

Bird, Graham

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Graham Bird\*

# Does the International Financial System Discriminate Against Developing Countries?

*The last 15 years have seen broad operational changes in the international system, accompanied since the beginning of the 1980s by a change in economic philosophy in a number of important industrial countries. Professor Bird examines the effects of various features of the post-Bretton Woods era on developing countries and proposes some reforms for the future.*

Any attempt to answer the question whether the international financial system discriminates against developing countries requires an initial clarification of the terms used. First, following the breakdown of the Bretton Woods system, there is legitimate debate about whether there has been an international financial "system" as such. During the Bretton Woods era there was a clearly established set of guidelines which underpinned international financial relationships, but since 1973 this has not been the case. Fixed, and centrally managed, exchange rates have been replaced by exchange rate flexibility, and, certainly during the 1970s and early 1980s, the official sector was replaced by the private sector as the most important source of balance of payments financing. Some observers have gone as far as characterising the post-Bretton Woods era as being a "non-system". Certainly, there has been a looser set of international financial arrangements than previously.

Second, in what way can the extent of discrimination, whether positive or negative, within any set of international financial arrangements be assessed? One approach would be to identify the costs and benefits associated with such a set and then calculate the extent to which these are equitably distributed amongst the countries involved. A slightly different approach would be to evaluate the extent to which any international financial system assists member countries in realising

their own domestic policy objectives. Where the system assists some more than others it might be seen as being discriminatory. Of course, where the system facilitates the pursuit of domestic policy objectives in some countries but impedes it in others the discrimination is, in a sense, more marked.

Third, what is meant by the phrase "developing countries"? It is now surely accepted that this is much too broad a classification. What might be to the advantage of one country might be to the disadvantage of another, even though both countries have a per capita national income which is sufficiently low to warrant the label "developing". Any meaningful discussion of economic development needs to use a more disaggregated approach which differentiates between developing countries.

Having made these introductory remarks, it is now possible to explain more precisely what this article attempts to do and what approach it adopts. Basically it takes the period since the breakdown of the Bretton Woods system and examines whether the changes that have occurred in the international financial "system" since then have been to the advantage or disadvantage of developing countries. The conclusion emerging is somewhat ambiguous depending on the particular part of the time period selected, the particular change identified and the particular countries chosen. The short answer to the question in the title is therefore not a simple "yes" or "no" but instead a more frustrating "it all depends". The rest of the paper examines this short answer in more detail.

\* University of Surrey, Guildford, UK. For further discussion and documentation of the issues raised in this paper see the author's recent book: *International Financial Policy and Economic Development: A Disaggregated Approach*, Macmillan, London 1987.

We begin by identifying some broad operational changes in international financial arrangements since 1973 and examining their implications for developing countries. Having acquired an overall picture we then move on to isolate some rather more specific changes which are of particular relevance to the developing world.

The most significant operational changes have been: first, the move away from generalised fixed to generalised floating exchange rates; second, the move to the market place as a means of providing balance of payments financing; third, the lack of effective policy co-ordination between industrial countries; fourth, the move away from a structured international financial system; and fifth, the rise of the "new protectionism".

Along with, and perhaps in relation to, these developments, political changes in a number of important industrial countries around the end of the 1970s and the beginning of the 1980s brought with them a change in economic philosophy. This involved a much stronger belief in the efficiency of private markets and therefore a much weaker commitment to the need for government intervention.

In addition, macroeconomic policy in industrial countries became much more firmly based on an attempt to reduce inflation through the pursuit of restrictionary monetary and fiscal instruments; although fiscal constraints were fairly dramatically relaxed in the USA as the 1980s proceeded.

### **Floating Exchange Rates**

Developing countries were largely opposed to the introduction of generalised floating for a number of reasons. First, it was felt that through the uncertainty to which they would lead they would have a globally anti-trade bias. Second, and more specifically from their own perspective, developing countries feared that they would have insufficient access to forward cover and would therefore be in a particularly disadvantageous position with regard to such uncertainty. A third concern was that, since many developing countries might continue to peg the value of their currencies to one specific, though not necessarily the same major world currency, variations in the value of these major currencies vis-à-vis each other might be inappropriate for developing countries, leading to disequilibrium in developing countries' real effective exchange rates – the so-called "third currency phenomenon". Related to this phenomenon was the worry, fourthly, that generalised exchange rate flexibility would increase the need for international reserves in some developing countries, even though globally greater flexibility in

exchange rates would be seen as reducing the need for reserves. Moreover, exchange rate flexibility, it was feared, would have implications for the optimum composition of reserves, since an additional risk of loss through a depreciation in the currency in which reserves are denominated is introduced, calling for more sophisticated reserve management.

