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AND THE POST-1971
INTERNATIONAL FINANCIAL SYSTEM

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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Less Developed Countries and the Post-1971 International Financial System*

Discussions of international monetary reform have typically emphasized the benefits to less developed countries 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-for-a-while increase in the price of monetary gold, to an increased flow of financial resources to less developed countries. Little attention will be given in this essay to these issues. More will be said on two relatively neglected areas: the position of less developed countries in a world of greater exchange-rate flexibility and the interactions of these countries 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 the old cliché about LDC heterogeneity. In this essay, two characteristics will receive special attention for the purpose of differentiating LDCs: endowments of natural resources with high direct or indirect world demand and degrees 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-rate flexibility can be expected to differ from those of Upper Volta.

Less Developed Countries and Exchange-Rate Flexibility

The less developed countries, speaking with notable unanimity via the "Group of 24," have indicated a preference for fixed exchange rates among the currencies of industrialized countries, while reserving their option to adopt for themselves more flexible exchange-rate arrangements. This LDC preference for fixed rates (at least for the industrialized na-

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tions) has caused some bewilderment and criticism, even among observers most sympathetic to LDC positions. Yet, as in the case of the general debate about 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 developing countries 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 that reality has imposed on the world, it seems necessary to review first 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 abandoned beliefs.

The following discussion attempts to separate two issues: exchange-rate flexibility between developed and less developed countries, on the one hand, and flexibility among developed countries, on the other. The first question to be explored is: Does it make sense for any type of less developed country to adopt a fixed exchange rate (or one with very limited real flexibility) between its currency and those of "the rest of the world"? If an affirmative answer is obtained to this first query, one can go on to ask: Given the desirability of such pegging, would fixed or flexible rates among key developed-country currencies be best from the viewpoint of this type of less developed country? More generally, even less developed countries choosing a substantial degree of flexibility for their exchange rate may prefer, without necessarily being guilty of logical inconsistency, the establishment of fixed rates among the currencies of industrialized nations, or at least among key currencies such as the dollar, the mark, and the yen, which would provide the anchor to the international monetary system.

Much of what follows relies on concepts developed in discussions regarding "optimum currency areas." 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, however, 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 nontradable 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 econ-

omies and others. But many less developed countries can be characterized with a minimum of ambiguity as small open economies. It may be useful to consider first why this type of country 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 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 Johnson (1970, pp. 97-98):

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 advantages 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.)

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 in which to denominate their financial instruments. Reserves held in key 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 major 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 proportion.

Corden (1972, p. 3) has defined 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 virtual invariance of its price level to fluctuations among key currencies establishes 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. In 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 major power to which it is attached, as has been the case for many years in the Republic of Panama. Natural disturbances originating domestically or disturbances of any kind originating abroad trigger adjustment mechanisms similar to those described by textbooks for the gold standard, or by Ingram (1962) for the Puerto Rican case. For the smooth achievement of both payments equilibrium and reasonably full employment, such an adjustment process requires either flexibility in domestic money wages or freedom of factor movements between the small country and the major 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 Friedman (1973) has suggested that the policies discussed above for an extreme type of small open developing country (fixed exchange rates, no monetary autonomy) can be applied to most developing countries, whose alleged monetary concupiscence presumably cannot be restrained by any other means.

So far, the discussion has focused on the exchange rate between the small and the large country with 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 to our small country.

But once some trade and financial flows are allowed between our small country and others (besides the large power), matters change. Consider a world made up of two large countries 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 rate unchanged, the impact of the 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 and on the real value of its foreign debt and exchange reserves will be felt at once.

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 attempts to keep in step with the hegemonic power, will also inflate approximately apace with 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 its balance of payments vis-à-vis our small country. This will tend to switch the source of its imports away from the hegemonic power, even as it sells it more of its exports. So long as this situation does not lead to a breakdown of relatively free trade and convertibility, the adjustment burden for the small country will be relatively minor (and almost pleasant). Clearly, however, the situation described above will not reach a new equilibrium until the second large 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 it again involves a sudden inflationary expansion of 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 be 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 the

disturbance is handled by compensatory fiscal and monetary policies in the large countries, without resorting to exchange-rate changes between them.

Do most developing countries conduct all or nearly all their trade and financial transactions with one major industrialized country? A little-noticed benefit for many developing countries of the 1944-71 world economic order, characterized by 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, with its inward-looking trading and financial blocs led by colonial and hegemonic industrialized powers. Of total Latin-American exports, for example, 46 per cent 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 developing countries went to the United Kingdom, France, and Belgium; by 1972, that share had declined to 31 per cent. Similar trends have taken place on the import side. One should note that convertibility has allowed substantial and persistent imbalances in the bilateral trade and payments of many developing countries vis-à-vis large industrial countries.

