Commonwealth Economic Papers: No. 18

Towards a New Bretton Woods

Challenges for the World Financial and Trading System

Selected background papers prepared for a Commonwealth Study Group

Volume 1

Commonwealth Secretariat

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CHALLENGES FOR THE WORLD FINANCIAL AND TRADING SYSTEM

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VOLUME 1

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PREFACE

The papers included in this collection, published in two volumes, were prepared to assist the Study Group which the Commonwealth Secretary-General set up early this year in response to a request by Commonwealth Finance Ministers for an overall examination of the international trade and payments system. The Group, headed by Professor Gerry Helleiner of the University of Toronto, comprised nine eminent experts in finance and trade, drawn from a wide range of Commonwealth countries. The Group met four times during January-July 1983 and their report was submitted to Commonwealth Governments in August 1983 and published for general circulation in September 1983 under the title "Towards a New Bretton Woods: Challenges for the World Financial and Trading System".

Many of the papers were prepared, on request, by distinguished people with specialised knowledge of the functioning of the international economic system. These often contain not only an analysis of the relevant problems, as the respective authors see them, but also fairly specific policy proposals. In addition, the Secretariat prepared a large number of background papers which represented an effort to present in summary form relevant information and analyses on the principal issues pertinent to the Group's terms of reference. Some of these papers are also included in these volumes.

The main subject areas covered by the papers are: the state of the world economy; the problems of specific country groups in the areas under consideration; the evolution and functioning of the international finance and trade institutions, particularly the IMF and the World Bank Group; special issues concerning official and private financial flows; and problems in the international trading system.

While the papers are not the product of any major new research effort, which would not have been possible in the short time available, it was felt that they would nevertheless be of interest to a wider audience than the Study Group for which they were written. Knowledge of their availability has already generated considerable demand for some of the papers. It should be noted that no attempt has been made to edit or revise these papers to any significant extent in the light of subsequent developments. However, obvious errors have been corrected and figures updated either by the Secretariat or the authors themselves. Rosemary Minto and S.K. Rao were responsible for the detailed editorial work and Qamar Siddiqi provided supervisiory assistance.

On behalf of the Secretariat and the Study Group, I would like to express my gratitude to the authors for their willing and expeditious response to requests to produce papers at short notice and for the useful contribution this background effort made to the analyses and recommendations contained in the Group's Report.

Finally, I must emphasise that the conclusions expressed in the papers remain those of the authors and do not necessarily reflect the views of members of the Study Group, the Commonwealth Secretariat or Commonwealth Governments.

B. Persaud
Director and Head
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THE CRISIS IN THE WORLD ECONOMY - SOME THOUGHTS ON THE SITUATION TODAY AND IN THE THIRTIES

R.C. Wanigatunga
Commonwealth Secretariat

"Economics still does not allow final answers on these matters. But as usual, something can be said." J.K. Galbraith in The Great Crash.

I. Introduction

There is mounting anxiety that the world economy is currently in the throes of a recession[1] which could well escalate into a severe depression similar to that which bedevilled most countries in the inter-war period.

It is perhaps useful briefly to see the background to the current recession and then examine its salient features and attempt to assess its possible causes. The policies adopted to deal with it are also relevant. The inter war period is treated likewise. Finally, a brief comparison of the two periods is made.

In both periods, what is being dealt with is a malaise of the developed market economies, which has, of course, had severe repercussions for the rest of the world, none more so than the developing countries considered as a group. The developed market economies, led by the US, account for much of world income and trade and their dominance was even greater in the 20s and 30s (Table 1).

II. The Current Recession

The background

The post Korean war period up to the mid 60s saw a rapid rate of growth of world income and of world trade (tables 2-4): the latter was greatly assisted by trade liberalisation in industrialised countries (albeit concentrated on intra-regional Western European trade) and the "convertibility" of major currencies. In the developed economies, the numbers in employment rose sharply and the rate of unemployment remained low (Table 5), while the general level of prices rose only mildly. This period was also characterised for the most part by a high and sustained level of aggregate demand, at a level very often approximately that necessary to maintain "full employment", partly as a result of the following of "Keynesian"economic policies [2] in most countries, and rising real expenditure on durable consumer and "public" goods.

Among the "leading sectors" for which there was great demand (and which indirectly fuelled growth) were the automotive industry (and services and industries "linked" to it), consumer electrical goods, i.e. the "leading sectors" of "high mass consumption,"[3] services such as tourism associated with the increased use of leisure, and services relating to education and health.

On the supply side, relative prices of primary products, especially of energy, were low. There were significant advances in overall productivity due to shifts of resources, particularly labour, from agriculture, and advances in technology.

By the later 60s, however, the rate of growth of output was beginning to falter and other ominous developments were discernible. The marginal capital-output ratios were rising[4] and the rate of return to capital[5] showed a tendency to fall. There was an observable decline in the rate of expansion of the "leading sectors" and a failure for others to counterbalance this trend. The numbers employed in most OECD countries were not increasing as rapidly as before, but unemployment was not a major problem as yet.

International trade,however, continued to expand, partly as a result of further trade liberalisation and the increase in intra-industry specialisation.

Current recession

From the early 70s right up to 1982 the OECD economies have behaved very erratically (tables 4 and 5) and there have been very disturbing developments in relation to the rate of growth of output, unemployment levels and rates, inflation and in international trade.

The economies of most OECD countries went into recession in 1974/75,with GNP stagnating,while over the previous two years it had grown by over 11 per cent. The decline in GNP was accompanied by the highest rate of inflation since 1945, with consumer prices increasing by nearly 25 per cent over 1974 and 1975.[6] Unemployment levels and rates tended to rise. International trade slowed down.

There were some improvements in most areas (with the notable exception of employment) between 1975 and 1979, followed by a second recession far worse in its effects than the earlier one, with real output stagnating over the period 1979-82 and unemployment rising rapidly (since 1980) to rates which though significantly below the average rates of the inter-war period are,nevertheless,historically very high. The rates of return to capital and investment[7] (levels and

Table 1 - Selected Countries and Country Groupings in relation to World Trade and Income
(figures in per cent)

Countries/Groupings	Trade[1]						Income		
	1928	1938	1950	1960	1970	1981	1929	1970	1980
North America	16.1	12.2	18.4	15.3	16.2	16.7	38.3	34.6	24.3
US	..	..	13.9	11.1	12.1	13.5	..	32.0	22.0
Western Europe	48.2[2,3]	47.5[2,3]	37.7[2]	40.6	43.5	40.9	32.4[4]	25.4	29.4
UK	..	..	11.1	9.4	6.6	5.4	..	3.9	4.4
France	..	..	4.8	4.6	5.8	6.0	..	4.8	5.5
Germany	..	..	4.2	7.5	9.1	8.1	..	6.0	6.9
Japan	..	..	1.5	3.3	5.8	7.0	2.1	6.3	6.9
Total Industrial Areas[5]	67.6	63.5	57.6	59.2	65.5	61.8	72.8	66.4	62.9

.. not available.
1. Imports. 2. Excludes Spain, Yugoslavia and Gibraltar. 3. Excludes Finland. 4. North West and South East Europe. 5. Excludes South Africa and Australasia.
Sources: For trade data before 1960, GATT (Report by a panel of Experts), Trends in International Trade (Geneva, 1958) pp 12-15 and for subsequent trade data GATT International Trade (various): for pre-war data on income, A.J.H. Latham The Depression in the Developing World (Croom Helm, London 1981) p.153 and for later data on income, calculations from UNCTAD Trade and Development Statistics (various).

