ESSAYS IN INTERNATIONAL FINANCE

No. 108, April 1975

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DEPARTMENT OF ECONOMICS

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This is the one hundred and eighth number in the series ESSAYS IN INTERNATIONAL FINANCE, *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

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Library of Congress Cataloging in Publication Data

Díaz-Alejandro, Carlos Federico.
Less developed countries and the post-1971 international financial system.

(Essays in international finance; no. 108
ISSN 0071-142X)
Bibliography: p.
1. International finance. 2. Underdeveloped areas—Money.
I. Title. II. Series: Princeton University. International Finance Section. Essays in international finance; no. 108.
HG136.P7 no. 108 [HG3881] 332s [332.4'5'091724] 75-5685

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

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-

*Helpful comments from Benjamin I. Cohen, Richard N. Cooper, Gerald K. Helleiner, Harry G. Johnson, Charles P. Kindleberger, Edwin M. Truman, Delbert Snider, Ernest Stern, and John Williamson are gratefully acknowledged. None of them should be blamed for flaws in this essay.

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