Not all less developed 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 less developed and socialist countries have remained relatively modest. But the generalization is untenable that, for all practical purposes, most developing countries have an optimum currency including just it and its major trading partner. Diversification has advanced too far in most less developed countries for one to take 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 developing countries, particularly the smaller ones, become more difficult.

Consider, for example, a less developed country whose exports (or imports) amount to 30 per cent of its gross national product. Suppose that half its exports go to France and half to the United States, while 40 per cent of its imports come from France and 60 per cent 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 1: Would this country rationally prefer fixed or floating rates among the dollar, the franc, and the yen? Question 2: Is this hypothetical example,

with its trade and financial diversification, more likely to be realistic under fixed or floating rates among the dollar, the franc, and the 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 small country's peg: Should it be with respect to the dollar, the franc, the yen, or some kind of a weighted average of the three (or to SDRs)? In the simplest extreme case discussed earlier, pegging to the currency of one major country tied the small-country price level to the level of that major country yet left it 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 has also cast doubts on the hope that stabilizing speculation would keep exchange-rate movements small and gradual, responsive only to fundamental disturbances.

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 contributing to such a price level. If the explicit goal is to maintain balance-of-payments equilibrium by manipulating the effective exchange rate, more complicated calculations will be required, involving price elasticities by regions. 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 with *trade* flows? In short, the simplicity and neatness of pegging to a single key currency will inevitably be lost.

The hypothetical example given above of a small diversified developing country 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 less developed countries 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 for small countries that previously benefited 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 the franc surplus and the dollar deficit match at that rate, the dollar-franc rate fluctuations will in all likelihood lead to higher reserve holdings by the small country, because the balance-of-payments position of the small country, 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 its trade and financial transactions with one major power, with which it kept a permanently fixed exchange rate, the decision as to the currency in which to hold external assets and liabilities (public or private) 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 can be devised, similar to those guiding the multi-currency pegging. For example, the central-bank holdings of different foreign currencies could be made a function of (besides interest rates) possible deficits with the different key-currency zones, and 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 for expected fluctuations among key currencies and interest rates. Such general rules, however, are easier to enunciate than to make specific in practice, particularly when substantial capital flows are involved in the payments and surpluses with different currency areas. Furthermore, the monetary authorities' attempts to avoid exchange risks will not be costless, 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 developing countries, going well beyond those involved in expanding and upgrading central-bank (and private-sector) staffs of financial analysts. If the small open country pegged its currency to just one of the key currencies, trade and financial transactions could be diverted toward the area using that key currency, even when real costs would suggest a more diversified pattern. The antitrade bias of greater exchange-rate flexibility perceived by some analysts becomes a trade-diverting bias for the small country 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 country 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 in a world of generalized floating it is not just an "irrational" dislike of the neocolonial flavor of pegging to just one key currency that leads several less developed countries to prefer fixed exchange rates across the board. The likely retreat from effective multilateralism and the reversal of trends toward trade and financial diversification involved in pegging to just one key currency would involve real economic costs, yet so would pegging to a bundle of them (but to a smaller degree).

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 developing countries with new problems, is a better system from their viewpoint than any *feasible* alternative. When discussing disturbances originating within large industrialized countries, I pointed out that these countries could generally avoid exchange-rate changes by wise fiscal and monetary management to offset disturbances. Alas, it is precisely departures from such wisdom that have created most disturbances in the first place, so that hopes for offsetting wisdom seem utopian. The relatively fixed rates for key currencies from 1944 to 1971 were compatible on the whole with trade and financial liberalization in the industrialized countries. But the late 1960s gave clear indications that, with the degree of interdependence achieved and with a realistic assessment 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 the 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 it supposes a degree of competence among rich-country policymakers (or of social cohesion in their societies) which simply is not there. In particular, the misuse by the United States of the "exorbitant privilege" of the dollar doomed the Bretton Woods system.

There are also some positive aspects for developing countries of generalized key-currency floating. Some large and not-so-large developing countries, such as Brazil and Colombia, have already experimented successfully with crawling or trotting pegs. While exchange-rate policy in those countries 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 developing countries to rely more on exchange-rate policy and less on quantitative restrictions for balancing their international accounts, with likely gains in efficiency and growth.

Apart from less developed countries with secular inflationary problems or inefficient trade and payments policies, and those in peculiar entrepôt circumstances such as Lebanon and Singapore, the developing countries with the larger and more diversified domestic markets will be the ones who find it easiest to experiment with greater exchange-rate flexibility. These countries will be able to follow a more independent monetary policy, complementing their political independence. The dilemma imposed on the small open countries by generalized floating is in fact just one more manifestation of the "small-country problem" on the 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. But it may well be that the monetary impotence of small open countries has been exaggerated by focusing on the tradable/nontradable-goods dichotomy discussed earlier. A digression on this point is warranted.

