banks. They will hardly ever provide loans for high-risk projects with relatively low commercial prospects as those in the traditional sector. Many attempts have been made to "Africanize" the staff of these banks but these have not wrought any real change. Monetary policy instruments have been used but the divergence of objectives has led to circumvention of central bank measures. That is known to have happened when indirect means of influencing the credit volume were used: the banks eluded them in spite of flanking measures or did not respond to incentives. Even when direct measures – e. g. selective credit control – were applied, the allocation of funds did not proceed in the direction desired by the central bank.

Application of Monetary Theory

The difficulties described here are encountered in the application of the instruments at the disposal of monetary policy irrespective of the underlying theoretical interpretation of the relevant causal connections and the levers accordingly selected for the monetary policy. If one starts from the Keynesian concept, interest rates and bank liquidity are unsatisfactory levers. In the traditional sector with its subsistence-economy orientation the demand for money is not interest rate-elastic as money is only in demand for immediate purposes (e. g. for family festivities or, seasonally, related to the harvest). Besides, the specific refinancing modalities of the unorganized credit market make it virtually impervious to outside influence on the liquidity of the financing agencies involved in it. In the modern sector, on the

other hand, a certain interest rate-elasticity may be assumed to exist; but many borrowers have access to financing facilities abroad so that the demand for money cannot always be directed in a certain way through the *internal* interest rates. It is difficult to judge to what extent the existence of adequate free liquidity reserves frees the commercial banks from dependence on central bank refinancing facilities. Most of them, however, may be assumed to have access to refinancing facilities abroad on which they can draw in case of need. Moreover, the economies under consideration are using much more money in the form of cash than is customary in industrialized countries, so that there is less scope for the creation of money by banks and equally for exerting an influence on the volume of money via the banks' liquidity.

If a judgment of monetary policy is based on the monetarist concept, it has to be noted first of all that the opposite transmission mechanisms hardly ever operate in the presumed way since there are no alternative types of investments in the traditional sector and few such types in the modern sector: in most cases money and goods are the only alternatives. The financial dualism vitiates in any case the transmission of monetary impulses: the connection between the organized credit market and the unorganized one is tenuous and general effects on the economy are all but ruled out. While it is true that the demand for money in the traditional sector does not respond to interest rate changes, money demand and supply obey other laws than assumed in theory. In this sector it would be especially wrong to expect the banks and the public to follow a consistent, known pattern in the use of the monetary base. The fundamental problem of the monetarist concept is probably the difficulty of determining and controlling the monetary base because a computation on the basis of the issued central bank money and the amounts held by

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commercial banks would be useless without corroborative statistical information about hoarded money and economic processes which do not involve the use of official money.

To sum up, the concepts of monetary theory rest on presumptions regarding the level of monetization and the institutional framework which do not pertain to the economies under consideration. These economies lack the objective requisites for using the instruments known to the industrialized western countries, and their monetary policy is directed to a different set of objectives.

These deficiencies manifest themselves not only in regard to theoretical concepts but in regard to the implications of the international monetary system for the national economies integrated with it. If one of the affiliated countries is in long-term payments deficit, the central bank concerned will be requested to take monetary measures to restore the balance of payments. As explained earlier, it would, however, be idle to expect developing countries to make efficient use of money policy. Their monetary policy is targeted on developing the national economy, and the policy-makers are unlikely to respond of their own volition to outside demands for greater attention to stable money.

Moreover, states whose independence is of recent date manifest a strong tendency to cling to their newly-gained autonomy irrespective of international arrangements even when a different course would entail economic advantages. Their aspiration to autonomy is curbed only by the economic necessity of integration in the western international monetary system in order to avoid jeopardizing their participation in international trade.

Adaptation of the International Monetary Order

The question is whether and how the international monetary order should be adapted to the particular needs and requirements of the developing countries. It has to be borne in mind from the outset that there is a limit to such adaptations: the willingness of the industrialized countries to accept economic disadvantages for themselves and hazards to the integration of the international monetary and economic order for the sake of adjustments to the needs of the developing countries.

