

Diaz-Alejandro, Carlos F.

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ECONOMIC GROWTH CENTER

YALE UNIVERSITY

Box 1987, Yale Station
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THE LESS DEVELOPED COUNTRIES

Carlos F. Díaz-Alejandro

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THE POST-1971 INTERNATIONAL FINANCIAL SYSTEM AND

THE LESS DEVELOPED COUNTRIES

Carlos F. Díaz-Alejandro *

Yale University

Discussions regarding the stakes of less developed countries (LDCs) in international monetary reform have typically emphasized the benefits to LDCs of an international monetary system conducive to fast growth and freer trade and financial policies in the industrialized countries. Much has also been written regarding schemes to link expansions in world liquidity, either by issuing special drawing rights (SDRs) or by a once-and-for-a-while increase in the price of monetary gold, to an increased flow of financial resources to LDCs¹. Some attention will be given in this paper to these issues, but more will be said on two relatively neglected areas: the position of LDCs in a world of greater exchange rate flexibility, and the interactions of LDCs with the emerging international capital markets.

The 1972-74 commodity boom, including the remarkable increases in oil prices, on the one hand, and the plight of some African nations in the Sahel and of Bangladesh, on the other, have dramatically underscored during recent years the old cliché about LDC heterogeneity. In this paper two characteristics will receive special attention for the purpose of differentiating among LDCs: endowment of natural resources with high direct or indirect world demand, and degree of openness to international trade and finance. Inevitably, Saudi Arabia will seek from the international financial system

services different in quality and quantity from those sought by Chad, while Brazilian attitudes toward greater exchange flexibility can be expected to differ from those of Upper Volta.

LDCs and Exchange Rate Flexibility

The LDCs, speaking with notable unanimity via the "Group of 24," have indicated a preference for fixed exchange rates for the currencies of industrialized countries, while reserving their option to adopt for themselves more flexible exchange rate arrangements. Such LDC preference for fixed rates (at least for the industrialized nations) has caused some bewilderment and criticism, even among observers most sympathetic to LDC positions². Yet, as in the case of the general debate of fixed versus flexible rates, although with substantive differences in the arguments, something economically sensible can be said on both sides of the debate as to whether LDCs can be expected to benefit or suffer from the adoption by industrialized countries of more flexible exchange rates. While I end up preferring the greater flexibility which reality has imposed on the world, it seems necessary to first review the arguments on the other side, which the profession has tended to ignore, very much as new converts fear showing any sign of sympathy for past abandoned beliefs.

Much of what follows relies on concepts developed in discussions regarding "optimum currency areas"³. In those discussions a small, open economy is viewed as one with a high share of tradable goods in its Gross National Product, with prices in foreign currency of those tradable goods being given exogenously to the small country. Note that this definition can apply to

Holland or Portugal as well as Honduras; our concern here is with the latter type of country. Another key concept is that of a disturbance, which may be caused by policy or by nature, and which may originate inside or outside the country. These useful concepts, alas, are not easily quantifiable. The borderlines between tradable and non-tradable goods and between small and large countries are misty, and even the definition of a disturbance is not unambiguous. The analysis of exchange rate policy, including ours, is plagued by such difficulties ruling out a precise differentiation between small, open economies and others. But many LDCs can be characterized as small, open economies with a minimum of ambiguity. It may be useful to first consider why this type of LDC may prefer not only to fix its own exchange rate, but also to see all major exchange rates fixed in relation to one another.

Even the most ardent advocates of greater exchange rate flexibility have recognized that small, open economies would do well to fix their exchange rates in terms of a dominant currency. The basic argument is well presented by Harry G. Johnson, albeit with some departures from his usually high standards for scientific language:

"One is accustomed to thinking of national monies in terms of the currencies of the major countries, which currencies derive their usefulness from the great diversity of goods, services, and assets available in the national economy, into which they can be directly converted. But in the contemporary world there are many small and relatively narrowly specialized countries, whose national currencies lack usefulness in this sense, but instead derive their usefulness from their rigid convertibility at a fixed price into the currency of some major country with which the small country trades extensively or on which it depends for capital for investment. For such countries, the advantage of rigid convertibility in giving the

currency usefulness and facilitating international trade and investment outweigh the relatively small advantages that might be derived from exchange rate flexibility. (In a banana republic, for example, the currency will be more useful if it is stable in terms of command over foreign goods than if it is stable in terms of command over bananas; and exchange-rate flexibility would give little scope for autonomous domestic policy.)"⁴

The small, open economy will wish to peg to the currency of the country with which it has most of its trade and financial relations. Thus, Guatemala will peg to the dollar and Chad to the French Franc. If the international trade and financial flows are exclusively with the country to whose currency the peg is determined, fluctuations between that key currency and other key world currencies will matter little to the small country. Its domestic price level will be unaffected by those fluctuations, while prudent managers of the external assets and liabilities of the small country will have little doubt as to the choice of foreign currency denomination for their financial instruments. Reserves held in hegemonic currencies will assure the citizens of the small country holding the national currency that domestic disturbances, such as the failure of an exportable crop, need not destroy the "international moneyness" of their currency holding, and will allow the small country to draw on the real resources of the hegemonic power during the crisis. The balance of payments of the small country will be influenced by fluctuations among key currencies only in a very indirect fashion, of quantitatively negligible proportions.

Max Corden has defined⁵ a "pseudo-exchange-rate union" as one in which members agree to maintain fixed exchange-rate relationships within the union, but without explicit integration of economic policy, and with neither a

common pool of foreign-exchange reserves nor a single central bank. Thus, Guatemala could be said to have a unilateral commitment to a pseudo-exchange-rate union with the United States, while Puerto Rico has a full exchange-rate or monetary union. In the extreme case when the small country has all its trade and financial transactions with the hegemonic country, the practical invariance of its price level to fluctuations among key currencies establish a "pseudo-optimum currency area," needing only greater factor mobility, particularly of unskilled labor, to approach the complete requirements of an optimal currency area, from the viewpoint of the small country. On this respect, one could also contrast the cases of Guatemala and Puerto Rico.

An extreme type of small, open economy practically eliminates the possibility of policy-induced domestic monetary disturbances by doing away with its own Central Bank, relying on the currency and monetary system of the hegemonic power to which it is attached, as in the case for many years of the Republic of Panama. Natural disturbances originating domestically, or disturbances of any kind originating abroad trigger adjustment mechanisms similar to those described by text books for the gold standard, or by J.C. Ingram for the Puerto Rican case⁶. Such an adjustment process requires for the smooth achievement of both payments equilibrium and reasonably full employment either flexibility in domestic money wages or freedom of factor movements between the small country and the hegemonic power. As such small countries are likely to carry a very large share of their foreign trade and financial transactions with one large country, the relevant foreign disturbances will be those originating within that power, much as West Virginia is affected by what happens in the rest of the United States, and cares

relatively little about disturbances originating in France. It is noteworthy that Milton Friedman has suggested that policies discussed above for an extreme type of small, open LDC (fixed exchange rates, no monetary autonomy) can be applied to most developing countries, whose alleged monetary concupis-
cence presumably cannot be restrained by any other means⁷.

So far the discussion has focused on the exchange rate between the small and the large country to which it is associated. If in fact all international trade and financial flows of the small country are with one large country, the exchange rate between that large country and the rest of the world will be largely a matter of indifference for our small country. But once some trade and financial flows are allowed between our small country and others (besides the large hegemonic power), matters change. Consider a world made up of two large and one small country, whose exchange rate is pegged to one of the large countries. If a disturbance arising in one or another of the large countries, and affecting only their mutual trade, is handled by successful fiscal and monetary measures as well as by reserve changes, leaving their exchange rates unchanged, the impact of such disturbance on the small country will be negligible. If, however, the disturbance is allowed to modify the exchange rate between the large countries, the impact on the effective exchange rate of the small country, its terms of trade, and on the real value of its foreign debt and exchange reserves will be felt at once⁸.

The disturbance hypothesized in the previous paragraph is rather special. Consider now a more general type of disturbance, say a sudden expansion of military expenditures not covered by taxes in the large country to whose currency the small country is pegged. If the large countries are also pegged

to each other, the excessive monetary expenditures will spill out toward the small and the second large country, according to the relevant marginal propensities in the inflating large country. The small country, whether it follows a passive monetary policy or actively wishes to keep in step with the hegemonic power, will also inflate approximately in proportion to the hegemonic power. If the other large country checks the imported inflationary pressures, it will maintain a tendency toward surplus in its balance of payments, including vis-à-vis our small country which will tend to switch the source of its imports away from the hegemonic power, even as it tries to sell to it more of its exports. So long as this situation does not lead to a breakdown of relatively free trade and convertibility in the system, the adjustment burden for the small country will be relatively minor (and almost pleasant). Clearly, however, the situation described above will not have reached a new equilibrium until the second industrial country either inflates in proportion to the hegemonic power or revalues its currency.