It has been noted that a central element in optimum currency theory is the share of tradable goods in GNP. The assumption was that, for any given level of per capita GNP, that share is higher in small open economies than in larger economies. The closer one looks at this proposition, the less obvious it becomes. By definition, small open economies have a

higher share of imports and exports in GNP, but such a fact need not imply that its share of *importables* and *exportables* in GNP is also higher than in larger economies of similar per capita GNP levels. If as a first approximation one takes services as the major component of "nontradable goods," one can point to cross-country and time series indicating that, for a given per capita income, the service share in GNP is not significantly changed by size of country. And the service share in GNP does not seem to change much as one moves up the income ladder.

If by "large country" one means a *geographically* large one, it could be argued that domestic transport costs in those nations represent (on average) a higher share of GNP than in small ones. The percentage gap between the retail price for Volkswagens in Kansas City and their c.i.f. price in the United States will be larger than the corresponding gap between their Amsterdam retail price and their c.i.f. price at the Dutch border. If this is so, the elasticity of retail, or local, prices of imported goods in the United States with respect to exchange-rate changes may be lower than in Holland or in Uruguay.

As costs of transport and communication fall internationally and domestically, however, the elasticity defined above should tend toward equality for all countries not using administrative controls over trade flows. The distinction between small and large countries would then seem to evaporate, unless it can be shown that for any per capita income there are other reasons for expecting systematic differences in the share of nontradables in GNP for small and large countries.

There is a way out of this difficulty, bringing together the two criteria for defining optimum currency areas. The universalization of markets for tradable goods has been accompanied by a similar universalization of capital markets; it would be difficult to decide whether in recent years the mobility of tradable goods has been greater or less than that of financial capital. Thus, not only the prices of tradables but also the rates of return to capital have tended to equality within the Atlantic trading community and the developing countries that are attached to it. Although unskilled labor remains the factor (after "land") least mobile internationally, the postwar period has also witnessed a 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 tradable goods. The key policy variable becomes, *ceteris paribus*, the ratio of unskilled wage rates expressed in domestic money to the exchange rate. Just as an 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 nontraded 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, starting from an equilibrium situation, an exchange-rate change by itself will not change 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, that blocks a speedy and smooth return to equilibrium after a disturbance has shocked the system. When devaluation is viewed from this angle, why cannot a small open country 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 small countries is less likely a priori than among those in large countries, but the social cohesion (or "discipline") of the former may be higher.

In some developing countries, convertibility at a rate firmly pegged to a hegemonic currency is not only a policy designed 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.

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 developing countries (and not-so-small ones, like Mexico) were faced with choices new to them but 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 developing country 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 an asset. Ultimately, however, one returns to key assumptions regarding central-bank behavior in different countries. A small open economy following a prudent monetary policy, 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 moneyness of its domestic currency or upsetting its wealthy elites.

Those arguing that less developed countries should, for their own good, lock their monetary tools with a species of chastity belt and throw away the key appear 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 debatable for the 1970s. Developing countries that 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 major powers.

To summarize, the failure of the industrialized countries to discipline their macroeconomic policies led to the collapse of the Bretton Woods system, and it is unlikely that these 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 developing countries, however. Some may take 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 consistent with the often-voiced desire of those countries to eliminate neocolonial dependency inherited from the past. In many sovereign developing countries, 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 countries 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 or having more than a small share of international reserves held in this currency. Over the longer run, the new international financial system may give an additional push to integration efforts, particularly among the smaller developing countries, by emphasizing the connection between economic size and effective monetary sovereignty.

Inevitably, less developed countries 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 in the public or private sectors, particularly those engaged in export drives. Competition with multinational corporations, each having its 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 major financial centers. Insofar as floating key currencies hamper the workings of international capital markets, additional costs may be incurred by developing countries in tapping that source of finance.

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

Less Developed Countries 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, 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. 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. 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, estimates by the World Bank 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.

These amounts are quite spectacular, and one is tempted to contrast them with the stagnant figures for concessional finance. But several warnings are in order. The amounts shown are gross magnitudes, and we know little about the extent to which Eurocurrency borrowing is replacing more traditional forms of LDC borrowing, particularly suppliers' credit, or the degree to which the borrowing is offset by LDC lending in the form of short-term deposits with Eurobanks, 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, say, to tap the new oil facility of the IMF is not as pressing as that of other countries. In short, we do not know with accuracy either the degree to which gross LDC borrowing in Eurocurrency markets has led to decreased borrowing elsewhere or the extent to which such borrowing has led to a real-resource transfer toward those countries.