Table 2 - Growth in International Trade, 1963-81

	billion dollars		Average annual percentage increase in world trade			
			by value		by volume	
	1973	1980	1973-80	1969-73	1973-80	1980-81
Manufactures	348	1,089	18	11	5	3½
Minerals (excl. fuels)	32	91	16)	7	4)	-9
Fuels	63	468	33)		-4)	
Agricultural products	121	296	14	4	4½	3
Total	574	1,973	19	8½	4	¾

Source: Commonwealth Secretariat. Protectionism: Threat to International Order (1982) p.6.

Table 3 <u>Foreign Trade as a percentage of GDP for Selected Countries</u>

	UK	France		Germany		Italy		U.S.A.	
1914-19	37.0	1921-24	27.6	1910-13	38.7	1920-24	26.4	1919-28	10.8
1924-28	38.1	1925-29	26.6	1925-29	34.9	1925-29	32.2	(	(
1929-33	27.9	1930-34	23.1	1930-34	29.3	1930-34	23.1	(1929-38	(6.9
1934-38	23.8	1935-38	20.9	1935-38	18.4	1935-38	14.9	(	(
1949-53	36.6	1951-54	26.1	1950-54	23.2	1950-52	23.6	1954-63	7.9
1953-56	34.2	1955-58	28.6	1955-59	32.4		..		
1960-62	40.5		28.1		37.2		31.2		8.9
1970-72	40.0		32.9		44.1		38.1		11.3
1979-81	53.8		44.3		58.9		51.4		20.3

<u>Note:</u> Split years denote annual averages

Sources: Simon Kuznets "Quantitative Aspects of the Economic Growth of Nations; Level and Structure of Foreign Trade: Long Term Trends" Economic Development and Cultural Change Vol. 15 No. 2, up to 1959 and calculated from IMF, International Financial Statistics (various) for later data.

Table 4 Growth and Price Performance

A. Growth of Real GDP	1960/73	1973/75	1975/79	1979/81	1981/82[e]	1982/87[e]
(avg annual compound rates)						
World	5.5	1.7	4.3	1.8	1.2	3.4
Developed countries	5.0	0.3	4.0	1.3	0.6	3.1
US	4.1	-0.8	4.5	0.9	-0.4	3.4
Japan	9.9	0.6	5.2	3.6	2.5	4.3
W.Europe	4.8	0.8	3.4	0.8	0.8	2.6
Oil exporting developing	8.2	2.3	5.4	0.3	0.4	5.7
Other developing	5.5	4.8	5.4	3.0	1.7	3.7
Centrally planned	7.2	5.6	4.6	3.2	3.2	3.5
B Change in GDP Deflator(%)						
OECD-six major countries	3.9	11.4	7.1	8.8	7.3	6.0
U.S.	3.0	9.6	6.9	9.1	6.0	5.8
Japan	5.3	14.1	4.9	3.0	3.5	3.0
France	4.7	11.6	9.6	11.7	13.8	9.3
W.Germany	4.0	7.4	3.7	4.9	4.3	3.5
UK	4.7	19.4	12.7	15.1	8.5	6.0

1983

Sources: Samuel Brittan, "Clues to World Stagnation", Financial Times of July 22 1982, quoting World Economic Outlook, Wharton Econometric Associates for GDP and OECD Economic Outlook (various) for data on the general level of prices.

Table 5 Unemployment Data for Selected Economies

	US		UK		France		Germany	
	Rates (%)	Nos (millions)	Rates (%)	Nos (millions)	Rates (%)	Nos (millions)	Rates (%)	Nos (millions
1921	11.7***	..	17.0*	..	..	..	..	..
1924	..	..	10.3*	..	..	..	..	..
1928	..	..	10.8*	..	..	..	..	..
1929	4.2***	..	7.3**	1.5	..	..	..	..
1930	8.7***	..	11.2**	2.4	..	..	..	..
1931	14.2	7.1	15.1**	3.3	..	..	..	..
1932	22.7	11.4	15.6**	3.4	..	..	43.8	..
1933	23.4	11.9	14.1**	3.1	..	..	..	..
1934	19.1	9.8	11.9**	2.6	..	..	..	..
1935	17.6	9.1	11.0**	2.4	..	..	..	..
1937	16.9***	..	7.8**	2.1	..	..	..	..
1938	19.0***	..	9.3**	1.8	..	..	..	..
1939	16.4	8.8	5.8**	2.2	..	..	..	..
1970	4.8	4.1	2.2	0.6	2.4	0.5	0.6	0.2
1973	4.8	4.4	2.3	0.6	2.6	0.6	1.0	0.3
1974	5.5	5.2	2.1	0.5	2.8	0.6	2.2	0.6
1975	8.3	7.9	3.9	0.9	4.1	0.9	4.1	1.1
1976	7.5	7.4	5.3	1.3	4.4	1.0	4.1	1.1
1977	6.9	7.0	5.7	1.4	4.7	1.1	4.0	1.0
1978	5.9	6.2	5.7	1.4	5.2	1.2	3.8	1.0
1979	5.7	6.1	5.4	1.3	5.9	1.4	3.3	0.9
1980	7.0	7.6	6.8	1.6	6.3	1.5	3.8	0.9
1981	7.6	8.3	10.6	2.4[a]	7.4	1.8	4.8	1.3
1982	9.5	10.7	12.3	2.8[a]	8.5	2.0	7.0	1.8
1983	10.5	..	13.3	..	9.8	..	8.5	..

.. not available.
a Excluding school leavers.
* These rates are computed on the basis of trade union membership and are somewhat higher that they would be if otherwise computed.
** Estimates on basis of revisions of figure of *type by Jim Tomlinson.
*** Anna Schwartz's estimates.

Sources: The Beveridge Report (H.M.S.O.London,1942) pp.24 and 107, Jim Tomlinson "Unemployment and Policy in the 1930s and 1980s" Three Banks Review, September 1982 pp 18 and 20, OECD, Labour Force Statistics 1969-80 and OECD, Economic Outlook, (various), Anna Schwartz "Understanding 1929-38" in Karl Brunner (ed) The Great Depression Revisited (Nijhoff, The Hague, 1980) p.17 and OECD Main Economic Indicators, August 1983.

rates) began to deteriorate progressively: real wages tended to run ahead of productivity, which itself was declining in the manufacturing as well as in other sectors[8], especially after 1972-74.

