

ESSAYS IN INTERNATIONAL FINANCE

No. 139, October 1980

A LIBERAL INTERNATIONAL ECONOMIC
ORDER: THE INTERNATIONAL MONETARY
SYSTEM AND ECONOMIC DEVELOPMENT

DEEPAK LAL



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

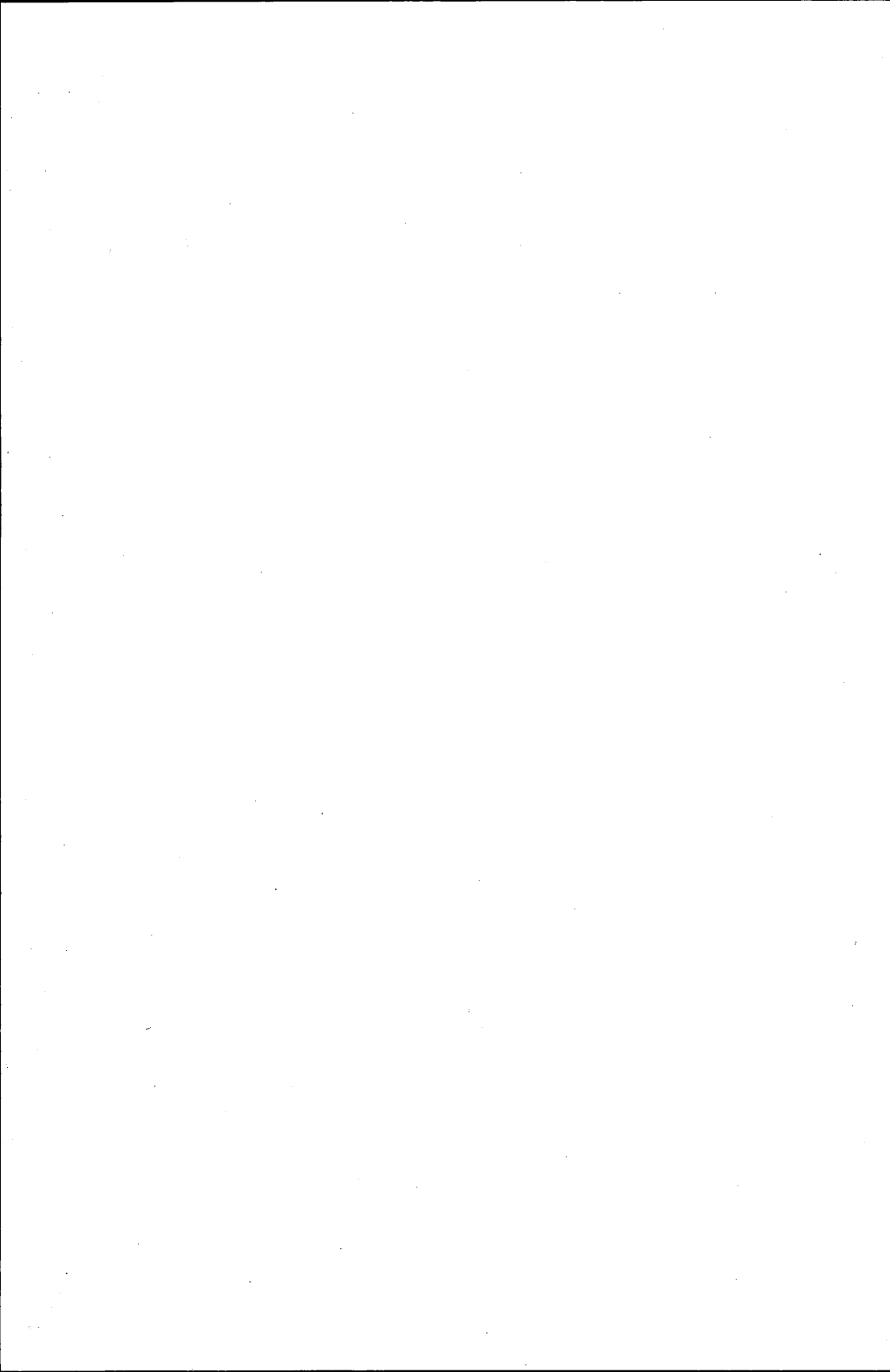
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Introduction

Since the suspension of the convertibility of the dollar into gold in August 1971 and the subsequent collapse of the Bretton Woods system, the world has gradually moved to what is now described as an international monetary "nonsystem." The Jamaica agreement of January 1976 to amend the Articles of Agreement of the International Monetary Fund legalized the managed floating of exchange rates, which has been widespread since 1973. A fierce and voluminous debate continues on whether the existing nonsystem needs to be reformed by the erection of a new system to replace Bretton Woods and, if so, on what form the new system should take. This debate presupposes some agreement on the necessity of any international economic (including monetary) system or order and on the basic objectives of this system. The debate has gained considerable topical interest with the desire of the less developed countries to seek a new international economic order.