The figures given 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 per cent of the total borrowing. They were, in descending order of importance, Mexico, Algeria, Peru, Brazil, Iran, Greece, Indonesia, Spain, Zaire, Yugoslavia, and Panama. While this short list shows a heavy concentration of semi-industrialized or natural-resource-rich countries, it also accounts for a nontrivial share of third-world population. A similar concentration exists among developing countries issuing long-term bonds in world capital markets. In 1972, for example, the top ten borrowers were, again in descending order of importance, Israel, Mexico, Spain, Brazil, Singapore, the Philippines, Hungary, Greece, Panama, and Venezuela, each borrowing at least \$40 million, and accounting for 90 per cent of all LDC bond issues reported by the World Bank.

Several interrelated issues are raised by the observed trends: (1) the stability and permanence of the Eurocurrency capital market; (2) the desirability of LDC borrowing in such a market to obtain either real resources or greater liquidity; (3) the possibility of generalizing to a larger group the experience of a few less developed and semi-industrialized countries; and (4) the implications of the upsurge in the world capital market for the future of the international institutions that during most of the post-World War II period replaced it for less developed countries.

Even before the oil-price increase of late 1973 and the 1974 "slumpflation" in major industrialized countries, the unregulated Eurocurrency market 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 the 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 "Euowillies" of the European summer of 1974. It is noteworthy that such nervousness originated mainly from worries about the British and Italian economies and 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 essay, the principal lesson to be learned 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 that dwarf those available from bilateral and multilateral concessional finance, at least for an important type of developing country. Furthermore, such transactions are carried out in a cold, standoffish commercial spirit that contrasts sharply with the tangled emotional relations surrounding concessional finance. Without dramatics, countries as diverse in their domestic policies as Algeria, Cuba, Peru, Colombia, the Ivory Coast, and the Philippines have been making quiet deals with the money lenders and obtaining funds that may in large part be spent in any country and for anything. It appears self-evident that the developing countries as a group have an important stake in the continuation of a Eurocurrency market that retains its characteristics of free access, competitiveness, and depoliticization, even if it becomes somewhat more regulated than it is at present. Indeed, these countries 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 achieve the flexibility and depoliti-

cization reached by the Eurocurrency market. But a broadening of the capital markets available to developing countries could help correct the most disturbing features of Eurocurrency operations, from the LDC viewpoint. More on this below.

Eurocurrency operations remain revolving credits, typically for a period of three to eight years, with floating interest rates. 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 to be used in disbursements and repayments, can be modified. In contrast with the long-term bonds issued by less developed countries at given interest rates, or borrowing from the World Bank, developing countries borrowing in the Euromarket undertake a considerable share of the 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 less developed countries. It is also noteworthy that the Eurobond market, little used by developing countries so far, experienced a sharp decline in transactions during the first half of 1974.

Influential voices in the development-finance field have been raised, warning developing countries of the dangers of Eurocurrency transactions. It is worth quoting them at length. The President of the Inter-American Development Bank, Antonio Ortiz Mena, stated on April 1, 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, without 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 united.

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. . . .¹

Similar concepts were expressed by William S. Gaud, then Executive Vice President 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-

¹ Antonio Ortiz Mena, Address at the Inaugural Session of the Fifteenth Meeting of the Board of Governors, Santiago, Chile, Apr. 1, 1974, as distributed by the Inter-American Development Bank.

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 have 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 initiative to that end.²

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

Different grounds for criticizing LDC Eurocurrency borrowing should be kept distinct. One strand deals with the excesses, dangers, and misallocations that 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 the 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 either 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 per cent in 1972 with the 1 per cent of Mali or the 3 per cent of Honduras. One may observe, incidentally, that, for many developing countries that borrowed in the Eurocurrency market during 1970-73, the real burden of servicing that debt has been lower than calculated at the time the loans were made, because the rate of world inflation actually experienced was not expected by most lenders. But inflationary expectations, perhaps excessive ones, are now being built into new loan agreements, so that such an 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, somewhat unfairly, be caricatured in a summary statement: "LDC foreign borrow-

² William S. Gaud, speech at a lunch on the first day of a *Financial Times* conference on "The European Community and the Third World," London, Nov. 7 and 8, 1973, as distributed by the International Finance Corporation.

ing is fine, but only if kept under our tutelage." Distrust both of LDC ability to manage their own financial affairs sensibly 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 or that Eurocurrency bankers are the new heroes of development; the point is that one should 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, with their risks and dangers.

Access to Eurocredits has expanded the financial options open to many developing countries, 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 developing countries 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. The complementarity can be quite specific, as when a developing country heavily using Eurocredits allows the local establishment of branches of foreign banks and financial institutions active in the Eurocurrency market. Other developing countries tap the Eurocurrency market mainly to finance medium- or long-term projects involving real-resource transfers that could have been financed by direct foreign investment or concessional capital flows. While Algeria and Peru appear to use Eurocredits primarily for the latter purpose, Brazil and the Philippines seem to use them mainly for the former.