Suppose now that the disturbance originates in the second large country, and that again it also involves a sudden inflationary expansion of its public expenditure. So long as the exchange rate between the two large countries remains pegged and world trade and financial rules are unchanged, the impact of this disturbance on our small country will remain even more indirect and minor than in the previous example, given the assumptions regarding trade and financial links.

If the disturbance in either of the two large countries is in a deflationary direction, the small country will still be least affected if such disturbance is handled by compensatory fiscal and monetary policies in the large countries, without resorting to exchange rate changes between them.

When the disturbance originating abroad involves just one international market which may be of particular importance to the small country (e.g., that for its major export, such as the banana market, or for its major import, such as the oil market), the small country will typically prefer to handle such disturbances by taxes or subsidies specific to the commodity with erratic fluctuations, rather than by changing its exchange rate, a measure which would affect all domestic prices for importables and exportables.

Do most LDCs conduct all or nearly all of their trade and financial transactions with one major industrialized country? A little noticed benefit for many LDCs of the 1944-1971 world economic order, including relatively fixed rates among key currencies and their eventual convertibility, has been precisely the creation of a multilateral framework within which trade and financial diversification could occur, in contrast with the pre-1944 order characterized by inward-looking trading and financial blocs led by colonial and/or hegemonic industrialized powers. Of total Latin American exports, for example, 46 percent went to the United States in 1950. By 1972, only one third of those exports went to the United States. In 1960 almost half of all exports of African LDCs went to the United Kingdom, France and Belgium. By 1972 that share had declined to 31 percent. Similar trends have taken place on the import side; one should note, however, that convertibility has allowed substantial and persistent imbalances in the bilateral trade and payments of many LDCs vis-à-vis large industrial countries⁹.

Not all LDC regions have experienced the diversification noted for Latin America and Africa, and it could be argued that gains in trade diversification with respect to the industrialized countries of Western Europe

are partly illusory, as that area has become more of a single decision-making unit. Intra-LDC trade, and that between LDCs and socialist countries, have remained relatively modest. But the generalization that for all practical purposes most LDCs have an optimum currency area including just a given LDC plus its hegemonic trading partner is untenable. Diversification has advanced too far in most LDCs for such a narrow view of their currency arrangements. Once actual and expected (or desired) trade and financial diversification is introduced, decisions on exchange rate policy and financial management for LDCs, particularly the smaller ones, become more difficult. Those difficulties may be illustrated as follows

Consider a hypothetical example of an LDC, whose exports (or imports) amount to 30 percent of its Gross National Product. Say half of its exports go to France and half to the United States, while 40 percent of its imports come from France and 60 percent from the United States. Its capital account transactions could be one third with France, one third with the United States and one third with Japan. Question one: would this LDC rationally prefer fixed or floating rates among the dollar, the franc and the yen? Question two: is this hypothetical example, with its trade and financial diversification, more likely to be a realistic one under fixed or floating rates among the dollar, the franc and yen?

For the small country having or aspiring to have the indicated international diversification, a world in which Balance of Payments adjustment among France, the United States and Japan occurred somehow without changes in their exchange rates, and without limiting their freedom of trade and financial transactions, would be clearly preferable to one with floating

rates among the three key currencies. The difficult decisions presented by that last scenario are several.

A first obvious decision has to do with the peg; should it be with respect to the dollar, the franc, the yen, or to some kind of a weighted average of the three (or to SDRs)? In the simplest, extreme case discussed earlier, pegging to the hegemonic key currency tied the small country price level to that of the major country, while remaining invariant to changes among key currency values, and price levels in the rest of the world. Now no pegging to any single currency will achieve the objective of isolating the domestic price level from fluctuations among key currencies. Put another way, under conditions of diversification, pegging to a single key currency will result in variations in the effective exchange rate of the small country. Those variations will result from fluctuations among key currencies, and will have nothing to do with the Balance of Payments position of the small country. The variations among key currencies may result from fundamental disturbances, such as those discussed above, or from the erratic performance of exchange markets. Post-1971 experience has served to allay the worst fears of those opposing exchange rate flexibility, but it also casts doubts on the hope that stabilizing speculation would keep exchange rate movements small and gradual, and responsive only to fundamental disturbances¹⁰.

To reduce its loss of control over its effective exchange rate, the small country will have to peg to a weighted average of key currencies. If the goal is to keep domestic prices in line with the "world" price level, the weights will have to correspond to those of each major country in such price level. If the explicit goal is to maintain balance of payments equilibrium

by manipulating the effective exchange rate, more complicated calculations, involving price elasticities by regions, will be required. In practice, crude (and changing) weighting rules are likely to be followed, as the ideal weighting system is difficult to define even in theory. For example, how should financial flows with different countries be weighted, as compared to trade flows? In short, the simplicity and neatness of pegging to a single key currency will be inevitably lost.

The hypothetical example of a small, diversified LDC given above included a trade surplus with France, matched by a trade deficit with the United States. Historically, this kind of triangularity gave countries such as Canada and Argentina numerous headaches at times of stress in the international economy, as during the 1930s. Many LDCs are in similar positions today. Current account surpluses, for example, are earned by many Caribbean islands in their dealings with the United States, while they register deficits with Western Europe. Allowing fluctuations among key currencies will introduce one more source of uncertainty about the terms of trade, servicing the foreign debt and the Balance of Payments of small countries previously benefitting from convertibility at fixed exchange rates.

Even if it is assumed that fluctuations are around a known long run average dollar-franc rate (using our hypothetical example) and that at that rate the franc surplus and the dollar deficit match, the franc-dollar rate fluctuations will in all likelihood lead to higher reserve holding by the small country, as the balance of payments position of that LDC, defined in either currency (or in domestic currency) for a given month or year, will be subject to one more element of uncertainty. The increased reserve holdings, of course,

carry a significant cost.

When our small country carried all of its trade and financial transactions with one hegemonic power, with which it kept a permanently fixed exchange rate, the decision regarding in which currency external assets and liabilities (public or private) should be held was straightforward. If somehow the small country could be assured of permanently fixed rates, with convertibility among key currencies, that decision would remain easy. But with floating key currencies, portfolio management becomes more difficult. Crude rules of thumb similar to those guiding the multi-currency pegging can be devised. For example, the holding by the Central Bank of different foreign currencies can be made a function of (besides interest rates) possible deficits with the different key currency zones, and the expected fluctuations among key currencies. Foreign public liabilities in a given key currency could be made a function of expected payments surpluses with that currency area, again adjusted by expected fluctuations among key currencies and interest rates. Such general rules, however, are easier to enunciate in general than to make specific in practice, particularly when substantial capital flows are involved in the payments and surpluses with different currency areas. Furthermore, the search by monetary authorities for avoidance of exchange risks will not be a costless operation, although such costs could be partially offset by learning effects and gains in self-confidence.

Attempts to minimize risks in a world of floating key currencies could lead to other costs for LDCs, going well beyond those involved in expanding and upgrading Central Bank (and private sector) staffs of financial analysts. If the small, open LDC pegs its currency to just one of the key currencies,

trade and financial transactions could be diverted toward the area using such hegemonic currency, even when real costs would suggest a more diversified pattern. The anti-trade bias of greater exchange flexibility perceived by some analysts becomes a trade-diverting bias for the small LDC pegged to one key currency. Similar considerations would apply, perhaps with greater force, to its international transactions on capital account; the small country may perceive that its exchange risks will be reduced by denominating its foreign debt in the intervention currency. To avoid such departures from effective multilateralism, the small LDC will have to peg to a bundle of key currencies, a decision which, as already discussed, presents its own problems.

The political implications of this analysis are fairly clear. But it is well to emphasize that it is not just an "irrational" dislike of the neocolonial flavor of pegging to just one key currency in a world of generalized floating which leads several LDCs to prefer fixed exchange rates across the board. The likely retreat from effective multilateralism, and a reversal of trends toward trade and financial diversification involved in pegging to just one key currency would involve real economic costs, and so would pegging to a bundle of them.