Fifth, where debt is denominated in currencies which appreciate, its real value may rise and debt management also becomes more of a problem.

Although it is true that an attempt to maintain generalised fixed exchange rates during the post-1973 period would have resulted in the pursuit of domestic economic and trade policies in the developed world which would have been unfavourable to developing countries, and that, so some extent, the cost of generalised exchange rate flexibility can be minimised through developing countries' own exchange rate policies, there is considerable empirical support for claiming that at least some of these fears have proved justified. Third currency instability has caused changes in real effective exchange rates, and there is evidence that exchange rate flexibility has constrained the growth of trade. At the same time there is little evidence to support the claim that flexible exchange rates have enabled countries to pursue policies of demand expansion and trade liberalisation, indeed in many cases just the opposite seems to be the case.

While these observations suggest that developing countries have a common interest in reforming the global exchange rate regime to remove excessive flexibility, it is also the case that some developing countries have been more adversely affected than others, depending on the pattern of their trade, the currency denomination of their reserves and debts, their access to forward cover, and their own exchange rate policy.

### **Private Market Financing of Payments Deficits**

During the 1970s and early 1980s the private banking sector took over the principal role in providing balance of payments financing to developing countries. However, the pattern of lending was heavily skewed. Recipients of bank loans, essentially the middle income exporters of manufactures (and oil), were able to de-emphasise adjustment or to select longer-term adjustment strategies. Non-recipients were, however, often forced to turn to the IMF where they became subject to conditionality which favoured short-term balance of payments stabilisation.

The attitudes of different developing countries to this

alteration in the provision of international finance was therefore clearly not uniform.

More recently the banks have endeavoured to extricate themselves from lending to even those developing countries previously seen as creditworthy and have therefore, in a sense, exacerbated the debt problems which many countries have been encountering. Without delving into the various causes and consequences of the global debt problem we can note that a broad range of developing countries might be expected to be unhappy with the existing status quo. However, while the formerly creditworthy developing countries might be looking for measures from the official sector to support private lending, the least developed countries will tend to favour more direct lending by the official agencies. Again, there is little reason to presume that all developing countries will have similar interests as regards the nature of reform.

### **Lack of Policy Co-ordination**

Although economic summits give the image of a degree of co-ordination in terms of the design of macroeconomic policy in industrial countries, the hard evidence suggests that this image is illusory. Most notoriously the 1980s have witnessed a significant misalignment of policy between the USA, the major European economies and Japan. This has itself led to exchange rate problems and to protectionist pressure.

The design of US macroeconomic policy, which has involved a largely bond-financed fiscal deficit has pushed up world interest rates, and this in turn has had implications for heavily indebted countries with a large amount of floating interest rate debt. While the recent fall in the value of the dollar has helped alleviate the problems facing some developing countries, especially those whose export earnings are in other currencies, it has also served to devalue the often already low foreign exchange holdings of much of the developing world. The collapse of the dollar and related stock market falls have also raised concern about world recession.

### **The De-structuring of the System**

With the moves to generalised floating and to the private sector as the principal source of balance of payments financing, much of the underlying structure of the Bretton Woods system fragmented after 1973, although the debt problems of the 1980s, which in part resulted from this fragmentation, resulted in a certain amount of restructuring with the Fund and the World Bank again assuming importance.

As noted above, some developing countries initially

did quite well from the move away from a structured system based on the official sector and the Bretton Woods institutions. Other, and essentially poorer, developing countries did much less well. The impression that exchange rate flexibility and the private provision of international liquidity removed the need for additional reserves militated against their interests.

While, by the mid-1980s, there might be much more agreement amongst developing countries concerning the need for a move back towards a more structured system, their views on the precise details of such a restructuring might be expected to differ for the reasons discussed already.

### **The New Protectionism**

As mentioned earlier many of the developments of the post-1973 era imply trade deliberalisation, and this is what has been observed, with many studies cataloguing the rise of the new protectionism; "new" in the sense of being based on non-tariff barriers against which it is more difficult to legislate.

While protectionism in developed countries is, in general, against the interests of developing countries anxious to expand exports and earn more foreign exchange, not least to help service their debt obligations, developing countries will be differentially affected by it depending upon its precise form.