Section 1 of this essay briefly surveys the answers that have been provided to these fundamental questions and argues the case for what has been termed "the liberal international economic order." To do so, some well-trodden ground must be covered, but a number of relatively unfamiliar arguments in favor of such an order are also advanced. In particular, I contend that the arguments in favor of free trade in assets parallel those for goods and services. I also take issue with a common argument advanced against the feasibility of a "spontaneous emergence of free trade" in a world where most countries have some degree of monopoly power (see Kindleberger, 1976a). The arguments for a full-fledged liberal international economic order set the stage for the policy discussions in the next two sections.

Policy debates on the international monetary system have centered around the desirability of alternative arrangements for three dimensions of an international monetary system: the role of exchange-rate adjustments, the nature and role of international reserve assets, and the degree of control of international capital movements. Much of the debate on

The research for this paper was done while the author was a Visiting Fellow in the Research School of Pacific Studies at the Australian National University. It forms part of an ongoing project on the New International Economic Order, in collaboration with David Henderson, which is funded by the Nuffield Foundation. Discussions with, and comments on earlier drafts by, Heinz Arndt, Max Corden, Ian Little, and David Henderson have proved most useful. The views expressed are the author's and should in no way be identified with those of the World Bank.

these issues has been based on what Corden (1977, p. 43) has termed "target theory rather than optimising theory." This has meant that, unlike other debates on public policy (e.g. concerning alternative tax structures, price-stabilization schemes, investment criteria, and trade policies), those on the reform of the international monetary system are not usually conducted within the explicit framework of welfare economics. In my view, however, it is both possible and desirable to view the choice of an international monetary system in terms of welfare economics. This is the purpose of section 2.

I take issue with the views of both those who believe in the feasibility and desirability of fixed exchange rates and those who want some rules for a system of managed floating. I argue that fixed exchange rates are not feasible in the real world, where monetary independence is identified with national sovereignty and there is some downward rigidity in money wages and the prices of nontraded goods. The advocacy of managed floating is shown to be based on an implicit model in which governments have perfect (or at least greater) foresight than other market participants. In the real world of irreducible uncertainty, I argue, no such assumption is valid. In consequence, free trade in goods and services (including capital flows) and freely floating exchange rates represent the optimal system for the world as it is.

While many, but by no means a majority of, economists might be willing to concede the optimality of such a regime for advanced (OECD) countries, most would seem to argue for some form of managed flexibility of exchange rates and capital controls for less developed countries (see Díaz-Alejandro, 1975; Cline, 1976; Joshi, 1979; Black, 1976). The merits of these arguments are examined in section 3, which also briefly discusses the pros and cons of the demands of developing countries for a link between foreign aid and the creation of international fiduciary money in the form of Special Drawing Rights. I argue that, except for a few of the least developed countries, a currently heretical case can be made for the application of the arguments of the earlier sections of the essay to most of these countries. It would be in their interests to endorse the monetary arrangements of a liberal international economic order—free floating and no capital controls.

1 The Case for a Liberal International Economic Order

The purpose of public policy is to raise levels of economic welfare, usually identified by economists, though not by politicians and diplomats,

with the level of individual consumption broadly defined. It is a fact of life that the individuals concerned are organized into nation-states. The question then arises: What should be the economic objectives of a rational nation-state which subscribes to the relatively mild liberal individualistic premises that, *ceteris paribus*, it is better for individuals to be in their own chosen position and that the source of economic welfare (which is of course only a part of total welfare) is consumption by its current and future citizens?

Economic Objectives of "Rational" Nation-States

It is necessary first to define the set of individuals to be counted as members of the nation—those whose economic welfare is the nation's concern. The individuals defining the nation have common rights and duties concerning the provision of various public goods, as well as the attainment of any commonly shared *national* redistributive goals realizable through either voluntary or coercive transfers between citizens of the nation. Furthermore, the rights of noncitizens to join and of citizens to leave the nation (immigration and emigration policies) are under national control and need to be specified, irrespective of whether national rule making concerning these rights is democratic, dictatorial, or oligarchic.