As already noted, in spite of the arguments presented in the previous pages, I end up believing that generalized floating among key currencies, although presenting LDCs with new problems, is a better system from their viewpoint than any feasible alternative. When discussing disturbances originating within large industrialized countries, it was pointed out above that those countries could generally avoid exchange rate changes by wise fiscal and monetary management offsetting disturbances. But it is precisely departures from such wisdom which have created most disturbances in the first place, so

that hopes for offsetting wisdom seem utopian. While the relatively fixed rates for key currencies during 1944-1971 were compatible on the whole with trade and financial liberalization in the industrialized countries, the late 1960s gave clear indications that with the degree of interdependence achieved and with a realistic assesment of the macroeconomic policy performance of the rich countries, fixed rates required for their survival growing trade and financial controls, which stimulated protectionist sentiments. Given the post-1966 failure of hegemonic powers to carry out sensible macroeconomic policies and given the degree of trade and financial interdependence achieved, asking industrialized countries to maintain fixed exchange rates and liberal trade and financial regimes and expansionary policies is asking for the moon, and supposes a degree of competence among rich-country policy-makers (and/or social cohesion in those societies) which simply is not there. The misuse by the U.S. of the "exorbitant privilege" of the dollar, in particular, doomed the Bretton Woods system.

There are also some positive aspects of generalized key currency floating for LDCs. Some large and not-so-large LDCs, such as Brazil and Colombia, have already experimented successfully with crawling or trotting pegs. While in those countries exchange rate policy has been used primarily to offset domestic inflationary trends, yielding only modest fluctuations in the real effective exchange rates, their example coupled with that of key currencies may induce other LDCs to rely more on exchange rate policy and less on quantitative restrictions for balancing their international accounts, with likely gains in efficiency and growth.

Besides LDCs with secular inflationary problems, or inefficient trade

and payments policies, and those in peculiar entrepôt circumstances, such as Lebanon and Singapore, it will be the LDCs with the larger and more diversified domestic markets which will find it easier to experiment with greater exchange rate flexibility. Those countries will be able to follow a more independent monetary policy, complementing their political independence. The dilemmas imposed on the small, open LDCs by generalized floating is in fact just one more manifestation of the "small country problem" in a contemporary international scene, where political power accumulates in large countries, or coalitions of them, and is used to further economic goals. The small country also occupies a paradoxical position in the theory of trade and finance: it is supposed to face a perfectly elastic demand for its exports (so it need not worry about meeting the Marshall-Lerner condition) yet its smallness presumably deprives it of policy tools available to larger countries. When trade theorists discuss interactions between tariffs, subsidies and the exchange rate (or multiple exchange rates), showing how alternative mixes of those policy instruments can yield equivalent relative price structures, little or no attention is given to how different decisions on exchange rate policy influence the capital account of the balance of payments nor the "moneyness" of domestic currency. All of this, of course, is one more example of the lack of integration between the real and financial elements of international trade theory. On balance, the emphasis of trade theorists may be correct and it may well be that the monetary impotence of small open LDCs has been exaggerated by focusing on the limits set by the tradable/non-tradable goods dichotomy discussed earlier.

Although by definition small open economies have a high share of imports

and exports in GNP, it is not obvious that their share of importables and exportables in GNP will also be higher than in larger economies. To start with, the share of services in GNP does not seem to be very strongly related to size (whether geographic or economic) nor to per capita income. In some economies tourism or temporary emigration may transform some services into "exportables", but that effect does not appear to be systematically related to size. Local tastes or the relative size of the subsistence sector can also influence the degree of substitutability between locally produced and consumed agricultural and manufactured goods, and similar ones traded internationally.

A way out of these ambiguities may be sketched as follows. The universalization of markets for clearly tradable goods has been accompanied by a similar universalization of capital markets; it would be difficult to settle whether in recent years the mobility of tradable goods has been greater or less than that for financial capital. Thus, it is not only the prices of tradables but also the rate of return to capital which have tended to equality within the Atlantic/and Pacific trading communities and those LDCs attached to it. Unskilled labor remains the factor (after "land") least mobile internationally, as the postwar has also witnessed growing universalization in the market for skilled labor. Under these circumstances, a change in the exchange rate by a given country may be viewed as an attempt to change the wages of its domestic unskilled labor expressed in truly tradable goods. The key policy variable becomes, ceteris paribus, the ratio of unskilled wage rates expressed in domestic money to the exchange rate. As a single unemployed or partly employed individual attempts to improve his lot by cutting

down the wage at which he will supply his labor, a country with payments problems is faced with the need to shade the real rewards in terms of tradable goods of its major immobile factor of production. Such a change, of course, can be accomplished either by changes in the exchange rate or in money wage rates. Either change can be said to be caused by the international immobility of unskilled labor in the face of payments imbalances. As a result, larger net exports of goods and services as well as larger net inflows of capital can be expected. It could also be assumed, not implausibly, that non-traded goods use unskilled labor more intensively than traded goods, which rely more on skilled labor, capital and rare natural resources.

Modern devaluation theory emphasizes that an exchange rate change, starting from an equilibrium situation, will not change any relative prices or any other real variable over the long run. Devaluation is then best viewed as a way of getting around some market imperfection, such as wages and prices which are sticky downward, which block a speedy and smooth return to equilibrium after some disturbance has shocked the system. When viewed from this angle it becomes less obvious why a small open LDC cannot use exchange rate changes, just as larger countries do, to achieve desired reductions in real wages or in real money supplies. "Money illusion" among wage earners in the modern sector of small countries is less likely a priori, but their social cohesion (or "discipline") may be higher.

It may be noted that in some LDCs convertibility at a rate firmly pegged to a hegemonic currency is not only a policy designed by conservative Central Bankers to assure holders of domestic currency of its "moneyness", but also (or primarily) a policy aimed to assure elites that, if political trouble threatens domestically, they can speedily transfer their locally-held

wealth to New York, Paris or London. Such wealth, of course, will include many assets besides domestic money. Large reserves and a pegged rate under those circumstances may be convenient insurance for the elites, but not necessarily desirable policies from the viewpoint of, say, unemployed unskilled workers. While in some countries the elites may derive most of their earnings from exports, making them willing to contemplate frequent devaluations, in other countries elite expenditure patterns may be so oriented toward truly tradable goods and services (e.g., tourism abroad) as to induce them to support firmly pegged and convertible exchange rates.

During the 1950s and early 1960s even small countries with fixed parities maintained a modest degree of autonomy over monetary policy, thanks to imperfections in international capital mobility. As such mobility improved dramatically during the late 1960s and early 1970s, small countries (and not-so-small ones, like Mexico) were faced with new choices, familiar to small industrialized economies: letting their remaining monetary autonomy evaporate, imposing or tightening exchange controls, or abandoning fixed rates.

It remains true that the socially optimal degree of exchange rate flexibility in a small open LDC is likely to be, ceteris paribus, somewhat smaller than in large industrialized countries. Very frequent devaluations of the effective exchange rate or low levels of international reserves will raise doubts among holders of domestic currency as to the "moneyness" of such asset. Ultimately, however, one returns to key assumptions regarding Central Bank behavior in different countries. A small open economy following a prudent monetary policy and producing a staple with good export prospects (oil instead of bananas), and surrounded by large industrialized countries undergoing

rampant inflation coupled with generalized key currency floating could certainly revalue its exchange rate fairly frequently without jeopardizing the "money-ness" of its domestic currency nor upsetting its (non-exporting) wealthy elites. If one were to explain why Canada has followed a more flexible exchange rate policy than Mexico it is unlikely that a plausible answer can be built around differences in the share of tradables in GNP between those two countries; different degrees of confidence on monetary and political authorities, allowing tolerance for flexibility in one case while imposing the discipline of fixed rates plus convertibility in the other, appears to be a more likely (if unquantifiable) explanatory variable.

Those arguing that LDCs should, for their own good, lock their monetary tools within a species of chastity belt and throw away the key, prefer to assume a relatively tranquil world environment, offering an anchor of price level stability. Such a view was valid for the late 1950s and early 1960s, but certainly did not apply during the 1930s and early 1940s, and is quite debatable for the 1970s. LDCs which followed autonomous monetary policies during the 1930s, including exchange rate changes, such as Argentina, Brazil and Colombia, weathered the Great Depression far better than those adhering to Friedman-Johnson policies of passive adjustment to the actions of hegemonic powers¹¹.

To summarize: the failure of industrialized countries to discipline their macroeconomic policies led to the collapse of the Bretton Woods system and it is unlikely that those countries will be able to provide an international framework characterized by relatively free trade, convertibility, steady growth and fixed parities in the foreseeable future. Such a turn of events

need not be an unmixed curse for LDCs, however. Some LDCs may take up the opportunity to revamp their own trade and payments system, improving its economic efficiency. Others may move in the direction of greater autonomy in monetary policy, a step which is consistent with the often-voiced desire of those countries to eliminate neocolonial dependency inherited from the past. In many sovereign LDCs, in fact, monetary arrangements have changed little since the days of colonial "currency boards", and those monetary arrangements are not fundamentally different from that of Puerto Rico.