Eurocredits, then, can either complement or substitute for other capital inflows, just as foreign borrowing in general can either substitute for or complement domestic savings, depending on policy and circumstances. A corollary is that links with world capital markets can be used by developing countries also as complements or substitutes to the expansion of their own domestic capital markets, depending on their dominant socio-economic 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.

As noted earlier, most developing countries have not been directly involved with the Eurocurrency market or 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 countries into forms of integration involving greater financial cooperation, including joint development banks that could act as intermediaries 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. But "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. And the solidarity needed to obtain intra-LDC guarantees or joint borrowing may not exist outside the Arab and Latin-American countries.

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 (as have multinational corporations). As the biggest and richest developing countries obtain direct access to external funds, and others 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 developing countries has been changed by the proliferation of alternative sources of funds. Indeed, the rationale justifying Brazilian, Nigerian, and Philippine borrowing from the International Bank for Reconstruction and Development (excluding International Development Association credits) on 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 countries.

The most significant accomplishment of the recent expansion of LDC borrowing in the Eurocurrency market has been to show that the deba-

cle of the 1930s did not kill LDC access to world capital markets for all time. It is natural to ask why such a 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 unusual inflation, dramatic increases in oil prices, enormous balance-of-payments deficits in important industrial countries as well as in several developing countries, 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 from 1944 to 1971 with liberalization and thickening of long-term financial flows, in spite (or because?) of floating exchange rates.

Merchandise and service exports from developing to industrialized countries, while still hampered by protectionist obstacles, have expanded markedly during the 1960s and early 1970s, but LDC 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 by the Secretariat of the Organization of American States, for example, concluded that the U.S. securities market has a regulating apparatus too complex and costly for the purposes of most Latin-American foreign issues. The 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 U.S. markets to LDC securities, whether debt or equity, as effectively as have the more stringent legal limitations imposed on entry to the national capital markets of the European countries. As in the case of certain nontariff 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, according to the work carried out at the Organization of American States:

1. Regulations related to balance-of-payments problems. These have tended to be relaxed by countries trying to avoid revaluation and tightened by those warding off devaluation of their currencies. Some LDCs which placed their debt in the industrialized countries that were relaxing controls over capital outflows suffered when revaluations there became inevitable, while tighter controls may have prevented some borrowing LDCs from gains arising out of creditor-country devaluations.

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

3. Information-disclosure requirements, including numerous and cumbersome regulations that increase the cost of public bond flotations, which many observers consider as unnecessary for the protection of purchasers of securities or as 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 LDC and other foreign issues or are severely circumscribed as to the amounts of these 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. 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 within the industrialized countries the initiative and control over the financial flow, with centralized agencies deciding which countries should receive how much. Less developed countries have long resented having their commodity exports, even when produced by local entrepreneurs, transported and sold by foreign commercial firms; the proposals just discussed would again bring a rich-country intermediary between the exporters of IOU's and their final buyers.

For a number of developing countries, such guarantees may even be unnecessary in order to generate an important flow of portfolio investment once the most cumbersome and arbitrary restrictions to entry are removed from the national capital markets of industrialized countries. After these restrictions are lifted, further encouragement of portfolio investment could take the form of a generalized tax exemption for interest earned on LDC securities by industrialized-country buyers, like that enjoyed by U.S. buyers of U.S. municipal bonds. It should be noted that at present direct investments in developing countries from industrialized countries enjoy 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).

Even under present circumstances, some developing countries could do more to test the limits of existing regulations in the capital markets

of industrialized countries, as a prelude to seeking changes in these restrictions. For example, in the United States many states limit purchases of foreign securities by insurance companies to a small percentage of the companies' total portfolios, but it appears that in most cases such ceilings have 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, in the U.S. market at least, involves a significant reduction in costs.

Even if it means "helping the competition," multilateral and bilateral development institutions could supply developing countries with a much greater flow of information and technical assistance than at present regarding direct access to world capital markets. For countries unable to go to those markets on their own or in groups, even if rules of access are liberalized, guarantees of their securities by the World Bank or regional banks 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 deserves study and could be justified on "infant market" grounds.

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 countries, particularly those with import bills heavily loaded with food and oil. For these countries, new and old type of concessional finance seem 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 developing countries and some financial institutions in industrialized countries. While the small countries wish to expand their options in international finance, the developed-country institutions wish to remain free from severe controls (as in the Eurocurrency market) or to be unshackled from anachronistic regulations that mainly benefit 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 developing countries, which have their own reasons to cement links with developed-country financial institutions. Both types of developing countries have a clear and direct interest in the evolution of the rapidly changing system of international financial intermediation. For example, how the recent lifting by the

United States of some 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 developing countries is a matter of clear interest to many such countries. In the current discussions on international monetary and financial reform, these are matters the developing countries would do well to emphasize.

The Developing Countries and the New SDRs

By December 31, 1973, the developing countries 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 developing countries put together. As the developing countries can be expected to 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 these countries.