But apart from thus defining the set of individuals whose economic welfare is its concern, should the nation-state care at all about the actual ownership of claims to physical and other assets within its borders, or about the particular composition of output or assets? To set aside for the moment second-best domestic distributional considerations, assume that each nation can enforce its desired domestic income distribution. Then suppose that the citizens of two nations engage in mutually agreeable trades until each group ends up "owning" all of the other's physical assets in economies assumed to be stationary (to avoid complications arising from differential rates of return on savings, which I take up below). Should this be a matter of concern to either national authority?

In these static economies, there would seem to be no reason why it should be (ignoring political problems concerning, for instance, the risks of expropriation, which are discussed below). The respective consumption and income flows will, of course, still depend upon the initial resource endowments of the two countries' citizens, their rates of time preference, and the respective productivities, but the location of the income-generating assets will not in itself be a source of additional benefit. The foreign ownership of a country's assets, moreover, does not diminish the country's capital stock or remove it from the country. It means

only that, as a result of national and foreign portfolio preferences, the portfolio of assets has been altered (and in the process of adjustment the relative prices of different assets may have changed). At any point in time, most of a country's capital stock is physically fixed and cannot be shipped out (except in economists' models with perfectly malleable capital goods). The only question is: Who has the rights to the income stream that is generated by the stock? If nationals are willing without coercion to exchange their rights from local assets for those from foreign assets, both sides to the bargain have presumably gained. Hence, from an *economic* viewpoint, the fear of foreigners' buying up local assets would not be rational.

This argument remains unchanged even when the assumptions of a static economy are relaxed. Allow additions to the local capital stock through *flows* of savings (local or foreign). If there are no disparities between private and social rates of return to investment in either nation, there is again little *economic* reason to be concerned with the location of investments made by citizens with current savings. (The case of disparities between private and social returns to investment, domestic and foreign, is considered in section 3. There may also be noneconomic reasons concerning ownership and control that may lead to national concern over foreign ownership, on which more below.)

What would be the optimal international economic order from the viewpoint of such rational nation-states? Would this optimal order emerge spontaneously from the self-interested actions of such nation-states, or would it need to be enforced?

Alternative World Environments

Assume a world of nation-states each of which follows the economically rational objective of being concerned with the consumption levels of its citizens. Further assume for the moment that each state can correct any *domestic* disparities between private and social values and can legislate the optimal domestic income distribution through nondistortionary lump-sum taxes and subsidies. Following Grandmont and McFadden (1973), we can categorize four world environments that are conceivable in principle.

The first consists of centrally planned nations in which a central committee of Platonic Guardians acts as if the nation consisted of a single consumer. The rest of the environments consist of nations with multiple consumers and relatively decentralized national markets, but they differ in the size of the nations. In the second, the nations are "infinitesimal" in international markets in that they cannot influence world prices or dis-

turb world trade equilibrium. In the third, they are "small" in that they treat world prices as parameters but influence the determination of world trade equilibrium. In the fourth, they are "large" in that they treat world prices as variables.

In the first world environment, it has been shown that free trade is to the advantage of each nation. The mutual gains from trade for a world of initially autarkic centrally planned nations follows from the fact that "the refuge of [any degree of] autarky remains available when trade is possible" (Grandmont and McFadden, 1973). Starting from any allocation under autarky, the Platonic Guardians can choose from an enlarged feasible set of allocations under free trade, either the original allocation or one that is at least as good for every consumer. Given such a Pareto-optimal allocation under free trade, any alternative allocation that is feasible under autarky can improve the lot of some consumers in the nation only by worsening that of others. The same arguments apply when we consider the whole spectrum of choices while moving from autarky to restricted trade to free trade. Grandmont and McFadden emphasize that this proposition "does *not* require that nations be either 'infinitesimal' or 'small' in international markets, that nonincreasing returns to scale prevail, that all commodities be tradeable, or that factors be immobile."

For the second and third world environments, namely for "small" and "infinitesimal" multi-consumer trading nations, in which consumers are (locally) nonsatiated and externalities are absent, it can be shown that any alternative allocation feasible under varying degrees of autarky will not be Pareto-optimal, as compared with an equilibrium allocation under competitive trade. For any allocation achieved under autarky, a system of *domestic* lump-sum transfers can be found for which a competitive equilibrium exists and will be at least as satisfactory as autarky for every consumer. This conclusion does not require that traders be "small," that nonincreasing returns to scale prevail, or that factors be immobile.