For the sake of maintaining an effectively multilateral and diversified framework in their international trade and financial links, small LDCs may wish to peg their currencies to a bundle of key currencies, or to the new SDRs. In a world of convertibility, pegging to SDRs need not imply using more than one key currency for market intervention, nor having more than a small share of international reserves held in such currency. Over the longer run, the new international financial system may give an additional push to integration efforts, particularly among the smaller LDCs, by emphasizing the connection between economic size and effective monetary sovereignty.

Inevitably, LDCs will have to face several burdens in adjusting to a new international environment characterized by floating key currencies. Such an environment will impose additional maturation requirements on LDC "infant entrepreneurs", whether of the public or private sectors, particularly those engaged in export drives. Competition with multinational corporations, each having their own specialized group of foreign exchange experts, will not be made easier in the foreign trade arena, even assuming LDC use of forward exchange markets located in hegemonic financial centers. Insofar floating key

currencies hamper the workings of international capital markets, additional costs may be incurred by LDCs in tapping that source of finance.

Before turning to the changing relationship between many LDCs and international capital markets, it may be noted that if on balance LDCs rely less on exchange rate flexibility than the industrialized countries, the case for a larger LDC share in world reserves created by international agreement (the SDRs) is strengthened. While the float of the currencies of industrialized countries should presumably reduce their demand for reserves (eventually, at least)¹², for reasons given above many LDCs will continue to face limitations on their exchange rate flexibility due to their smallness, and will keep their currency pegged to one or more key currencies. So their demand for reserves (to hold) will be no smaller, and is likely to be higher, ceteris paribus, than under the previous system.

LDCs and Evolving World Capital Markets

If the greater mobility of financial capital observed in recent years accentuates LDC policy dilemmas, it also presents them with new opportunities. Already in 1970 Professor Charles P. Kindleberger proposed a greater use by developing countries of world capital markets, at purely commercial terms, particularly in view of LDC misgivings about direct foreign investment and their dissatisfaction with concessional international finance.¹³ Since then, even though LDC borrowing in the national markets of industrialized countries in the form of long-term bonds has remained relatively thin, their gross borrowing in the Eurocurrency market in the form of medium-term bank credits has boomed. Up through the first half of 1974, neither generalized floating among

key currencies nor the stresses placed on the Eurocurrency market by the turbulent world economic scene of 1973/74 had checked the upsurge in LDC borrowing. Although data in this area are notoriously imperfect and incomplete, reliable estimates place publicly-announced LDC borrowing in Eurocurrency markets at \$1.4 billion in 1971; \$3.6 billion in 1972; \$9.1 billion in 1973; and \$6.0 billion during the first half of 1974. Additional borrowing not recorded in published "tombstones" is said to be substantial.¹⁴ The borrowing entities include governments, state enterprises and, to a lesser extent, private businesses.

These amounts are quite spectacular and one is tempted to contrast them with the stagnant and rachitic figures for concessional finance. But several warnings are in order. The amounts shown are gross magnitudes and little is known as to the extent Eurocurrency borrowing is replacing more traditional forms of LDC borrowing, particularly suppliers' credit, nor the exact degree to which the borrowing is offset by LDC lending in the form of short-term deposits with Euro-banks, which are said to make up a good part of recent sharp increases in the international liquidity of some LDC central banks. LDC borrowing in the Eurocurrency market can reduce their borrowing opportunities elsewhere, either by making them less creditworthy in the eyes of other potential lenders or simply by revealing that their need for, say, tapping the new oil facility of the IMF is not as pressing as that of other countries. In short, neither the degree to which gross LDC borrowing in Eurocurrency markets has led to decreased borrowing elsewhere, nor the extent to which such borrowing has led to a real resource transfer toward those countries are known with accuracy.

The figures shown above also hide considerable concentration among borrowers. The eleven largest LDC borrowers in the Eurocurrency market during 1973, each accounting for more than \$200 Million, represented 84 percent of the total borrowing. They were, in descending order of importance: México, Algeria, Perú, Brazil, Iran, Greece, Indonesia, Spain, Zaïre, Yugoslavia and Panamá. While this short list shows a heavy concentration of semi-industrialized or natural-resource-rich countries, it also accounts for a non-trivial share of third-world population. A similar concentration exists among LDCs issuing long-term bonds in world capital markets. In 1972, for example, the top ten borrowers were, again in descending order of importance: Israel, México, Spain, Brazil, Singapore, Philippines, Hungary, Greece, Panamá, Venezuela, each borrowing at least \$40 Million, and accounting for 90 percent of all LDC bond issues reported by the World Bank.

Several interrelated issues are raised by the observed trends. A first one has to do with the stability and permanence of the Eurocurrency capital market. A second one involves the desirability of LDC borrowing in such a market, either to obtain real resources or greater liquidity. A third issue relates to the possibility of generalizing the experience of a few LDCs and semi-industrialized countries to a larger group. Finally, one may wonder what the upsurge in world capital market implies for the future of those international institutions that during most of the post-World War II period replaced it, from the LDC viewpoint.

Even before the oil price increase of late 1973, and the 1974 "slumpflation" in major industrialized countries, the unregulated Eurocurrency market had generated much nervousness, as it tended to lend on longer and

longer terms, even to newcomers, while continuing to rely on deposits of short term funds (often very short-term deposits, such as overnight). While few doubt that Central Banks of industrialized countries would step in with generous rediscounting facilities in case major Eurocurrency banks got into trouble, the uneasiness has persisted, apparently reaching a peak with the "euro-willies" of the European summer of 1974. It is noteworthy that such nervousness originated mainly from worries about the British and Italian economies, plus the incompetence or venality of some developed-country banks in their foreign exchange transactions, rather than from fears of LDC defaults.

From the viewpoint of this paper, the principal lesson from the expansion of the Eurocurrency market is straightforward. When unshackled from restrictive regulations, often inherited from the special conditions of the 1930s, private capital markets can mobilize gross sums dwarfing those available from bilateral and multilateral concessional finance, at least for an important type of LDCs. Furthermore, such transactions are carried out in a cold stand-offish commercial spirit which contrasts sharply with the tangled, emotional relations surrounding concessional finance. Without dramatics countries as diverse in their domestic policies as Algeria, Bulgaria, Cuba, Perú, Colombia, Ivory Coast, the Philippines and South Korea have been making quiet deals with the money lenders, and obtaining funds which may be spent largely on any country and for anything. It appears self-evident that the LDCs as a group have an important stake in the continuation of a Eurocurrency market retaining, even if it becomes somewhat more regulated than it is at present, its characteristics of free access, competitiveness and depolitization. Indeed, the LDCs may benefit from an extension of these characteristics of the Eurocurrency

market to the national capital markets of industrialized countries, although it is not clear that any contemporary national capital market can reach the flexibility and depolitization reached by the Eurocurrency market. But a broadening of capital markets available to LDCs could help correct the most disturbing features of Eurocurrency operations, from the LDC viewpoint.

More on this below.

Those operations remain medium-term banking revolving credits, typically for a period of 3 to 8 years, with floating interest rates.¹⁵ While the commitment period is as indicated, the loans are renewable at the end of each six-month period, at which time not only the interest rate, but other conditions of the loan, such as the currency which is to be used, can be modified. In contrast with long-term bonds issued by LDCs at given interest rates, or borrowing from the World Bank, the LDCs undertake a considerable share of risks and potential adjustment burdens. Until the first half of 1974, the Euromarket trend was toward a lengthening of maturities and a narrowing by lenders of the spread between their borrowing and lending rates. These trends in Eurocredits seem to have been checked or reversed during 1974, but for all borrowers, not just LDCs. It is also noteworthy that the Eurobond market, little used by LDCs so far, witnessed a sharp decline in transactions during the first half of 1974.

Influential voices in the development finance field have been raised, warning LDCs of the dangers of Eurocurrency transactions. It is worth quoting them at length. The President of the Inter-American Development Bank, Mr. Antonio Ortiz Mena, stated on April 1974:

"...the euro-currency market has provided a large volume of financing for the region [Latin America] in the last two years, but...this financing is being obtained on conditions that, with-

out careful planning, can frustrate orderly management of the external debt and even weaken the internal savings efforts of our countries.