The rate of inflation in a number of OECD countries rose sharply in 1979 but has declined since 1981 in response to "tight" monetary (and often fiscal) policies. The volume of international trade was estimated to be lower in 1983 than three years previously.[9]

Table 6 - The Declining Role of Manufacturing in Selected OECD Countries
(figures in percentages)

Country	Contribution to GDP						Contribution to Employment					
	1960	1965	1970	1973	1975	1979	1961	1965	1970	1973	1975	1980
Canada	..	..	..	..	..	..	24.0	23.8	22.7	22.0	20.2	19.8
US	28.6	28.9	25.7	25.0	23.5	24.2	..	..	26.4	24.8	22.7	22.7
Austria	..	..	..	..	..	..	33.1	33.0	29.5	..	30.1	29.5
France	..	..	28.3	..	28.3	27.1	27.7	27.7	27.2	28.3	27.9	25.7
W. Germany	40.4	40.5	41.3	39.0	37.3	37.6	38.7	39.3	40.5	36.4	35.8	35.1
Italy	..	..	..	..	..	..	27.7	28.9	..	..	..	26.7
U.K.	32.6	30.0	28.1	27.3	25.8	24.0	37.5	36.5	36.7	32.3	30.0	28.4
Japan	33.4	31.4	34.7	35.1	30.0	29.7	22.5	24.3	27.0	27.4	25.8	24.7

Sources: OECD, Labour Force Statistics 1961-72 and 1969-80, and UN Yearbook of National Accounts Statistics (various)

Possible causes for recession

The causes of the current recession are a subject for much vigorous debate among economists - as indeed are still those for the inter-war depression! Some variability in real performance is virtually inevitable even under the "the smoothest monetary policy"[10] and there was clearly a need, emerging well before the oil price "shock" of October 1973, for structural "adjustment" or investment in new leading growth areas.[11] The relative decline (and in absolute terms virtual stagnation or decline when 1982 is compared with 1977/78) of the manufacturing sector, which still accounts for a substantial proportion of output in most OECD countries, is

particularly striking (table 6). In most countries, the tertiary sector has tended to hold up well and employment in this sector has actually grown though the relative and absolute expansion of this sector has not been able to check the adverse developments in overall output and employment.

It has been argued that the massive rise in the real price of oil in late 1973 and the smaller but nevertheless sharp rise in 1979 have contributed to the recession because of their effects on the terms of trade of the OECD countries. One estimate puts the effects of the 1973 price increase at about 2.5 per cent of OECD GNP[12/]. Yet much of the surpluses of the major oil exporters found their way - directly or indirectly - to the OECD countries anyway. The rise in the oil price would cause at the worst a "once and for all" rise in the general level of prices rather than sustained inflationary pressure. What the oil price hike - soon to be followed by the rise in price of all forms of energy - called for was a reduction in real wages were employment levels to be maintained[13/]. The unwillingness to accept this "greatly increased but did not totally transform the problem of deflation"[14/]. The real problem for the OECD countries as a consequence of the oil price hike was that of urgent structural adjustment: the automobile and truck industries and their associates were dealt a heavy body blow. The price of many components of capital equipment also rose as a consequence of the oil price hikes. Those countries which could show some flexibility with regard to reducing real wages and diversification in industry (including the large-scale use of robots), like Japan, have done relatively well, while those who were unable to do so, like the UK, itself a net oil exporter, have fared relatively badly.

The "anti-inflationary" (or deflationary) policies followed by many OECD countries since the 70s to deal with the inflation aspect of "stagflation" have proved successful only in containing inflation. Indeed, government policies have also had the effect of contributing to high real rates of interest, exacerbated both domestically and internationally by the "divergent" monetary and fiscal policy stance in the US; and high real rates of interest are not conducive to increased investment. The curtailment of the public sector, itself a major consumer of "public goods" such as education and health (and a potential customer for capital goods relating to infrastructural development and for housing) has not been helpful in maintaining the level of aggregate demand or in stimulating existing "leading sectors" or potential ones such as energy generation and leisure related activities. Moreover, the "tough" monetary policies aimed at reducing the rate of increase of the money stock-rather than the stock itself-can, while stifling inflationary pressure and expectations, do little *per se* to generate the stimulus for increased investment in existing or potential "leading sectors". Indeed,

they make recession a virtual certainty before recovery in the real economy can begin.

Monetarists have tended to blame the dismal economic performance largely on the efficiency-distorting effects of the economic policies followed by governments in the early and mid 1970s. The following of expansionary policies by many OECD countries in the early 70s, largely with the aim of sustaining aggregate demand, did nothing to help to cure the malaise affecting their real economies: such policies could not in the long run bring about a sustained rise in real income but instead led to inflation and fuelled inflationary expectations. Indeed, in certain instances, as in the attempt at sustaining aggregate demand in the UK, it enabled highly unionised labour to obtain a rising share of the national product without a concomitant increase in productivity, thereby stultifying growth and jeopardising the level of employment[15/].

While factors like increased female participation rates in the labour force have contributed to the problem, they are not the major determinants of unemployment. The recent surge of unemployment has been very disconcerting. It is largely a belated response of individual businesses (of either reducing staff or going into liquidation) to the inimical environment in general and the low rate of return on capital and levels of capacity utilisation which are in turn manifestations of more fundamental influences that have persisted for some time.

Effects of the recession on developments in the international economy and on international economic relations

We have been dealing with a malaise from which few economies - whatever their type - can be insulated, given the degree of international interdependence. The dependence on foreign trade in goods has shown a marked tendency to increase in the post-war period (see table 2) to quite high levels for most countries - the US included. There is also now a susbstantial trade in services.

Trade flows are interlocked with growth performance, and it appears that the current stagnation in world trade stems largely from the recession in the large countries, notably the US, that constitute the major markets. Those countries that obtain much of their export and national incomes from primary products are particularly vulnerable as prices - with the exception of petroleum, the price of which has been hitherto determined by the regulation of supplies from a cartel of major producers - tend to fall substantially in response to recession in the major industrialised countries.

Matters have been exacerbated by the "dumping" of the agricultural surpluses of some developed country products, which has resulted in low prices for a few agricultural products, which, however, have a major impact on the foreign exchange earnings of many developing countries. International action on formation of commodity agreements has been generally ineffective. From 1977 to 1982, real export earnings of the low-income developing countries, which depend heavily on primary products, fell by about 23 per cent and for other net oil-exporting (non-NICs) developing countries by about 2 per cent[16].

Growth in many of these countries has been at minimal - if not negative - levels largely due to external factors. Not surprisingly, foreign investment has not stepped in to augment external resources, capacity to borrow from banks has been little, while increase in assistance in the form of aid and borrowings from international bodies has at best been marginal. For a few "dynamic" (largely) non-oil exporting developing countries with substantial potential for growth, the adverse external developments were "smoothed over" and growth potential enhanced by the re-cycling of "surplus" funds by the banks. This has proved to be a short-term palliative. At best, the funds have dried up for a long time: at worst, the inability of many borrowers to honour their loan commitments has brought about a potential situation of a major crisis for international and domestic banking systems in major economies, not altogether different from what happened after the New York Stock Exchange went "bust" in 1929. Moreover, these developments have tended to stymy growth in a major "dynamic" area of the world economy.

The momentum for further trade liberalisation has been lost and instead the level of protectionism has tended to increase with the increase taking on a covert rather than an overt form (in relation to obligations under the GATT Charter). While the increase in protectionism has hitherto been particularly felt by developing country exporters of some manufactures in which they have a clear comparative advantage, the major trading country blocs of the EEC and the US, after having put pressure on Japan and some of the Third World countries to restrict exports to them, are now involved in trade disputes with each other. Furthermore, pressures for protectionism as a means to get national economies out of the slump and to halt slides into massive unemployment levels in certain industries are escalating and the full effects of these may yet make themselves felt.