These conclusions for centrally planned nations and "small" and "infinitesimal" multi-consumer trading nations are not restricted to trade in commodities. As Kareken and Wallace (1977) have shown, similar conclusions apply when asset or portfolio autarky is compared with free trade in assets (where autarky means that "the residents of every country are prohibited from owning real assets, by assumption physically immobile, that are located in other countries"). They show that portfolio autarky is not in general Pareto-optimal, while free trade is optimal.

Mutatis mutandis, the free-trade regime will also be superior to various restricted-trade regimes.

Let us now successively relax some of the assumptions underlying these demonstrations of the mutually beneficial effects of free trade in commodities and assets. First, these results are based on models that abstract from uncertainty or else sidestep it by postulating complete Arrow-Debreu-type futures markets. Many authors have argued that in a world of uncertainty about preferences, the terms of trade, or technology, many of the standard theorems of trade and welfare theory do not hold in the standard trade-theoretic model, which abstracts from trade in international securities and hence in international risk-sharing arrangements. (See Helpman and Razin, 1978, for a review of these studies.)

However, Helpman and Razin have shown that the standard theorems are resurrected once international trade in securities is allowed. The basic reason is that the lack of (or restrictions on) international trade in real equities under conditions of uncertainty turns each of the trading countries into a virtual "closed" economy. The stochastic element for every good (including traded goods) for which there is only a domestic market makes every good in effect nontraded or partially traded. Hence, each country's production decisions are tied to its consumption decisions, as in a closed economy. The introduction of trade in securities, opening up extra international "insurance" markets, is required to "open" the economy completely (as purely "goods" trade does in the standard model without uncertainty). This enables the familiar gains from trade to appear. It becomes possible to separate the country's production and consumption decisions at commodity and asset price ratios that differ from those under autarky, so that there are gains from enlarging its potential consumption-possibility set beyond the domestic production-possibilities set.

Keeping within the confines of our first three world environments, let us next relax the assumptions concerning the optimal correction of any domestic divergences between private and social values. As it will not usually be feasible to use neutral fiscal devices, such as lump-sum taxes and subsidies, only a second-best welfare optimum will be attainable in each trading nation. There will then be a hierarchy of policies for dealing with particular domestic disparities, as well as with domestic income distribution. In this hierarchy, many *domestic* policies will dominate those restricting foreign trade in goods and assets. (See Corden, 1974, for an excellent summary of this modern theory of trade and welfare.) Furthermore, as Neary (1978, p. 508) has shown, once the realistic assumption is made that capital is sector specific in the short run, then a

“number of paradoxes which have attracted much attention in recent writings, such as a perverse price-output response, and a perverse distortion-output response, will ‘almost never’ be observed” when a small open economy is opened up to trade. Though free trade will not necessarily be optimal in *all* second-best situations, the combination of some domestic intervention and free trade will dominate a policy of restricted trade in many situations where the feasible set of domestic policy instruments is not so limited as to rule out their deployment in dealing with domestic distortions.

This still leaves one unrealistic assumption, that the domestic distributional effects of alternative trade policies can be dealt with neutrally through lump-sum domestic taxes and transfers. In practice, lump-sum redistribution will generally not be feasible. Once again, however, there will be various second-best *domestic* redistributive mechanisms which, if feasible, will be preferable to protection in tackling the distributional effects that may flow from increased foreign trade. It should also be noted that the distributional effects of any economic change, even if domestic in origin, would also require domestic compensatory policies in line with each country’s distributional preferences.

Finally, we have the fourth world environment to consider, with “large” multiple-consumer nations for which world prices are variables. In this world, there is a case for levying an optimal tariff, which equates the marginal costs and revenues of a country’s imports and exports. For a country that can affect its terms of trade because of its monopoly/monopsony power in trade in commodities, mobile factors, or assets, such a tariff would be optimal from a national standpoint if other countries were either price takers or else did not retaliate against the tariff-imposing country. Although world welfare would be lower, the country imposing the tariff would gain. Furthermore, Johnson (1953-54) has shown that even if more than one country can affect its terms of trade and all the others retaliate, it is still possible for one of the countries to be better off in the tariff-ridden situation than with free trade.

It may be argued that in the real world many countries have at least *some* influence over their terms of trade. It may therefore be tempting for the smaller nations to levy optimum tariffs on their foreign trade. As their tariffs would have an almost imperceptible effect on the world economy, the dangers of retaliation against them would be minimal and there would be little incentive for rational countries to move unilaterally to free trade. In order to maximize world gains, it would be necessary to enforce free trade through universal agreements to eschew protective devices (see Scitovsky, 1942, and Kindleberger, 1976a). In the absence

of any international externalities in consumption, however, rational nations are unlikely to be moved by notions of cosmopolitan gains. They are more likely to prefer *national* gains to any given total of cosmopolitan gains. Why, then, should any such agreement to eschew the use of optimal tariffs be stable?