As you know, the usual form of loans in the euro-currency market is the revolving credit with a fluctuating interest rate. Although the credit is extended for periods that have been lengthening gradually to 10 and 12 years--and 14 and 15 years in some cases--in practice the credit is renewed every six months, each time at the interest rate prevailing in the London market (interbank offer rate, IBOR). Since 1969 there have been sharp fluctuations from a low of slightly over 5 percent to a high of 11 percent... It should be noted that the loans usually are amortized in full at the end of the agreed period and that the resources are completely untied.

These operations are transacted with scant knowledge of the feasibility of the projects, since brokers are commonly used to promote lending operations, especially in the developing countries. Obviously, such practices can lead to the excessive use of credit and to an improper allocation of financial resources... This observation is even more to the point if it is kept in mind that the countries sometimes resort to the euro-currency market to finance the total cost of an investment.

... in actual figures the euro-currency market supplied resources to those countries [eight major Latin American countries, in 1973] for more than double the financing authorized by the international agencies [the Inter-American and World Banks].

Finally, we note that the oil crisis is forcing the industrialized countries into the euro-currency market in order to finance their balance-of-payments deficits, which could displace the developing countries, ...

The foregoing considerations suggest the advisability of broadening the Bank's activities so as to increase its advisory services...¹⁶

Similar concepts were expressed by Mr. William S. Gaud, then head of the International Finance Corporation, on November 7, 1973:

"There are those who have welcomed this growing recourse to the private capital market by the developing countries as a desirable trend. It is said to represent a return to the traditional method of financing economic expansion, leaving the borrowing country free to make its own decisions on how the funds should be used.

I recognize that the Euro-currency market has played an important part in giving the developing countries access to the international capital market to an extent previously impossible since the end of World War II. I also recognize that it has permitted a transfer of resources to those countries that would not have been possible without it.

Nevertheless, I see very real risks for the developing countries in borrowing so heavily in a market with no established lending standards and no overall surveillance to prevent unsound practices...

There is also the fact that the Euro-currency market is, by its nature, delicately poised and very sensitive both to speculative monetary investments and to changes in the economic and financial policies of the capital-exporting countries...

Another basic uncertainty inherent in Euro-currency funds stems from floating interest rates on which those funds are generally made available to the developing countries. These constitute too volatile a base on which to finance long-term industrial and infrastructure projects.

There is another feature of these Euro-currency loans which should not be overlooked. Foreign private investment is important to the developing countries not only because it contributes capital for their development, but because it brings with it technology, management, training and access to foreign markets--items which are all in short supply in the Third World. Euro-currency loans bring with them none of these. Indeed, they are often made even without any appraisal of the soundness of the projects they are intended to finance.

Speaking to the U.N. General Assembly the other day Sir Alec Douglas-Home said: 'the key word for the future of economic development is partnership.' But there is no partnership between lenders and borrowers in the Euro-currency market--not only because lenders and borrowers are inevitably remote from each other, but also because the lenders gave no direct involvement in the enterprise in which their funds are ultimately invested.

I believe a greater effort needs to be made to supplement Euro-currency funds for the developing countries with other, long-term funds. That brings me to private foreign investment.

...

Europe can play an important role in creating new forms of mutually beneficial relationships between foreign investors and the Third World, and we in IFC are eager to support any initiatives to that end."

Other, less diplomatic, criticisms of LDC borrowing in the Euro-currency market are also heard. In some cases the borrowing is said to go to purchasing weapons, or to finance current expenditures. Corruption is alleged to exist in many deals, and 1920s-type stories of unholy alliances between unscrupulous and pushy brokers and venal LDC politicians abound.

Different grounds for criticizing LDC Eurocurrency borrowing should be kept distinct. One strand deals with excesses, dangers, and misallocations which may exist in any type of foreign borrowing by sovereign but imperfect governments, from rich but sometimes greedy bankers or institutions (the greed may be for money or power). Another strand refers to relative benefits and costs of different forms and combinations of foreign borrowing. The general issue of the developmental impact of foreign borrowing has been discussed amply; here it should be enough to remark that growing indebtedness, either in absolute amounts or relative to other variables, may be a sign of trouble, or a sign of economic health and high expectations. Compare, for example, a Mexican debt-service to exports ratio of 24 percent in 1972, with the 1 percent corresponding to Mali, or the 3 percent of Honduras. One may observe, incidentally, that for many LDCs which borrowed in the Euro-currency market during 1970-73 the real burden of servicing that debt has been lower than calculated at the time the loans were made, as the magnitude of world inflation actually recorded was not expected by most lenders.¹⁸ But inflationary expectations, perhaps excessive, are now being built into new loan agreements, so that such unexpected break for LDC debtors is unlikely to be repeated in the case of fresh debt.

The remarks by the heads of the IADB and the IFC can be, somewhat unfairly, caricatured in a summary statement: "LDC foreign borrowing is fine, but only if kept under our tutelage." Distrust of both LDC ability to manage sensibly their own financial affairs and of competitive international financial markets is not far from the surface. These are judgments which cannot be proven or disproven a priori; clearly, however, they represent a view of development and self-determination not universally shared. The point is not that one should assume that all LDC borrowing in private international markets is sound and healthy nor that Eurocurrency bankers are the new heroes of development; the point is to ask whether in the long run there is any other way to achieve both international interdependence and national self-determination than to deal through more-or-less competitive, standoffish and remote international markets, fully aware of their risks and dangers.

Access to Eurocredits has expanded the financial options facing many LDCs, and perhaps little more needs to be said to show the positive impact of the Eurocurrency market on those countries. It should be emphasized, however, that different LDCs are likely to use borrowing in that market for different purposes. To some, Eurocredits appear to be mainly a readily available source of international liquidity, at a cost equivalent to the difference between interest charges on the loans and the interest they receive on their Eurocurrency deposits. In these countries, Eurocredits and the large gross foreign exchange reserves accompanying them seem designed to increase confidence among local and foreign investors. In other words, in such cases inflows of portfolio capital are complementary to inflows of other types of foreign capital, particularly direct foreign investment. That complementarity

can be quite specific as when an LDC heavily using Eurocredits allows the local establishment of branches of foreign banks and financial institutions active in the Eurocurrency market.

Other LDCs tap the Eurocurrency market mainly to finance medium- or long-term projects involving real resource transfers, and which could have been financed by direct foreign investment or concessional capital flows (or even domestic savings). While Algeria and Perú appear to use Eurocredits primarily for this purpose, Brazil and the Phillipines seem to use such credits mainly for the former.

Eurocredits, then, can either complement or substitute for other capital inflows, in a similar fashion that foreign borrowing in general can either substitute or complement domestic savings, depending on policy and circumstances. A corollary is that links with world capital markets could be used by LDCs also as complements or substitutes to the expansion of their own domestic capital markets, depending on their dominant socioeconomic philosophy, policies and domestic economic conditions. It could be that whether by policy design or as a result of market pressures, links with foreign capital markets tend to hamper rather than promote local long term capital markets.¹⁹

In a world characterized by substantial and erratic rates of inflation, Eurocredits have one little-noticed advantage over traditional loans from aid agencies. The loan commitments from the latter, expressed in nominal terms, are typically disbursed slowly over a number of years; their real value will depend on the disbursement speed (much influenced by the lender) and rates or inflation. Eurocredit disbursements are faster and more under the influence

of the borrower, who can protect itself against erosion of the real value of the loan either by rapid purchases or by placing unspent amounts to earn market rates of interest.

As noted earlier, most LDCs have not been directly involved with the Eurocurrency market nor with other international capital markets. Some are too small or too poor to be creditworthy to private bankers. As in the case of generalized floating by key currencies, the expansion of world capital markets may nudge the smallest LDCs into forms of integration involving greater financial cooperation, including joint development banks which could act as intermediary with international capital markets. In other cases, small and poor countries may choose to search for an LDC "big brother" to guarantee their borrowing, as in a recent Sudanese loan from the Eurocurrency market guaranteed by Saudi Arabia. "Smallness" is likely to prove less of a barrier to market access than poverty, particularly poverty in natural resources. Bolivia and Nicaragua, for example, have been able to tap the Eurocurrency market on their own, but it is unlikely that Bangladesh or India will be able to do so in massive amounts during the foreseeable future. The solidarity needed to obtain intra-LDC guarantees or joint borrowing, however, may not exist outside the Arab and Latin-American countries. But even LDCs excluded from the Eurocurrency market will benefit indirectly from the borrowing by luckier LDCs in that market, insofar as the latter LDCs absorb less concessional finance, freeing it for the neediest cases.