While the above discussion suggests that many of the features of the post-Bretton Woods era have been to the disadvantage of developing countries, it is also the case that many of the discriminating features of the Bretton Woods system have endured. The distribution of the adjustment burden is still asymmetrical, in spite of flexible exchange rates, with most pressure being put on those deficit countries where the domestic currency does not double up as an international reserve asset and where reserve holdings are low. It is, for example, interesting to compare the alternative ways in which the developing countries and the USA have handled their respective debt problems. While developing countries have had to respond, in large measure, by pursuing adjustment policies, the USA has been in a stronger position to finance its deficits and in the process has, to some extent, crowded out developing countries from international capital markets. Meanwhile the distribution of the seigniorage associated with international reserve creation has continued to disfavour developing countries, with the principal sources of reserve growth being foreign exchange, and gold appreciation. Empirical evidence shows that reserve inadequacy is a particular problem for many developing countries.

Moving from the general to the specific, there is considerable evidence to suggest that in the early years after the demise of the Bretton Woods system institutional arrangements were still being modified to accommodate the needs of developing countries. The modifications included: the introduction of new facilities such as the Extended Fund Facility and the Trust Fund; the subsidisation of interest rates on borrowing from the IMF for the poorest countries; the liberalisation of existing facilities such as the Compensatory Financing Facility; as well as some relaxation in Fund conditionality.

In the first half of the 1980s, however, things changed. Fund conditionality became stricter, the CFF was deliberalised and regular SDR allocations failed to occur. It has only been as the international debt situation has become more critical that there has been some reassertion of the earlier trend, with particular attention now being focused on the plight of the least developed nations. Yet even some of the measures taken to assist such countries have been half hearted as the quite rapid need to enhance the IMF's Structural Adjustment Facility revealed.

### Measures for the Future

If there are indeed ways in which the international financial regime discriminates against developing countries, the question is what might be done to reduce such discrimination in the future?

The first point to underline is that developing countries are a heterogeneous group. While they may share some common interests relating to the nature of the international financial regime, beyond that their needs are likely to differ. International financial reform therefore has to adopt a disaggregated approach.

The second issue relates to the spatial level of reform; should it be the case that developing countries are frustrated by the lack of progress achieved by the North-South dialogue, this frustration should not lead them to assume that a Southern dialogue will be easy and productive. Developing countries will in general lose more than they will gain by de-linking themselves from the international financial regime.

The third issue relates to the nature of the reform process; should it be revolutionary or evolutionary? On the basis that the bargaining position of the developing countries is unlikely to be strong enough to carry through revolutionary change, it would seem wise for them to pursue a more gradualist and incremental approach, much as has operated historically. What sorts of modifications might be sought? With regard to

adjustment, there is still considerable scope for reforming Fund conditionality in such a way as to make it more appropriate to the needs of many developing countries, with greater emphasis being placed on structurally oriented and supply or growth based adjustment. To some extent such a change could be achieved by returning to the original rationale of the Extended Fund Facility. Appropriate adjustment might similarly be encouraged by extending structural adjustment lending by the World Bank.

However, adjustment may not always be apposite. In these circumstances, and in circumstances where adjustment is most appropriately brought about over a relatively protected period, international financing is required. In relation to this, measures to expand the lending capacity of the Fund (and the World Bank), to reform and re-liberalise the Compensatory Financing Facility – thus raising the proportion of low conditionality Fund finance –, to strengthen the role of the SDR in the international financial system and to modify the distribution formula so that a larger proportion of any given allocation goes to developing countries, would be beneficial to the South. In many ways, however, such reforms would be of principal benefit to the least developed countries. These countries could also be assisted by the extended use of interest rate subsidisation.

The better-off developing countries might, of course, prefer to see a larger proportion of official finance being used to support enhanced private capital flows. Here again there are proposals for loan insurance and guarantees, and the provision of lender of last resort facilities that are worthy of close consideration.

Many of the proposals mentioned above would contribute to the easing of the debt problem, but there is also a range of other, individually quite modest proposals, which could also be beneficial and usefully considered, including the reform of rescheduling packages, and various debt conversion schemes.

Although many of the reforms listed above would not seem out of place in a programme for a New International Economic Order the approach to (and in some cases design of) reform is significantly different in the incremental alternative. The design takes existing institutional arrangements and works within the general framework that they provide. The approach does not involve a sudden discrete and root and branch change but rather a gradual series of modifications, each of which, on its own, may seem relatively modest, but which, in aggregate, sum to significant reform.