The international monetary system - which was based on the fixed exchange rate system of Bretton Woods - came under severe pressure by the early 70s on account of the

different economic performance and monetary policies followed by the major economies. The system of "managed" floating rates that was adopted in 1973 has not only brought about uncertainty with respect to investment and trade, but reduced some of the efficacy of monetary policies because of the susceptibility of the exchange rate to change on account of flows of short-term funds when interest rates are varied. Concern about domestic inflation has influenced the stance taken by major economic powers with regard to decisions on the increase of international liquidity, which has been kept to a minimum, thereby stifling a potential stimulus to international trade and growth throughout the world economy.

III. The Inter-War Depression

The background

Many views exist as to the causes of the inter-war depression. Friedman has judged that its origin lay largely in the failure of monetary policy in the US, and specifically in the decline in the money stock and velocity[17/], while Samuelson has considered it the result of the random occurrence of a series of accidents[18/]. Other explanations are the saturation of the market or a series of disastrous policy measures at the national and international levels[19/] or the loss of income by primary producers (which reduced aggregate demand, given their relative importance in the inter-war period, especially in the US) through adverse movements of the terms of trade: there is also the view that it was a long-term cyclical decline on account of adverse developments with regard to the "leading sectors". Other views are that the 30s represented the trough of a long-term (50 year) wave, or that it was a manifestation of the inevitable decline of capitalism.

The inter-war period saw business cycles of great ferocity, substantial and sustained reductions of output (or a lengthy period of depression) right up to the beginning

of the War, dismal performance with regard to investment and concomitant developments with regard to employment. There was, in addition, a sustained reduction in the general level of prices, which tended to move in the same direction, though not with the same intensity, as output. The volume and values of trade were substantially reduced and there was a particularly severe impact on real incomes of the non-industrialised countries. Private international capital flows were reduced with adverse consequences. In all, severe strains were imposed on the international economic system, which very soon ceased to exist! All these developments were of course, inter-related.

The situation in the 20s

It would be misleading to deal with the Great Depression of the 30s in isolation from the rest of the inter-war period. Indeed, the events of the preceeding decade are of some relevance to explaining both the events of the 30s and, to a lesser extent, today's recession. The end of the First World War called for substantial changes in the supply side of the major economies, to cater to peace-time demand. Furthermore, the impetus for growth could no longer come from the "leading sectors" of yester year: changes on the supply and demand sides were called for. In the US, which produced very largely for the domestic market, the automotive sector (together with the consumer electrical goods sector and urban construction) soon began to supply an ever increasing demand and was able in the main to sustain the economy right up to 1929[20/]. In the European economies, not only was the post war adjustment problem much greater, but there were no new "leading sectors" that could propel the economies forward until re-armament got into high gear at the end of the 30s: the automobile and durable consumer electrical goods became areas of mass consumption only in the 50s[21/].

Highlighting the problems of post-war adjustments, there was a recession, followed by rapid fluctuations in output and in prices, which fluctuated more. But differences were manifest among the major economies and exacerbated by fluctuations in the national money stock. The US suffered an 18 and 4 percent[22/] decline in nominal and real incomes respectively in 1921 compared with 1920, while its money stock declined by 9 per cent. But its real income rose by 23 per cent between 1921 and 1923 and grew at 3.4 per cent per year up to 1929[23/]. At the same time, the general price level was virtually static in the second period, though prices for primary products were drifting downwards. Unemployment was of negligible proportions, while wages rose slightly (by 5 per cent between 1925 and 1929).

The UK economy behaved intially in a similar fashion to that of the US, but entered into a mini depression from mid 1921 with much chronic unutilised capacity in many of the key export industries: in cotton textiles, the UK lost ground to India and Japan and in shipbuilding, comparative advantage was soon lost to the Scandinavian countries. The wholesale price level rose by 33 per cent between December 1918 and June 1920 but then fell by about 50 per cent in 1922,declining slightly thereafter.24/ Unemployment rose to 15 per cent of the labour force in 1923 25/ and failed to decline below 10 per cent partly because the pound was fixed in relation to gold in 1925 at pre-war parity, which overvalued the pound by about 10 per cent 26/. It was only in 1929 that there was a sudden (but short-lived) spurt in activity with the impetus largely coming from automobile,chemicals and electrical goods industries.

Germany was seriously hampered in the immediate post-war period by the burden of reparations (though the UK and France too had to pay war debts to the US) and the distorting effects of the 1922-24 inflation. Yet substantial inflows of US capital after the formulation of the Dawes Plan of 1924 helped to stimulate investment, 27/ though there was no significant advance over pre-war rates. The French economy received a substantial boost through the return to the gold standard in 1926 at a rate that somewhat undervalued the Franc. 28/

In the 20s there was large-scale US lending to Europe and to many developing areas (see table 7). The UK lendings were much smaller and more concentrated geographically. The foreign lendings, especially those of the US, did much to sustain the German economy, and to "lubricate the flows of international trade", and enabled the level of aggregate demand in the periphery to increase. Moreover, the rapid growth of the US economy was helping to keep world trade buoyant .

Developments 1929-32

US funds were being "diverted" from overseas by 1928 to finance the stock market boom, 29/ thus exerting much deflationary pressure externally. By 1929, several ominous developments were discernible. There was a decline in the rate of investment - already low in many major countries outside the US (see Table 8); and inventories were building up in several major economies, including the US.

The New York Stock Market collapse though in part "a symptom of the underlying forces making for a severe contraction in economic activity .... must have helped to deepen the contraction". 30/ The subsequent banking collapse and monetary policy adopted were largely to be responsible for the US money income declining by 53 per cent in the period

Table 7 Pre-War Net Capital[1] Exports (-) and Imports (+) of Countries on a Seclected Basis

(figures in millions of US$)

	1928	1929	1930	1931	1932	1937	1938
A. Industrial Countries							
France[2]	- 236	+ 20	+257	+791	+917	- 166	+ 207
Netherlands	- 73	- 75	- 66	+259	+ 76	+ 181	- 143
Sweden	- 39	..	..	..	..	- 49	+ 52
Switzerland	- 94	- 86	- 36	+370	+ 94	- 33	+ 120
UK	- 569	-574	-112	-313	+179	+ 277	+ 269
Germany[3]	+ 967	+482	+129	-540	-103		
long term	+ 426	+157	+266	+ 43	+ 3	..	..
short term	+ 541	+325	-137	-583	-106	..	..
US							
long term	- 1,137	-244	-700	-422	-189	+ 877	+ 441
short term	- 789	-250	-221	+215	+257	+ 521	+ 97
Canada	- 17	..	..	..	..	- 180	- 99
Sub-total[4]	- 1,111	..	..	..	..	+ 842[5]	+ 801[5]
B. Non-industrial Countries							
Argentina	+ 131	- 10	+287	- 89	+ 10	- 130	+ 165
Australia	+ 209	+250	+ 40	- 50	- 31	+ 77	..
South Africa	+ 48	..	..	..	..	+ 66	..
India	+ 5	..	..	..	..	+ 120	..
Indonesia	+ 4	..	..	..	..	- 20	- 13
Sub-total of listed countries	+ 397	..	..	.	..	+ 113	..
C. Memo item World imports	31,738	..	..	..	..	24,394	21,417

.. not available

1. Short and long term unless specified.
2. Includes French Overseas Territories.
3. Excludes Austria and the Sudetenland.
4. Includes Denmark, Norway and Japan.
5. Incomplete total.