During most of the post-World War II period, international institutions, such as the World Bank group and the regional development banks have been playing a key financial intermediation role (in addition to multinational corporations

one may add). As the biggest and richest LDCs obtain direct access to external funds, and other LDCs choose to encourage other financial intermediaries over which they feel they have greater control, one may wonder about the pressures on the World Bank group and the Asian and Inter-American development banks. Clearly, the bargaining balance between those institutions and the more prosperous LDCs have been changed by the proliferation of alternative sources of funds. Indeed, the rationale justifying Brazilian, Nigerian and Philippine borrowing from the IBRD (excluding IDA credits) at terms similar to those of Haiti, Ethiopia and Bangladesh is far from self-evident and persuasive. As LDC heterogeneity becomes more marked the traditional multilateral intermediaries would do well to concentrate their attention on the least developed countries, raising the price at which their services, including technical help, are made available to the more fortunate LDCs.

The most significant accomplishment of the recent expansion of LDC borrowing in the Eurocurrency market has been to show that the debacle of the 1930s did not kill LDC access to world capital markets for all time. It is natural to ask why such renaissance did not take place in the national capital markets of the industrialized countries, and whether it can be extended to them. It may seem foolhardy to raise such issues during 1974, at a time when world financial markets quake under the pressures of recession, unusual inflation, dramatic increases in oil prices, enormous balance of payments deficits in important industrial countries, as well as in several LDCs, and an international monetary order groping its way toward a system. But the long run must be given its due, and barring disaster in the world economy, the dominant trend still points toward complementing the trade liberalization

achieved during 1944-1971, with liberalization and thickening of long term financial flows, in spite (or because?) of floating exchange rates.

Merchandise and service exports from LDCs to industrialized countries, while still hampered by protectionist obstacles, have expanded markedly during the 1960s and early 1970s, but their exports of IOU's have been mostly blocked by formal and informal barriers first imposed by many of the industrialized countries during the 1930s. A recent study, for example, concluded that the United States capital securities market has a regulating apparatus too complex and costly for the purposes of most Latin American foreign issues.²⁰ Such regulations, including those of the U.S. Securities and Exchange Commission and of individual states, have the effect of substantially if not entirely closing the United States markets to LDC securities, whether debt or equity, as effectively as have the more stringent legal limitations imposed on entry into the national capital markets of the European countries. As in the case of certain non-tariff barriers to merchandise trade, such as health regulations, it is not always clear whether all such regulations do much for the welfare of the consumer or security buyer in the industrialized country.

The barriers in industrialized countries to the importation of LDC IOU's (and those of others) can be summarized as follows:²¹

1. Those related to balance of payments problems. Such regulations have tended to be relaxed by countries trying to avoid revaluation, and tightened by those warding off devaluation of their currencies. Some LDCs placing debt where they could have suffered when revaluations become inevitable, while losing out from possible gains arising from creditor country devaluations.

2. Need to obtain permission from national authorities. This applies mainly to Europe and Japan, where ex-colonies and particular LDCs obtain favored treatment.

3. Information disclosure requirements, including numerous and cumbersome regulations which increase the cost of public bond flotations, which many observers consider as unnecessary for the protection of purchasers of securities, or discriminatory against LDC issuers.

4. Restrictions on financial institutions. In many states in the United States and in virtually all European countries, banks, insurance companies and pension funds are either prohibited from investing in, or are severely circumscribed as to the amount of, LDC and other foreign issues that can be held in their portfolios.

Not all plans for greater LDC access to capital markets will be equally desirable. It has sometimes been proposed, for example, that industrialized countries guarantee LDC public securities issued in their capital markets, at least regarding political risks. Other suggestions are the establishment in industrialized countries of open-end mutual funds to develop a portfolio of diversified corporate LDC securities, or of investment companies guaranteed by industrialized countries. To a greater or smaller degree, these proposals would retain the initiative and control over the financial flow within the industrialized countries, with centralized agencies deciding which countries should receive how much. The LDCs have long resented having their commodity exports, even when produced by local entrepreneurs, transported and sold by foreign commercial firms; the indicated proposals would again bring a rich-country intermediary between the exporters of IOU's and their final buyers.

For a number of LDCs, such guarantees may even be unnecessary to generate an important flow of portfolio investment, once the most cumbersome and arbitrary restrictions to entry, discussed above, are removed from the national capital markets of industrialized countries. After such restrictions are lifted, further encouragement of those flows could take the form of generalized tax exemption for interest earned on LDC securities by industrialized country buyers, such as those enjoyed by U.S. buyers of U.S. municipal bonds. It should be noted that at present direct investments into LDCs from industrialized countries benefit from a number of advantages, such as tax deferral, insurance facilities and other public sector encouragement, discriminating in favor of those flows over portfolio investments (and in favor of large over small investors, one may add.)

Even under present circumstances, some LDCs could do more to test the limits of existing regulations in the capital markets of industrialized countries, as a prelude to seeking changes in those restrictions. For example, while in the United States many states limit purchases of foreign securities by insurance companies to a small percentage of the total portfolio of those companies, it appears that in most cases such ceiling has not yet been reached. Only Mexico, it is said, has taken advantage of existing margins. Another example involves the use of private placements of long term bonds, instead of public offerings, which at least in the United States market involves a significant difference in costs, in favor of the former.²²

Even if it means "helping the competition," multilateral and bilateral development financial institutions could supply LDCs a much greater flow of information and technical assistance regarding direct access to world capital markets

than done at present. For those LDCs unable to go to those markets on their own or in groups, even if rules of access become liberalized, guarantees by the World Bank or regional banks of their securities could provide a practical and acceptable formula, with or without interest rate subsidies. The application of such guarantee schemes for particular purposes, such as export financing, also deserve study and could be justified on "infant market" grounds.²³

Liberalization of access to the national capital markets of industrialized countries and politically acceptable guarantee schemes are unlikely to be of much help to the poorest LDCs, particularly those with import bills heavily loaded with food and oil. For those countries concessional finance, of old and new types, seems necessary to achieve even modest per capita growth. Imaginative new types of concessional flows, including schemes to facilitate repayments in the form of new exports, as in recent agreements between Iran and India, could ease both adjustment costs and political frictions.

To summarize: possibilities appear to exist for tactical alliances between at least some capital-importing LDCs and some financial institutions from industrialized countries. While the LDCs wish to expand their options in international finance, the DC institutions desire to remain free from severe controls (as in the Eurocurrency market) or wish to be unshackled from anachronistic regulations, benefitting mainly specialized lawyers and bureaucrats in regulatory agencies. The desirability of a more flexible and expanded world capital market has been reinforced by the expected accumulation of financial assets by some oil-exporting LDCs, having their own reasons to cement links with DC financial institutions. Both types of LDCs have a clear and direct interest in the evolution of the rapidly changing

system of international financial intermediation. For example, how the recent lifting of some United States restrictions on its national capital market will affect the evolution of the Eurocurrency market, and the quantity and quality of financial assets and liabilities available to LDCs are matters of concern to many such countries. In particular, concentration trends among Eurobanks (reported during 1974) and joint moves by OECD countries to "rationalize" Eurocurrency lending and control world capital markets could threaten the relatively open and competitive nature which those markets had during 1970-1974. In the ongoing discussions on international monetary and financial reform, these are matters the LDCs would do well to emphasize and monitor.

The LDCs and the New SDRs

By December 31, 1973, the LDCs had used about one third of the SDRs allocated to them, a smaller proportional net use than that of the United Kingdom, but higher than for most industrialized countries. In absolute amounts, however, the net use of SDRs by the United States and the United Kingdom, as of the indicated date, was larger than that of all LDCs put together.²⁴ As it can be expected that LDCs will remain net users of SDRs one may wonder whether the "hardening" of SDRs agreed upon in June 1974 by the Committee of 20 will benefit those countries.

The LDCs have supported the thesis that the SDR should become the basis of a reformed monetary system, in which gold and reserve currencies would play a declining role. As emphasized by Gerald K. Helleiner, even without a link the LDCs benefit substantially from SDRs relative to alternative realistic manners of expanding international liquidity. The new SDR definition as a

large basket of currencies and its higher interest rate serve to further the goal of making SDRs the principal reserve asset and the numeraire in the international system. Note that the new SDR provides an attractive asset to hold, particularly for those LDCs wishing to avoid complications in their reserve management. It could also provide a natural unit of account for international arrangements, such as commodity agreements, in which LDCs are interested. Such practice would meet one of the arguments used against the generalized floating of key currencies.

The "grant element" in the net use of SDRs is of course reduced by a higher interest rate. But while for Brazil or Nigeria the credit-line conditions implicit in the net use of new SDRs may not be that different from those available to them in private markets, they still represent a bargain for less fortunate LDCs whose access to international liquidity involves heavier costs. To this extent the SDRs carry their own built-in but modest progressivity.