The developing countries 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 Helleiner (forthcoming) has emphasized, even without a link to development assistance the developing countries benefit substantially from SDR creation relative to alternative realistic ways of expanding international liquidity. The SDR's new 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 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 practices would meet one of the arguments 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 the credit-line conditions implicit in the net use of new SDRs may not be *that* different for Brazil or Nigeria from those available to them in private markets, they still represent a bargain for less fortunate countries 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 the less developed countries 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. Developing countries, as well as others, 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 returns available in the Eurocurrency market; this gap has now been narrowed. Nevertheless, the issue remains. It illustrates the question as to whether or not developing countries should seek exemptions from general rules governing the international monetary system. It appears that those most interested in retaining flexibility over reserve composition are also those least likely to benefit from an SDR standard, that is, relatively fortunate countries with considerable access to Eurocurrency and other capital markets. It is precisely because of such contacts and financial sophistication, and the close link between reserve and debt management, that these semi-industrialized countries opposed both limitations on the freedom regarding reserve composition and the application to them of objective indicators based on reserve levels for policy changes. (These are also the countries whose public support for the link is not always backed up by the private comments of some of their financial officials.)

Besides reducing the grant element of net SDR use, the "harder" SDR presents some technical complications in link schemes. These, however, can be handled if there is the political will to go ahead with such proposals. There is little to add to Williamson's (1973, p. 728) 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 appears particularly strong for distributing the linked share of SDRs according to a formula taking into account per capita income as well as population, so that it contains an explicit and substantial progressivity. And allocating such SDRs directly to the countries concerned continues to be the best way to promote responsible local leadership; the institutions most in need of buildup are in the developing countries, 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 the countries that become net receivers? Is it credible to expect the poorest countries to continue to pay interest on their net use of SDRs, particularly once the value to them 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 for a clean subsidy of LDC interest payments appears more desirable, and less complicated, than issuing different types of SDRs.

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 developing countries 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 the resulting paper or realized profits on the gold stocks of industrialized countries going to the developing countries. Such a return to a gold-exchange standard, of course, would mean a weakening or disappearance of SDRs, and so the developing countries 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, since that institution would also be weakened by a remonetization of South African gold. This siren song of instant profit, one hopes, should not lure developing countries to support such a retrogressive scheme. Others have put forth another proposal, much more attractive to developing countries, 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 mainly to help the least developed countries (via one mechanism or another). To feed starving children using resources provided by wealthy individuals who, for whatever reason, are willing to pay extravagant sums for a yellow metal is a bargain the world should not pass up.

A Final Word

While short- and long-term pessimism about the nonsocialist 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 (perhaps at a slower pace) of the expansionary trends in international trade and finance observed since World War II. Changes in world economic circumstances, particularly

increases in the relative prices of food, fuel, and other primary goods, will affect developing countries in sharply different ways. A possible decline in the growth of industrialized countries will also have a variety of repercussions in developing countries. The pull of forces originating in the world economy will remain potent for them, presenting opportunities as well as problems. During recent years, the opportunities have been reflected in export performance and sources of finance that only fifteen years ago would have seemed out of reach. For many, even a less prosperous but still multipolar world economy, tensions and all, will continue to provide a nontrivial amount of room for some (but not all) kinds of political and economic flexibility.

The least developed countries, 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. For the more fortunate and market-oriented countries, the expansion and integration of world commodity and money markets have raised the price of domestic policy mistakes and have reduced some kinds of policy flexibility. Experimentation with controls and other policies to buck pressures emanating from world markets requires more sophistication than, say, during the 1950s. Undoubtedly, LDC 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 conditions without sacrificing domestic goals. One example should illustrate the problem: With increasingly mobile capital and skilled labor, it will be more difficult for a developing country with extensive links with advanced market economies to manipulate the rates of return of those factors in order to influence its income distribution.

The international financial system that will eventually evolve from the troubled post-1971 circumstances will remain a source of concern to all types of developing countries, even though, admittedly, a good share of the time devoted by LDC finance ministers and their staffs to attending international monetary conferences since 1971 might have been more productively devoted to tackling domestic economic problems in their countries. Be that as it may, the substantial LDC participation in decision-making about international monetary issues is unlikely to decrease, particularly in view of the importance of the Organization of Petroleum Exporting Countries.

The fashionable disappointment sported by some observers in industrialized countries regarding allegedly "selfish" LDC behavior during de-

bates on international monetary reform seems to be simply one more symptom of the difficulty everyone has adjusting to more complex realities. Developing countries with few weapons in international power games and dismal poverty at home should not be asked to set an example of statesmanship and generosity in international forums hardly characterized by such virtues.