Source: GATT; Trends in International Trade (Geneva, 1958) p.53 quoting UN Capital Movements during the Inter-War Period, 1949

Table 8 - Investment Performance in Selected Major Economies
(figures show gross investment as a percentage of GNP/GDP)[1/]

	USA	UK	Germany	Japan	Italy	France
1919-20	13.8	12.5	13.9	21.0	12.9	17.3
1925-28	15.9	10.3	11.1	17.2	17.8	15.7
1929-32	9.1	8.6	6.3	15.8	16.0	14.9
1933-37	7.6	8.7	9.6	19.5	16.2	13.9
1938	10.8	6.0	14.1	26.9	16.7	13.7
1939	11.6	2.6	14.9	27.2	16.2	14.0
1960	17.0	16.3	24.4	30.0	21.9	20.3
1965	17.9	18.1	25.8	31.4	20.4	23.9
1970	18.1	18.6	24.8	34.5	20.5	24.1
1973	18.3	19.3	24.0	34.4	20.8	23.7
1975	18.0	19.3	21.7	33.1	20.7	23.4
1978	18.6	18.1	21.6	31.3	19.4	22.0
1979	18.7	17.5	21.8	31.2	19.4	21.6
1980	18.5	17.5	22.8	32.0	19.8	21.6
1981	17.9	15.9	22.0	30.9	20.3	21.2

1/ Prewar data on basis of GNP and subsequent data on basis of GDP: five year moving averages except for 1980 and 1981.

Sources: For pre-war data, W.W.Rostow Why the Poor get Richer and the Rich Slow Down (MacMillan, London, 1980) pp 297-9 and for post-war data, calculations from the UN Yearbook of National Accounts Statistics (various) and for data from 1980, OECD Economic Outlook, December 1982.

1929-33, while the net national product decline by 36 per cent[31]. Between October 1929 and October 1930 US production fell by 27 per cent and the price level by 14 per cent. Unemployment rose from negligible levels to 3.1 per cent in 1929, and very sharply after that: it was responding to output decline after a short time-lag.

The effects of the US depression were felt by the rest of the international economy: the system of the gold exchange standard rendered the "international financial system more vulnerable to disturbances"[32] especially as the US did not allow its money supply to expand when there was an inflow of gold. The big fall in US imports enabled the balance of payments to stay in surplus until June 1930, but the substantial decline in US imports on the onset of its depression had a serious impact on export earnings (and hence incomes) of others, especially those heavily dependent on primary products: in the period 1929-32 US imports declined from $7.4 billion to $2.4 billion.[33] Furthermore, US lending overseas continued to decline and was instrumental in bringing about severe strains on the banking systems of Germany and Austria (and creating a suitable climate for radical political change), besides adversely affecting investment overseas and trade flows.

The UK economy soon felt the adverse impact of the US collapse[34]. National income declined sharply and unemployment rose from 1.5 million in 1929 to 3.4 million, or to 15.6 per cent of the labour force, in 1932. The depreciation of sterling in late 1931 (by the UK leaving the gold standard) was a belated attempt to stimulate exports and reduce the impact of the world recession and to halt the "run" on sterling emanating from the European banking crisis. The depreciation of sterling was followed briefy by a deflationary policy. Throughout the crisis, the UK government was curbing expenditure and achieved a budget surplus - even at the cost of reducing unemployment benefits. By June 1932, however, a policy of "cheap" money was being followed: the discount rate was a mere 2 per cent[35].

The highly deflationary policy Germany was following between 1930 and 1932,[36] as well as the effects of the US collapse and the strains on its commercial banking system after the crisis of the Credit Anstalt of Vienna in the Spring of 1932, saw unemployment rising very rapidly from 1.2 million in 1929 to nearly seven million, or 43.8 percent of the labour force, accompanied by a substantial decline in real income. France was not immediately much affected by the general recession. Although deflationary policies were adopted, the decline caused to output and unemployment (which was a mere 500,000 largely due to the expulsion of "surplus" foreign workers) in 1930/31 was not comparatively severe. But by 1932, exports had contracted by over half and were slowing down the economy.

World trade declined substantially in terms of volume and value, through the income and price effects that emanated from the depression between 1929 and 1932. The volume and unit price of exports of manufactures fell by about 35% each. For the primary producers, the export prices fell by about 50 percent, though volume declined little.[37] Many primary products, the demand for which was related to investment demand, experienced even heavier falls in real prices. Export earnings of primary producers declined from $19 billion in 1929 to $7.5 billion by 1932[38]. Trade problems were exacerbated by the dumping of surplus wheat by the USSR, and the competitive depreciations of currencies (by Australia, New Zealand and Argentina), which were only mutually frustrating for these agricultural producers.

The decline in the exports of the primary producers, which led to heavy gold losses[39] had catastrophic effects on their income levels and government revenues. A few relatively successful commodity arrangements established under the aegis of the colonial powers in products where metropolitan capital was heavily involved mitigated the falls in export earnings and incomes of a small number of countries. There were no "compensatory" inflows of foreign investment either: instead, flows had all but dried up.

The onset of the depression exerted a stimulus for a massive and immediate increase in protectionism. While the primary product exporters, like India and Australia, increased protection in 1929, the US Smoot-Hawley Act of 1930 (debated in Congress in 1929) paved the way for a spate of "retaliatory" actions, by Canada, Italy and France - which affected imports from all sources. The Imperial Preference Scheme of 1932 created a large trading area that discriminated against the rest of the world. It is little wonder that trade as a proportion of national income fell substantially (see table 2). The international payments system, too, began to disintegrate. A few countries continued to stick with the gold standard while some abandoned it in favour of the gold exchange standard and others for the severance of the link with gold and a few resorted to the formation of payments agreements that verged on barter trade. The single major attempt to obtain international co-operation in dealing with what was becoming a global problem foundered on the rocks of "immediate-term" national self interest.

Developments 1933-39

In the period up to 1939 there was a limited up-turn of the world economy, the short sharp recession of 1938, and a recovery from it under the impetus of government policy and

re-armament. In no area was the performance spectacular. The period also saw countries intensify inward looking policies in their endeavours to escape from the ill effects of the world recession.

The US industrial production staged a brief recovery to 1923-25 levels by July 1933 but faltered and only reached this level again in December 1935[40/] and in mid 1937 when it exceeded this level by a relatively small margin before soon falling by 40 per cent. The US national income in 1937 was a little higher (3 per cent) than in 1929 real terms[41/] but per capita income had fallen and labour force had risen by about 10 per cent. Highlighting the mediocre performance, investment was low. Unemployment remained high: it was 23 per cent of the labour force in 1933 and 18 per cent in 1935: by 1938 it was up to 19 per cent (see table 4). The price level in 1937 was about 20 per cent lower than in 1929; it fell again in 1938 and the price level in 1941 was 8 per cent below that of 1929.[42/] The US performance was despite the steps taken to depreciate the dollar in relation to gold, moderately expansionary efforts at stimulating the economy, a heavy influx of "refugee" capital from Europe and substantial public outlays on infrastructural development.