Another price may eventually have to be paid by LDCs for the consolidation and expansion of an SDR system. Over the long run, collective control over international reserves will require rules limiting holdings of currencies. The LDCs, as well as other countries, are reluctant to accept international rules limiting their freedom regarding reserve composition. With the old SDR there was a large gap between returns in that instrument and those available in the Eurocurrency market; this gap has now been narrowed. Nevertheless the issue remains. It illustrates the broader question as to whether or not LDCs should seek exemptions from general rules governing the international monetary system. It appears that those LDCs most interested in retaining flexibility

over reserve composition are also those least likely to benefit from an SDR standard, i.e., relatively fortunate countries with considerable access to Eurocurrency and other capital markets. It is precisely because of these contacts and financial sophistication, and the close link between reserve and debt management, that such semi-industrialized countries oppose both limitations on reserve composition freedom, and the application to them of objective indicators based on reserve levels for policy changes. It may be added that these are also countries whose public support for the link is not always backed up by private comments of some of their financial officials.

Besides reducing the grant element of net SDR use, the "heavy" SDR presents some technical complications in link schemes, which, however, could be handled if there is the political will to go ahead with such proposals. There is little to add to John Williamson's brilliant review of the mostly secondary and unpersuasive arguments for and against the link. The simple and fundamental argument in this debate is well stated by Williamson:

"The international community has few instruments to improve the world distribution of income, and therefore it should utilise such opportunities as arise. One of these is the seigniorage resulting from the production of fiduciary reserve assets. There is a long and unfortunate tradition in economics of dismissing this type of argument just because it involves a value judgment additional to that embodied in the Pareto criterion. The degree of egalitarianism needed to justify preference for the link rather than neutrality is minimal, given the existing facts on world income distribution."

In view of the difficulties being experienced by the least developed countries, the case for distributing the linked share of SDRs according to a formula taking into account per capita income as well as population, so it contains an explicit and substantial progressivity, appears particularly strong. And allocating such SDRs directly to the countries concerned conti-

nues to be the best way to promote responsible local leadership; the institutions most in need of build-up are in the LDCs, not elsewhere.

If most or all of the new SDRs go in their first round to developing countries, particularly to the poorest ones, who will pay interest to those countries becoming net receivers? Is it credible to expect the poorest LDCs to continue to pay interest on their net use of SDRs, particularly once the value to LDCs of new issues falls below interest payments? Because of these queries, as well as to enhance the grant element of linked SDRs, an ex-ante scheme to cleanly subsidize LDC interest payments appears desirable, and less complicated than issuing different types of SDRs.²⁶

Whatever the fate of the link, the case for increasing the LDC share in IMF quotas has been strengthened by the generalized floating of key currencies, as discussed earlier in this essay, so that allocation to LDCs of SDRs "to hold" should be correspondingly increased.

Increases in the private market price of gold have raised hopes for an "instant link". One scheme would involve a sharp rise in the official gold price, with a share of resulting paper or realized profits on the gold stocks of industrialized countries going to the LDCs. Such a return to a gold-exchange standard, of course, would mean a weakening or disappearance of SDRs, so the LDCs would be trading immediate gain for a steadier, longer run advantage. Their hard-won new positions of influence within the IMF would become less meaningful, as that institution would also be weakened by a re-monetization of basically South African gold. This siren song of instant profit, one hopes, should not lure LDCs to support such retrogressive scheme. Richard N. Cooper has put forth another proposal, much more attractive to LDCs, which

implies the demonetization of gold by gradual sales to private markets of the gold hoards of the IMF and Central Banks. Profits from such transactions, at least those realized by the IMF, would go to help (via one mechanism or another) primarily the least developed countries. Using resources provided by wealthy individuals, who for whatever reason are willing to pay extravagant sums for a yellow metal, to feed starving children is a bargain the world should not pass up.

A Final Word

While short- and long-term pessimism about the non-socialist part of the world economy has been rampant during 1974, the most plausible forecasts still call for an eventual resumption of growth in major industrialized countries and a continuation (at a slower pace) of expansionary trends in international trade and finance observed since World War II. Changes in world economic circumstances, particularly those involving increases in the relative prices of food, fuel and other primary goods, will affect LDCs in sharply different ways; a possible decline in the growth of industrialized countries will also have a variety of repercussions in different LDCs. The pull of forces originating in the world economy on LDCs will remain potent, presenting opportunities as well as problems. During recent years the opportunities have been reflected in export performance and sources of finance which only fifteen years ago would have seemed out of reach. For many LDCs even a less prosperous but still multipolar world economy, tensions and all, will continue providing a non-trivial amount of room for some (but not all) kinds of political and economic flexibility. The fundamental assumption here

is that the industrialized countries will not let the essentially transitory and manageable problems faced by the world economy during 1974 degenerate into a serious depression accompanied by a backsliding into protectionism in trade and finance. But if the worst comes, middle-income countries could react by stimulating import-substitution within LDC common markets.

Even under optimistic assumptions regarding growth in the industrialized world, the least developed LDCs, it bears repeating, face problems more fundamental and less subtle than, say, coordinating monetary with exchange rate policy. Those problems are likely to require either dramatic domestic reforms in the indicated countries, or increased concessional capital flows from the rest of the world, or both. This group of countries, located mainly in South Asia and Central and East Africa, has been growing at lower per capita growth rates than other LDCs for many years. During 1972-74 natural calamities, an inflation-induced decline in the real value of aid disbursements, and price increases in their imports of food, fuels and fertilizers have sharply worsened the outlook for the almost billion persons in those countries.

For the more fortunate and market-oriented LDCs the expansion and integration of world commodity and money markets has raised the price of domestic policy mistakes and has reduced some kinds of policy flexibility. Experimentation with controls and other policies which buck pressures emanating from world markets requires more sophistication than, say, during the 1950s. Undoubtedly, LDCs planning offices and policy-making machinery improved at a dramatic pace during the 1960s. Every ounce of such gains, and more, will be needed during the 1970s to take advantage of world market condi-

tions without sacrificing domestic goals. One example should illustrate the problem: with increasingly mobile capital and skilled labor, it will be more difficult for an LDC with extensive links with advanced market economies to influence its income distribution by manipulating by itself the rates of return of those factors.²⁷

The international financial system which will eventually evolve out of the troubled post-1971 circumstances will remain a source of concern to all types of LDCs, even though one must admit that a good share of the time devoted by LDC Finance Ministers and their staff to attending international monetary conferences since 1971 may have been more productively devoted to tackling domestic economic problems in those countries. Be that as it may, substantial LDC participation in decision-making about international monetary issues is an accomplishment unlikely to be reversed, particularly in view of the importance of OPEC.

The fashionable disappointment sported by some observers in industrialized countries regarding allegedly "selfish" LDC behavior during international monetary reform debates seems to be simply one more symptom of the difficulty everyone has adjusting to more complex realities. LDCs lacking many weapons in international power games and with dismal poverty at home should not be asked to set an example of statesmanship and generosity in international forums hardly characterized by such virtues.

Footnotes

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¹See for example Gerald K. Helleiner, "The Less Developed Countries and the International Monetary System," Journal of Development Studies (forthcoming); United Nations, "The Present International Monetary Situation and the Reform of the International Monetary System," Economic Bulletin of Latin America, Vol. 17, No. 1, first half of 1972, pp. 124-29; Y. S. Park, "The Link Between Special Drawing Rights and Development Finance," Princeton Essays in International Finance, No. 100, September 1973.

²Thus, Jagdish N. Bhagwati, in his "The International Monetary System: Issues in the Symposium," has remarked:

"Any reform of the Bretton Woods system which builds into itself, via widened bands...or gliding parities...would be of enormous value in getting several LDC's off their fixed-rate fixation and prompting them to use their exchange rate regimes more freely and efficiently to balance their international accounts. Their objections to more flexibility need therefore to be resolutely ignored--in their own interest!"

Journal of International Economics, Volume 2, No. 4, September 1972, pp. 322-323.

³Ronald I. McKinnon, "Optimum Currency Areas," American Economic Review,

Vol. 53, 1963, pp. 717-24; Robert A. Mundell, International Economics (New York: The Macmillan Company, 1968), Chapter 12.