In view of the shortcomings of monetary policy as a means of balance of payments adjustments in the considered economies, the currency policy is bound to be the main instrument for direct action on external

trade. In the analysis of the question how the features of the international monetary system have to be designed in order to enable such action and thus an autonomous monetary policy geared to internal political objectives, the degree of flexibility of the exchange rates proves to be the crucial factor. The nature of the currency reserves (gold, foreign currencies, special drawing rights, etc.) is in this context of secondary importance. Depending on the particular development strategy pursued, the effects of an exchange rate policy will differ in degree. Flexible exchange rates afford more support for development strategies aiming chiefly at export promotion, and at export diversification in particular, than for those favouring import substitution which need complementing by subsidies. The countries of Black Africa have hitherto focused on a strategy of raw material exports and taken only initial steps towards import substitution. A policy of flexible exchange rates is all but unknown. The countries of the francophone currency unions, being tied to the French franc by a fixed exchange rate, have flexible rates vis-à-vis other countries, but this flexibility matters little as the bulk of their foreign trade is with France.

It is the advantage of flexible exchange rates that, as well as providing scope for a national monetary policy, they are no hindrance to integration in the international monetary system: they trigger off adjustment processes in the deficit countries and do not lead to attempts to shift the whole burden of financing the deficit to the surplus countries. Such attempts would in the long run cause the system to disintegrate. The various recent reform proposals which postulate a link between development aid and international monetary system show that this is a real danger. However attractive a link between special drawing rights and development aid or a raw material standard may be for developing countries in the short term, they do nothing for long-term adjustment processes, nor do they predispose the surplus countries in favour of goods exchanges.

Flexible exchange rates are certainly not devoid of positive aspects but neither can their problematic side-effects on the economies of the developing countries, especially during the transition period, be ignored. The exchange rates would undoubtedly plummet if they were suddenly allowed to float, and lead to factor reallocation and unemployment. Under a raw material export strategy there are special reasons to question whether a change of exchange rates would have an effect on the supply and demand for export commodities as great as desired. The markets for

agricultural products, the principal export sector, respond very slowly to exchange rate variations.

An international monetary system to suit the developing countries would thus have to take account of two principal requirements¹:

□ Flexible exchange rates which bear on foreign trade directly, not by way of money policy, and thereby render long-term integration of the developing countries in the international monetary system possible;

□ Complementary arrangements which mitigate the negative side-effects of full decontrol of the exchange rates on the developing countries.

These conditions can be met, mainly by introducing a limited measure of flexibility, perhaps by means of the "crawling peg" which affords some measure of stability in the short term but guarantees an adequate measure of flexibility in the long term. In this way the exchange rate policy could incidentally be used as a temporary back-up for certain development strategies. The negative effects of relatively unelastic demand for

imports and a virtually inflexible supply of exports could be eased if several developing countries joined together on a basis of fixed exchange rates and deferred to a common currency authority. The currency unions of the franc zone might here serve as a model. The chief advantages would be more rational use of a common foreign currency pool and increased flexibility of export supplies and import demand, combined with the positive external effects of flexible exchange rates via-à-vis the outside world.

The positive features of such "en bloc" integration of the developing countries in the international monetary system are most promising but the difficulties of translating this idea into practice must not be underrated. Even if such a currency union has more homogeneous members than the franc zone, the surrender of national autonomous rights to an economic union inevitably involves problems. That has been demonstrated by the diverse attempts to foster integration, for instance in Africa.

Any "en bloc" integration must be a appropriate to the concrete situation in the individual economies at the time. Our reflections here are necessarily only theoretical in the sense of Gunnar Myrdal's definition of theory as a systematic quest leading up to further questions and, eventually, to solutions.

¹ For more detailed information and literature see: Gabriele Ullrich: Monetäre Wirtschaftspolitik in Entwicklungsländern und Weltwährungsordnung (Monetary policy in developing countries and international monetary system), Göttingen 1979.

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