The UK economy was the first to recover to 1929 levels (by 1934) in terms of industrial output: but the 20s were not years of substantial growth. While there was some progress in automobiles, chemicals and electrical goods, the traditional industries remained depressed. The national income was not much higher in 1938 than in 1933, despite the policy of "cheap" money fuelling a housing construction boom. Public policy was in general largely deflationary and there was no major effort on the part of the government to stimulate the economy. Investment, too, did not rise substantially. Unemployment declined from 16 per cent in 1932 to about 8 per cent in 1937, but rose next year to 9 per cent (Table 5).

In Germany, there was rapid economic recovery under the National Socialist Government's expansionary fiscal policy, coupled with a public works programme and the return of business confidence. Investment began to pick up. Unemployment fell from 6 million in October 1933 to 2.8 million in February 1935 and 1.2 million two years later. France, belatedly - in 1936 and again in 1938 - devalued; exports had declined further to Ff 1300 million by 1935[43/], from FF 3600 million in 1930 and FF 1500 million in 1932. Real income fell by 13 per cent by 1935 whereas prices fell by about 20 percent under the impact of deflationary economic policy. Devaluation helped to stimulate the economy a little but by 1938 little real advance had been made. Investment was at low levels.

World trade remained in the doldrums. The volume of world trade in 1937-8 was 7 per cent below the level of 1928.[44] The value of trade at 24.4 billion dollars in 1937 was substantially below 31.7 billion dollars, the value of trade in 1928[45]. In 1938, prices of primary products were 31 per cent below those of 1928 while those of manufactures were 17 per cent lower. As a percentage of GNP, trade had declined substantially: it was no longer even the handmaiden of growth. The contraction owed much to the trade barriers being imposed with increasing severity - the US Tariff Reciprocity Act notwithstanding - and exchange controls, especially in Germany and Italy, as well as the relative stagnation of the world economy, but less to the so called "competitive devaluations" of the major currencies, because other than in the very short term they tended to cancel each other out.

Capital flows behaved somewhat perversely, with "refuge" capital moving to the US despite the relatively sluggish performance of that economy (table 8). US capital outflows, too,[46] declined, and there was understandably relatively little investment in the non-industrialised countries.

The chronic inter-war depression was a phenomenon that affected all (market economy) countries, but its intensity, duration, impact and indeed some of its underlying causes were often very different nationally. Yet the depression was truely international: the massive declines in income, especially in the US, soon adversely affected trade flows and incomes in other countries: international capital flows were reduced and had further adverse repercussions. Government policy, especially of the major economies, had often serious repercussions for the rest of the world. The efforts of the various countries to insulate themselves from the adversities of the depression only worsened the problems of all.

Possible causes of the inter-war depression

While there was clearly no single cause for this depression, real factors - as acknowledged by Keynes and Friedman alike - had a large role to play. In most countries (with the possible exception of the US) old "leading sectors" had to be replaced by those that were contemporaneously needed. Yet, the environment of the period, which became increasingly unattractive to private investment, made it unlikely that the challenge would be taken up. As the depression got on its way, business confidence, and with it investment demand, faltered, bringing about a major fall in aggregate demand.

There was, as Galbraith succintly put it, a lack of "economic intelligence" on the part of the state, with the important exceptions of Nazi Germany and the "piecemeal" attempts by the Roosevelt Administrations to get the US economy "back on course". In general, there was reluctance to stimulate economic activity, with politicians haunted by the spectre of the type of hyper-inflation that bedevilled Germany, Austria and Hungary in the early 20s.

IV. Comparisons of the 30s and the Present Recession

Although in both periods there have been adverse developments with regard to output, employment, investment, world trade, and major changes in the general level of prices, an essential difference is one of scale. Indeed, the present period may be broadly characterised as a recession rather than as a depression, which is an apt description for the inter-war period.

With regard to output, as seen in table 3, there was a faltering in and indeed a slightly negative rate of growth over a relatively short period in the 70s. The inter-war period saw three massive falls in output, and general stagnation in output levels over a very long period of time. Investment has behaved in a manner similar to output: it has receded a little, but not totally collapsed as in the inter-war period.

In both periods, there was a need for substantial structural adjustment in the major economies. These changes involve not only the re-allocation of resources and changes in patterns of national expenditure but also changes in the relative shares of the national product that accrue to labour and capital. In neither period, were these issues squarely faced up to by public policy and acted upon. Instead, there was a tendency for public policy to attach a diminishing role to the public sector in the expectation that greater (relative) involvement of the private sector would eventually bring about the necessary changes or at least bring about greater economic efficiency. Such a policy was not successful in the inter-war period to any satisfactory degree, and although all circumstances were not identical, it is likely to be devoid of major success in anything but the very long term.

With regard to unemployment, which has been recently rising at an alarming rate in terms of numbers out of work, the rate of unemployment is in general well below the rate of the worst years of the depression. It is not projected to increase much further, and has possibly risen - by a few percentage points at least - because of increased female participation rates[47]. On the other hand, the depressing

outlook with regard to output applies here too: in addition, it is not certain, in the light of the inevitable structural adjustments on the one hand, and possible major increases in labour productivity in many economic activities on the other, that the so called "natural rate of unemployment" will not remain at historically high levels for a very long time to come.

Furthermore, though the numbers unemployed are quite high and youth unemployment is a major problem, the phenomenon of unemployment is itself not as painful an experience today (at least in the developed countries) in contrast to the 30s . Much improved social security systems and unemployment benefits effectively guarantee - with the possible partial exception of the US - that the unemployed and their families have a standard of living, which though well below that of most of the employed, nevertheless does not entail deprivation of basic requirements.

Trade has slowed down of late, but its decline hitherto has been marginal. This has to be contrasted with the massive and sustained reduction in the volume and values of trade in the period 1928-39. But the poorer primary product exporters have been affected in a not very dissimilar fashion in the current recession from the worst days of the 30s. And of late, the other non-oil exporters have encountered severe contraction, either because of the drying up of their sources of (external) capital or relative stagnation in most export markets, or both, a situation that prevailed in both periods, for most developing countries.

The general level of prices fell substantially in the inter-war period, when output fell and in broad terms the two moved in parallel fashion. However, in the 70s and early 80s a major problem as been the rate of (positive) growth of the general level of prices. In the first recession (1974-5) and the recovery (1975-9) the movements of the general level of prices and real output were anything but parallel: there was indeed "stagflation" between 1974 and 1975 - no growth but a rapidly rising general level of prices. In 1979-82, the rate of growth of output and the rate of growth of the general level of prices showed a little less "stagflation" but the rate of rise in the price level only declined significantly after about two years of recession in a period when "anti-inflationary" policies were generally operative.

International economic relations are admittedly strained and similar pressures to those in the 30s have emerged. While there is a long way to go before they manifest themselves in concrete actions on the scale of the 30s,

these pressures are bound to be exacerbated if output and employment levels remain stagnant. Developed countries now depend far more on each other (and indeed on the rest of the world) and the wisdom of not fragmenting the international trade and payments system is apparent to the major actors. At the same time, concern over pressing national economic problems and the lack of full consensus on how to deal with them at the national and international levels inhibit these countries from tackling their problems through a concerted action or from making innovations relating to the international economic system.