⁴Harry G. Johnson, "The Case for Flexible Exchange Rates, 1969," in George N. Halm, editor, Approaches to Greater Flexibility of Exchange Rates; The Bürgenstock Papers, Princeton University Press, 1970, pp. 97-98. The so-called banana republics will thus tend to have inflationary trends no larger than those of the hegemonic industrialized countries. In the Western Hemisphere, for example, countries such as the Dominican Republic, Guatemala, Honduras, Haiti and Mexico registered during 1959-1973 rates of inflation very similar to that in the United States. Contrast with Paul A. Samuelson's column in Newsweek, June 17, 1974, p. 91, in which he uses 1923 Germany and "banana republics" as examples of wild inflation. Clearly, at least some scientific economists do not know their bananas!

⁵See his "Monetary Integration," Princeton Essays in International Finance, No. 93, April 1972, p. 3.

⁶J.C. Ingram, "Some Implications of Puerto Rican Experience," in R. N. Cooper, editor, International Finance (Penguin Books, 1969,) pp. 87-104.

⁷See statement by Milton Friedman in Hearings before the Subcommittee on International Economics of the Joint Economic Committee Congress of the United States, June 21, 1973, U.S. Government Printing Office, Washington D.C., 1973, pp. 114-118 and pp. 126-128. The statements by Allan H. Meltzer and Ricardo H. Arriazu in the same volume are also relevant to our discussion. Harry G. Johnson, in his "Commercial Policy and Industrialization," Economica Vol. 39, No. 155, August 1972, p. 274, advises Panama against having its own central bank.

⁸For an elaboration of this and related points see United Nations Conference on Trade and Development, International Monetary Reform and Co-operation for Development (Report of the Expert Group on International Monetary Issues), United Nations, New York, 1969, pp. 22-24.

⁹Basic data on trade flows were obtained from International Monetary Fund, Direction of Trade. In 1972 the Middle East obtained 40 percent of its imports from the United States, the United Kingdom and Germany, while those three countries took only 21 percent of its exports. Asian LDCs in 1972 obtained only 18 percent of their imports from the United States, while that country purchased 27 percent of their exports.

¹⁰See Fred Hirsch and David Higham, "Floating Rates--Expectations and Experience," The Three Banks Review, No. 102, June 1974, pp. 3-34. After reviewing recent experience of key currencies (through early 1974) these authors conclude: "Fluctuations and swings in rates have been substantial. Private operators have not given an impressive performance of their superior capacity to stabilise the exchanges. Markets in forward exchange remain limited to short maturities, and margins have widened except by comparison with the more speculative episodes under the par value regime." (p.32).

¹¹As noted by Kindleberger, the Friedman-Johnson view omits mention of the disadvantages for a small country of financial integration with a hegemonic power. He puts the general point as follows: "Financial integration is helpful when mistakes of policy or other disturbances are likely to originate at home. In a liquidity crisis, the smaller entity is assisted by financial intermediation, i.e., discounting, at a higher level in the financial structure. But where the trouble originates abroad, financial integra-

tion communicates it to the local level. The fear of the locality without independence of monetary policy is that its interests will be neglected in time of stress. The counterpart of lack of knowledge of local conditions at the center is lack of interest in them." Charles P. Kindleberger, "International Financial Intermediation for Developing Countries," mimeographed (April 1974), pp. 13-14.

¹²After reviewing 1970-74 experience regarding exchange rate flexibility and reserve use, John Williamson concludes (in an unpublished paper) that there is no evidence that floating has led so far to the expected economies in the use of reserves. Although the evidence is still sketchy, he argues that a system of managed floating during an unsettled period results in at least as much reserve use as does a reasonably well-functioning par value system with credible parities. He also argues (as we did earlier) that a country pegging to a given intervention currency seems likely to have its reserve use increased by the advent of generalized floating and that a country pegging to a composite of currencies might experience some similar, but mitigated, effect.

¹³See Charles P. Kindleberger, "Less Developed Countries and the International Capital Market," in Industrial Organization and Economic Development; In Honor of E. S. Mason, edited by Jesse W. Markham and Gustav V. Papanek, (Boston, Houghton Mifflin, 1970), pp. 337-349. See also Richard N. Cooper and Edwin M. Truman, "An Analysis of the Role of International Capital Markets in Providing Funds to Developing Countries," Weltwirtschaftliches Archiv, June 1971, Number 2, pp. 153-182.

¹⁴The major data source on Eurocurrency borrowing has become the World

Bank's International Finance Division, which prepares a quarterly report entitled Borrowing in International Capital Markets. Summaries of such reports are carried regularly in the IMF Survey (published twice a month). Our data come from these sources. Preliminary information indicates that Euromarket lending to LDCs has declined during the second half of 1974.

¹⁵For these and other technical features of Eurocredits, see A.F. Mohammed and F. Saccomanni, "Short-Term Banking and Euro-Currency Credits to Developing Countries," International Monetary Fund Staff Papers, Vol. XX, No. 3, November 1973, especially pp. 618-624.

¹⁶Address by Mr. Antonio Ortiz Mena, President of the Inter-American Development Bank, at the Inaugural Session of the Fifteenth meeting of the Board of Governors, Santiago, Chile, April 1, 1974, as distributed by the IADB, pp. 9-10.

¹⁷"Private Investment and Local Partnership," Speech by Mr. William S. Gaud, Executive Vice President, International Finance Corporation, at a lunch on the first day of a Financial Times Conference on "The European Community and the Third World," London, November 7 and 8, 1973, as distributed by IFC, pp. 2-4 and 13.

¹⁸Arghiri Emmanuel has also noted that one should not equate "debt with a debt problem", and has added (somewhat impetuously): "...in a period when all currencies are losing between 5 and 10% of their value each year, I would strongly recommend any individual or any state to run into debt up to the extreme limit of their lenders' readiness to oblige, notwithstanding any apprehension about future servicing". See his "Current Myths of Development", New Left Review, No. 85, May-June 1974, p. 63.

¹⁹See Albert Fishlow, "Indexing Brazilian Style: Inflation without Tears?" Brookings Papers on Economic Activity, No. 1, 1974, pp. 274-276.

In spite of government promotion an active long-term capital market has not materialized in Brazil; rather, Eurocurrency borrowing has flourished.

²⁰See the report of the General Secretariat, Organization of American States, The Capital Market of the United States in Relation to the Financing of Latin American Industry, Washington, D.C., 1973.

²¹See memorandum by Peter Treadway, Organization of American States, "Measures Affecting Latin American Access to Developed Countries' Capital Markets and Proposals for Reform," mimeographed, no date.

²²A reliable New York investment banker estimates the following data for a first-time issue by an LDC of 15 year bonds, for \$15 million, around the middle of 1974:

	<u>U.S. Registered Public Issue</u>	<u>U.S. Private Placement</u>	<u>Eurodollar Public Issue</u>
Coupon	8.25%	8.25%	9.00%
Legal fees and other expenses	\$149,000	\$75,000	\$150,000
Selling spread	\$300,000	\$162,500	\$375,000
Net interest cost	8.53%	8.40%	9.33%

Public issues in the United States require, inter alia, a hefty prospectus some have compared, for its length and detail, with IMF country reports. The prospectus must include a section on the debt record of the issuing country.

²³See, for example, Channa Weinberg, "Sanbar Proposal; Plan for Increasing Trade Between Developing Countries," in Kidma, No. 2, 1973, pp. 3-6.

²⁴See Dhruva Gupta, "The first Four Years of SDRs," in Finance and Development, Volume 11, No. 2, June 1974, p. 9, Table 4.

²⁵John Williamson, "International Liquidity: A Survey," The Economic Journal, Vol. 83, No. 331, September 1973, p. 728. See also my comment in International Monetary Fund, International Reserves; Needs and Availability, Washington, D.C., 1970, pp. 34-35.

²⁶John Williamson first raised the concern that a competitive interest rate would increase the danger that recipients of linked SDRs would default on interest payments. He proposed paying directly out of new SDRs link allocations the interest due to net accumulators of previously issued SDRs. See his "SDRs, Interest, and the Aid Link," Banca Nazionale del Lavoro Quarterly Review, June 1972, pp. 199-205. See also Peter Isard and Edwin M. Truman, "SDRs, Interest and the Aid Link: Further Analysis," Banca Nazionale del Lavoro Quarterly Review, March 1974, pp. 3-8. Isard and Truman convincingly argue that interest payments by LDCs on their use of SDRs allocated under an aid link could be subsidized to increase the development assistance content of the link without impairing the relative attractiveness of the SDR as a reserve asset, a point also stressed by Gerald K. Helleiner, op. cit.

²⁷This reflects, of course, the general problem of growing world interdependence, emphasized by Richard N. Cooper, most recently in his Economic Mobility and National Economic Policy, Wicksell Lectures 1973 (Stockholm: Almqvist and Wiksell International, 1974).