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The International Finance Section publishes at irregular intervals papers in four series: **ESSAYS IN INTERNATIONAL FINANCE**, **PRINCETON STUDIES IN INTERNATIONAL FINANCE**, **SPECIAL PAPERS IN INTERNATIONAL ECONOMICS**, and **REPRINTS IN INTERNATIONAL FINANCE**. **ESSAYS** and **STUDIES** are confined to subjects in international finance. **SPECIAL PAPERS** are confined to surveys of the literature suitable for courses in colleges and universities. An **ESSAY** should be a lucid exposition of a theme, accessible not only to the professional economist but to other interested readers. It should therefore avoid technical terms, should eschew mathematics and statistical tables (except when essential for an understanding of the text), and should rarely have footnotes. Most important, it should have a certain grace of style and rhythm in its language.

This does not mean that a **STUDY** or **SPECIAL PAPER** may be awkward and clumsy, but it may be more technical. It may include statistics and algebra, and may have many footnotes. **STUDIES** and **SPECIAL PAPERS** may also be longer than **ESSAYS**; indeed, these two series are meant to accommodate manuscripts too long for journal articles and too short for books.

To facilitate prompt evaluation, please submit three copies of your manuscript. Retain one copy for your files. The manuscript should be typed on one side of 8½ by 11 strong white paper. All material should be double-spaced—text, excerpts, footnotes, tables, references, and figure legends. More complete guidance appears in the Section's style guide; prospective contributors are urged to send for it before preparing their manuscripts.

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List of Publications

The following is a list of the recent publications of the International Finance Section. The issues of the four series marked by asterisks, Essays Nos. 1 through 60, and Studies Nos. 1 through 10 are no longer available from the Section. They may be obtained in Xerographic and microfilm editions from Xerox University Microfilms, 300 N. Zeeb Road, Ann Arbor, Michigan 48106. The former are priced at \$6 and the latter at \$5.¹

ESSAYS IN INTERNATIONAL FINANCE

90. John Williamson, *The Choice of a Pivot for Parties*. (Nov. 1971)
91. Fritz Machlup, *The Book Value of Monetary Gold*. (Dec. 1971)
92. Samuel I. Katz, *The Case for the Par-Value System, 1972*. (March 1972)
93. W. M. Corden, *Monetary Integration*. (April 1972)
94. Alexandre Kafka, *The IMF: The Second Coming?* (July 1972)
95. Tom de Vries, *An Agenda for Monetary Reform*. (Sept. 1972)
96. Michael V. Posner, *The World Monetary System: A Minimal Reform Program*. (Oct. 1972)
97. Robert M. Dunn, Jr., *Exchange-Rate Rigidity, Investment Distortions, and the Failure of Bretton Woods*. (Feb. 1973)
98. James C. Ingram, *The Case for European Monetary Integration*. (April 1973)
99. Fred Hirsch, *An SDR Standard: Impetus, Elements, and Impediments*. (June 1973)
100. Y. S. Park, *The Link between Special Drawing Rights and Development Finance*. (Sept. 1973)
101. Robert Z. Aliber, *National Preferences and the Scope for International Monetary Reform*. (Nov. 1973)
102. Constantine Michalopoulos, *Payments Arrangements for Less Developed Countries: The Role of Foreign Assistance*. (Nov. 1973)
103. John H. Makin, *Capital Flows and Exchange-Rate Flexibility in the Post Bretton Woods Era*. (Feb. 1974)
104. Helmut W. Mayer, *The Anatomy of Official Exchange-Rate Intervention Systems*. (May 1974)
105. F. Boyer de la Giroday, *Myths and Reality in the Development of International Monetary Affairs*. (June 1974)
106. Ronald I. McKinnon, *A New Tripartite Monetary Agreement or a Limping Dollar Standard?* (Oct. 1974)
107. J. Marcus Fleming, *Reflections on the International Monetary Reform*. (Dec. 1974)
108. Carlos F. Díaz-Alejandro, *Less Developed Countries and the Post-1971 International Financial System*. (April 1975)

PRINCETON STUDIES IN INTERNATIONAL FINANCE

16. Ronald I. McKinnon and Wallace E. Oates, *The Implications of International Economic Integration for Monetary, Fiscal, and Exchange-Rate Policy*. (March 1966)
17. Egon Sohmen, *The Theory of Forward Exchange*. (Aug. 1966)
18. Benjamin J. Cohen, *Adjustment Costs and the Distribution of New Reserves*. (Oct. 1966)
19. Marina von Neumann Whitman, *International and Interregional Payments Adjustment: A Synthetic View*. (Feb. 1967)

¹ Essays 62, 66, 67, 68, 71, 73, 75, 77, 82, and 88; Studies 12, 14, and 15; and Reprints 4, 6, 7, 8, 9, and 10 are still available from the Section. For a complete list of publications, write to the Section or consult the publications list in Essay 91 or earlier.