Among the factors accounting for the differences in the behaviour of the key variables, the following could be perhaps usefully highlighted.

First, contractionary though monetary policy has been at times, it has never brought about (or permitted) a reduction in the money stock (as in the US in the 30s) but rather been concerned with bringing about a reduction in the rate of growth of money demand.

Secondly, the state is heavily involved in national expenditure - both in consumption and investment - and a significant downward shift in the state's expenditure is very "sticky" except over the very long run. Although many governments of late have tended to give priority to holding down inflation, over checking the rise in unemployment, there are several constraints that prevent in practice the following of "tougher" policies, especially as the stimulative role of public expenditure - at least in the short run - is recognised by all.

Thirdly, manufacturing is no longer the sector that dominates the economy with regard to value added and employment as it was in the inter-war period, and the very poor performance in output (and fall in employment) in this sector for the OECD countries as a group in the 70s has not led to major reductions in overall output and employment levels, as in the 30s.

Footnotes

1. For the purpose of this exercise inflation is defined as a sustained increase in the general price level, reflation as an increase in real output in the short run followed by a lower growth rate and a higher price level in the longer run, deflation as a reduction in the level of real economic activity, depression as a state where there is unemployment of labour and capital for a substantial period of time and recession as a mild form of depression: cf Brian Griffiths, Inflation (Weidenfeld and Nicolson, London, 1977), pp 10-12.

2. James E. Meade, Stagflation, Vol. 1 (George Allen and Unwin, London, 1982), p 3.

3. W.W. Rostow, Why the Poor get Richer and the Rich Slow Down (MacMillan, London, 1980), pp. 55 and 95.

4. Ibid, p. 95.

5. James E. Meade, op cit, p. 16.

6. OECD, Economic Outlook, December 1982, p. 152.

7. Michael Parkin, "Inflation without Growth: A Long Run Perspective on Short Run Stabilization Policies" in Karl Brunner and Allan Meltzer (editors), Stabilization of the Domestic and International Economy, (Carnegie Rochester Conference Series, North Holland) p. 51. Also Assar Lindbeck, "The Recent Slowdown in Productivity Growth", a paper presented at a Conference of the Royal Economic Society, London, July 22, 1982, and "Financial Times" of October 18, 1982 quoting an OECD study.

8. Assar Lindbeck, op cit. Also, Herbert Giersch and Frank Wolter, "On the Recent Slowdown in Productivity Growth in Advanced Economies", a paper presented at a Conference of the Royal Economic Society, London, July 22, 1982.

9. IMF, World Economic Outlook, 1983, p. 176.

10. Robert E. Lucas, "Understanding Business Cycles" in Karl Brunner (editor), The Great Depression Revisited (Nijhoff, the Hague, 1980) p. 25.

11. W.W. Rostow, op cit, pp. 37-38.

12. Assar Lindbeck, op cit.

13. James R. Meade, op cit, pp. 3 and 14.

14. Ibid , p. 29

15. Ibid , pp. 3 and 24-25.

16. IMF, World Economic Outlook, 1983, p.182.

17. M. Friedman and A. Schwartz *A Monetary History of the United States 1867 - 1960* (Princeton University Press, Princeton, 1971).

18. Charles P. Kindleberger, *The World in Depression 1929-39* (Allen Lane, London, 1974) pp. 19-20

19. Ibid, pp. 291-307.

20. W.W. Rostow, op cit, p. 35.

21. Ibid , p. 37.

22. M. Friedman and A. Schwartz, op cit, p.232.

23. Ibid, pp. 242-43.

24. J.W.F. Rowe, *Primary Commodities in International Trade* (Cambridge University Press, Cambridge, 1965) p.78.

25. Charles P Kindleberger, op cit, p.45.

26. Ibid.

27. Ibid , p. 38.

28. Ibid , pp. 48-52.

29. Ibid, pp. 70-72.

30. M. Friedman and A. Schwartz, op cit, p.306.

31. Ibid, p. 301.

32. Ibid, p.359

33. *The Beveridge Report* (HMSO, London, 1942) p. 219.

34. Jim Tomlinson "Unemployment and Policy in the 1930s and 1980s", Three Banks Review, September 1982.

35. Charles P. Kindleberger, op cit, pp.180 - 1.

36. Ibid, p. 139.

37. GATT (Report by a Panel of Experts), Trends in International Trade (Geneva, 1958) p. 13.

38. Ibid.

39. Charles P Kindleberger, op cit, pp. 101-104.

40. Ibid , p. 233.

41. M. Friedman and A. Schwartz, op cit, p. 493.

42. Ibid , p. 545.

43. Charles P. Kindleberger, op cit, p. 248 .

44. GATT, op cit, p. 20.

45. Ibid , p. 131.

46. Charles P. Kindleberger, op cit, p. 283.

47. For example, 40 per cent of the labour force in the UK currently, compared with 20 per cent in the inter-war period.

RECOVERY, SURVIVAL AND THE INTERNATIONAL MONETARY SYSTEM: NOTES TOWARDS INITIAL REFORMS

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Credit is suspicion asleep.

- H. Wallich, 1982

The external deficits of the developing countries have reached record levels.
Of those that are net importers of oil, half now face current account deficits of 12 per cent of gross domestic product or more - about three times their level of a decade ago. Deficits of this magnitude clearly cannot be sustained in terms of future debt service capacity.

- J. de Larosiere, 1982

The immediate financial problems of the banks should never be allowed to conceal the more fundamental political consequences in countries which face severe contraction and lower living standards as a result of their losses of foreign exchange and debt burdens.

- Brandt Commission, 1983

Successful adjustment to worsened terms of trade requires an expansion of investment rather than a contraction in demand; otherwise the underlying disequilibrium will be suppressed rather than corrected, resulting in damage to the development process without removing the prospect of renewed payments pressure in the future. Adjustment through growth implies a need for time to make the adjustment - and hence, bridging finance - as well as additional capacities - and hence, long-term resources from abroad.

- UNCTAD Group of Experts on Low-Income Countries and The International Monetary System, 1983

The International Monetary System: Elements of Pathology?

The international monetary and financial system is not operating satisfactorily. For about a decade and a half it has lurched into crises, been patched up, had brief returns to apparent good working order and lurched again. The underlying structural trend has been negative. In these aspects it has paralleled the global economy in prolonged recession - over 1979/82 more plausibly titled depression. Arguably, therefore, the monetary/financial system's weaknesses are neither surprising nor a basic cause of 1969-1982 global economic evolution. However, as of 1983 the state of the international monetary and financial system is such as to give real cause for fear that it will by its weaknesses precipitate a further crisis - especially but not only for peripheral economies - and/or abort the nascent or tentative recovery apparently beginning in some OECD and NIC economies.

A quick catalogue of weaknesses must begin with the International Monetary Fund because - despite its limited resources and the record low level of its quotas relative to international liquidity - it has regained a central role in countries' external financial adjustment. This is not so much through its own resources - critical as these are to economies with very limited access to commercial finance. Rather it turns on an increased tendency for the World Bank, Paris and London Clubs (rescheduling), bilateral donors and commercial banks to perceive an IMF programme as a *sine qua non* for any major adjustment-supporting action on their part.