The Terms-of-Trade Argument for Protection and the Legislation of a Liberal International Economic Order

To answer this question, an application of n -person cooperative game theory is particularly useful. It allows us to look at the traditional two-country-two-commodity optimal-tariff model incorporating retaliation as a two-person non-zero-sum *noncooperative* game (like the Prisoner's Dilemma). If the world economy consisted of two noncooperating trading blocs, the final configuration would be unpredictable and the free-trade equilibrium would have to be enforced. This implicit model underlies much thinking on an international economic order, as is brought out by the following quotation from Kindleberger (1976a, p. 16):

In the international economy it has long been recognized that the world of the benign invisible hand does not obtain. Unlike the households and firms of the national economy, countries in the international economy and especially in the international polity have power. A country can improve its terms of trade, that is get imports cheaper, by imposing a tariff on goods bought abroad. The fallacy of composition argues that if each country tries to gain at the expense of others, all lose, so that it is useful to simulate the world of the invisible hand by commitments to the rule of free trade and the gold standard.

But since the world economy is *not* (at least as yet) composed of two mutually opposed trading blocs, are the same conclusions valid for a multi-country trading world in which all traders can within limits choose the quantities they want to buy and sell at mutually agreed prices (and hence are implicitly "price makers" in one sense)?

The relevant model is that of n -person cooperative game theory. Within this framework, it can be demonstrated that, following from a famous theorem of Edgeworth's recently revived in the mathematical theory of the "core" of an economy, when there are many trading nations with some "monopoly" power and those nations have the preferences of *homo oeconomicus*, the only stable equilibrium point in the process of higgling and haggling among these "rational" nations will be where they all act as if they were price takers, namely the free-trade, competitive equilibrium.¹ As Arrow and Hahn (1971, p. 186) point out:

¹ This proof holds (see Malinvaud, 1972) under the usual convexity assumptions, in the presence of all markets (absence of externalities), when the costs of bargaining

Contrary to the view sometimes expressed that competitive equilibrium has an inherent instability in that it would pay, for example, the owners of some one commodity to form a cartel and exploit their monopoly power [the] theorems on the relation between competitive equilibria and the core suggest that any such attempt would be broken up by the formation of coalitions involving some buyers and some sellers of that commodity. The sellers ultimately can depend for sure only on what they can achieve by trade among themselves, and of course, this may be very little indeed.

This line of argument might appear to be a cruel joke to those suffering from the oil prices legislated by the OPEC cartel since 1973. But the theorist, as always, has a way out! The argument depends upon symmetries in expected behavior. As Arrow and Hahn state:

If a coalition with monopoly power somehow makes it credible to all others that its demands will not be compromised no matter how much it suffers and that none of its members can be drawn off into side bargains, then it may indeed get its way. The difficulty with this type of argument is its asymmetry. If one coalition can threaten in this way, so can the coalition composed of all others. The asymmetry in expected behavior needed for the efficacy of threat strategies is plausible only when based either on *differential bargaining costs* (so that the counter-coalition cannot really form) or on *extra-economic motives* of loyalty to and identification with some group, such as nation, class, or race (p. 187, emphasis added).

Clearly, the success of the OPEC cartel can be sufficiently explained within this framework by the two italicized conditions. It proved impossible to organize a countervailing consumer coalition, despite U.S. efforts, partly because oil-importing developing countries were sympathetic to OPEC and wanted to follow OPEC's lead by organizing similar cartels for other commodities. Among the producers, Saudi Arabia's adherence to the OPEC cartel was to an important extent motivated by its desire to use the "oil weapon" as a lever to obtain perceived Arab rights.

This argument suggests that *if* nations were moved purely by economic self-interest, *if* there were enough of them, and *if* any particular resource (commodity or factor) were not *wholly* owned by a single nation, then the economic power of any individual nation would be so weakened that it might as well behave like a price taker.² Free trade would seemingly

(and coalition formation) among nations are low or at least uniform, and when expectations of behavior are symmetrical. It is not my purpose to argue for the realism of these assumptions but merely to show that within the conventional framework (which also makes use of these assumptions), there is no presumption, as is often asserted, that free trade will need to be enforced.

² To the best of my knowledge, Graham (1948, pp. 10-12) was the only international trade theorist aware of this deficiency (based on game-theoretic considerations) in the classical terms-of-trade argument.