20. Fred R. Glahe, *An Empirical Study of the Foreign-Exchange Market: Test of a Theory*. (June 1967)
21. Arthur I. Bloomfield, *Patterns of Fluctuation in International Investment before 1914*. (Dec. 1968)
22. Samuel I. Katz, *External Surpluses, Capital Flows, and Credit Policy in the European Economic Community*. (Feb. 1969)
23. Hans Aufricht, *The Fund Agreement: Living Law and Emerging Practice*. (June 1969)
24. Peter H. Lindert, *Key Currencies and Gold, 1900-1913*. (Aug. 1969)
25. Ralph C. Bryant and Patric H. Hendershott, *Financial Capital Flows in the Balance of Payments of the United States: An Exploratory Empirical Study*. (June 1970)
26. Klaus Friedrich, *A Quantitative Framework for the Euro-Dollar System*. (Oct. 1970)
27. M. June Flanders, *The Demand for International Reserves*. (April 1971)
28. Arnold Coltery, *International Adjustment, Open Economies, and the Quantity Theory of Money*. (June 1971)
29. Robert W. Oliver, *Early Plans for a World Bank*. (Sept. 1971)
30. Thomas L. Hutcheson and Richard C. Porter, *The Cost of Tying Aid: A Method and Some Colombian Estimates*. (March 1972)
31. The German Council of Economic Experts, *Towards a New Basis for International Monetary Policy*. (Oct. 1972)
32. Stanley W. Black, *International Money Markets and Flexible Exchange Rates*. (March 1973)
33. Stephen V. O. Clarke, *The Reconstruction of the International Monetary System: The Attempts of 1922 and 1933*. (Nov. 1973)
34. Richard D. Marston, *American Monetary Policy and the Structure of the Eurodollar Market*. (March 1974)
35. F. Steb Hipple, *The Disturbances Approach to the Demand for International Reserves*. (May 1974)
36. Charles P. Kindleberger, *The Formation of Financial Centers: A Study in Comparative Economic History*. (Nov. 1974)
37. Margaret L. Greene, *Waiting Time: A Factor in Export Demand for Manufactures*. (April 1975)

SPECIAL PAPERS IN INTERNATIONAL ECONOMICS

1. Gottfried Haberler, *A Survey of International Trade Theory*. (Sept. 1955; Revised edition, July 1961)
- * 2. Oskar Morgenstern, *The Validity of International Gold Movement Statistics*. (Nov. 1955)
- * 3. Fritz Machlup, *Plans for Reform of the International Monetary System*. (Aug. 1962; Revised edition, March 1964)
- * 4. Egon Sohmen, *International Monetary Problems and the Foreign Exchanges*. (April 1963)
- * 5. Walther Lederer, *The Balance on Foreign Transactions: Problems of Definition and Measurement*. (Sept. 1963)
- * 6. George N. Halm, *The "Band" Proposal: The Limits of Permissible Exchange Rate Variations*. (Jan. 1965)
- * 7. W. M. Corden, *Recent Developments in the Theory of International Trade*. (March 1965)
8. Jagdish Bhagwati, *The Theory and Practice of Commercial Policy: Departures from Unified Exchange Rates*. (Jan. 1968)

9. Marina von Neumann Whitman, *Policies for Internal and External Balance*. (Dec. 1970)
10. Richard E. Caves, *International Trade, International Investment, and Imperfect Markets*. (Nov. 1974)

REPRINTS IN INTERNATIONAL FINANCE

11. Fritz Machlup, *The Transfer Gap of the United States*. [Reprinted from *Banca Nazionale del Lavoro Quarterly Review*, No. 86 (Sept. 1968)]
12. Fritz Machlup, *Speculations on Gold Speculations*. [Reprinted from *American Economic Review, Papers and Proceedings*, Vol. 56 (May 1969)]
13. Benjamin J. Cohen, *Sterling and the City*. [Reprinted from *The Banker*, Vol. 120 (Feb. 1970)]
14. Fritz Machlup, *On Terms, Concepts, Theories and Strategies in the Discussion of Greater Flexibility of Exchange Rates*. [Reprinted from *Banca Nazionale del Lavoro Quarterly Review*, No. 92 (March 1970)]
15. Benjamin J. Cohen, *The Benefits and Costs of Sterling*. [Reprinted from *Euromoney*, Vol. 1, Nos. 4 and 11 (Sept. 1969 and April 1970)]
16. Fritz Machlup, *Euro-Dollar Creation: A Mystery Story*. [Reprinted from *Banca Nazionale del Lavoro Quarterly Review*, No. 94 (Sept. 1970)]
- * 17. Stanley W. Black, *An Econometric Study of Euro-Dollar Borrowing by New York Banks and the Rate of Interest on Euro-Dollars*. [Reprinted from *Journal of Finance*, Vol. 26 (March 1971)]