The Fund is not performing this role very well - at least not if being widely accepted as a counsellor, being able to meet a substantial portion of short- to medium-term bridging finance needs and contributing to adjustment predominantly through increased supply (e.g. of exports, food, energy) to reduce external imbalance are seen as criteria. First, its resources are too limited to meet more than a small proportion of the additional finance required - under a third even for least developed and other poor or structurally disadvantaged economies (e.g. Sierra Leone, India, Mauritius respectively). Secondly, and partly as a result, its programmes are still too short-term - with respect to drawing and to repayment - to permit adjustment through increasing supply to close structural imbalances. This is especially true on the repayment side since an IMF drawing programme is likely to prove unworkable in the year immediately after drawings cease and in the peak repayment years even if substantial structural change toward balance is being achieved. Thirdly, and again

partly related to both of the previous factors, the IMF's model programme assumes excessive growth of demand as the basic cause of crisis and reduction of that demand as the cure. In cases of economies in long-term structural crises (e.g. Ghana and, for different reasons, Uganda), suffering from sustained weakness in the purchasing power of their exports (e.g. Zambia, Mauritius) or savaged by the 1979-82 international economic depression following successful weathering of 1973-75 (e.g. Kenya, Tanzania, Malawi, Swaziland) the causal factor behind imbalance is not excessive expansion of demand. Rather contraction of the capacity to import, to maintain capital stock and to sustain agricultural production growth equal to that of population are central. Especially when real resources per capita are already very low, attempting to solve these supply-side problems by generalised demand cuts is humanly destructive, politically extremely destabilising and - except perhaps in the very short run - economically ineffective.

As a direct consequence of these three weaknesses, there is a fourth. Many countries do not consider the Fund to be a reliable partner in adjustment nor a credible source of political economic analysis and advice. As a result, approaches to the Fund with respect to high conditionality drawings are delayed, negotiations on programmes are interminably protracted and "agreed" programmes and targets conceal such divergent perceptions and goals as to raise the number and speed of breakdowns. Given the evident need of many economies for bridging finance during structural adjustment, the cost of delaying action while the objective position deteriorates and the increasing tendency of the World Bank, bilateral donors and commercial banks to wait for a Fund programme, the price of such delay is high as evidenced in cases as varied as Brazil and Tanzania.

Both the World Bank and bilateral aid agencies have increasingly tended to accept the Fund's analysis of developing economy crises. This may not be true at the intellectual level - their basic thrust is toward increasing supply and their time frame of reference much longer. It is true in terms of their unwillingness to consider providing substantial additional resource transfers prior to conclusion of an IMF programme even when the country puts forward a reasoned alternative set of proposals. Their effectiveness is further limited by two additional characteristics - relatively slow response (e.g. beginning serious negotiations only after a Fund programme is agreed rather than in parallel) and very high commitment to project (new capital stock), as opposed to programme (interim maintenance for and increased utilisation of existing capital stock), lending as exemplified by the Bank's 10 per cent limit on programme lending as a share of the total.

Commercial banks - whose 1970s recycling did much to sustain Third World growth over 1973-78 and to delay the post-1979 descent into stagnation (or negative growth) - have swung from excessive (at least *ex post*) optimism to self-validating pessimism. If imbalance is to be overcome largely by increased supply this requires additional finance in the interim (not reduced exposure by the banks) and attempts to reduce or reverse net lending will maximise losses to the banks as well as the costs of economic decline to the borrowers. (The positive scenario also requires expanding - not contracting as over 1981/82 - world trade and increasing - not decreasing as over the past decade - market access for both primary and processed commodity exporters and NICs. That, however, is a topic for another study.)

Rescheduling - like IMF programming - is too short-term and too little oriented towards supply enhancement. Relatively short breathing spaces and increased interest rates increase the likelihood of programmes' becoming unstuck (especially as they leave little or no margin for adverse future external events and, indeed, usually are over optimistic on attainable exports, requisite imports and terms of trade). They are not businesslike because their over-caution increases probable total future losses for borrowers and lenders alike.

Crisis Containment, Recovery Reinforcement: International Financial Requisites

Crisis containment requires halting the decline of import capacity and real per capita national purchasing power which most poor, many NIC and middle- to upper-income peripheral and some high-income industrial economies have experienced over 1979-82. Unless this is achieved five sets of consequences are likely to ensue:

1. continued contraction of world trade because poor and intermediate economies cannot sustain present real import levels;

2. consequential renewed depressionary pressure on the world economy as a whole (reversing the 1970s positive contribution from surprisingly sustained rises in developing economy and NIC imports and, thus, in OECD exports to them);

3. increased social and political instability leading either to immobilisme or violent change in a significant number of developing countries;

4. major forced defaults to commercial banks, governments, the World Bank and the IMF by pauperised economies - especially among the least developed and among African and island economies more generally;

5. substantial consequences of default both in terms of the cost of Northern salvage operations (presumably the 1930s spiralling collapse pattern would be averted - at a price) and of further damage to normal global trade and trade-oriented production finance.

The dangers of such a scenario developing are greatest with respect to two groups of economies: the NICs and the least developed/structurally disadvantaged. In the case of the NICs the primary problems are the present levels of debt outstanding, its short average life, record real interest rates and sluggish export growth. The prime requirements for averting crises are avoidance of panic by banks, lengthening average debt maturity, sharply lower real (as well as nominal) interest rates and both a recovery of global trade and at least a gradual reversal of the new protectionism.

The case of the least developed/structurally disadvantaged is more serious. The post-1979 collapse of real import capacity related to radically worsened terms of trade and (partly consequential) export volume falls has created structural imbalances, human misery and a deterioration of productive capacity both worse and far less readily reversible than in the NICs. While debt service - often from desperate use of supplier credit and bank loans to lessen the pace of the 1979-1981 decline on the unwise, but hardly unique, view that global recovery would come in 1981-82 as it had in 1976-77 - is 20 to 40 per cent of export earnings, for many of these economies their basic problem is import strangulation. Maintenance of existing capital stock and utilisation of installed capacity (in agriculture and transport, health and education as well as in manufacturing) is impossible at present import levels even though these give rise to unmanageable current account deficits. Domestically the cumulative output declines create recurrent budget deficits (with erosion of import and export duty, sales tax and company tax bases), cost-push inflation (from reduced capacity utilisation), profiteering (whether on parallel markets or legally), and physical lack of incentive goods to make nominal increases in anyone's income (especially that of peasants whose basic purchases are simple domestic or imported manufactured goods) effective in real terms. In human terms

malnutrition and de facto unemployment are rising, the quality of education and health care eroding, and personal purchasing power declining to levels below those of the 1960s. This pattern is affecting previously middle-income economies (e.g. Mauritius, Jamaica) as well as least developed (e.g. Malawi, Bangladesh) and those which weathered their 1973-75 crises and regained apparently stable growth by 1977 (e.g., Kenya, Tanzania) as well as those with longer-term negative economic patterns (e.g. Ghana, Zambia). The pattern is most severe and uniform in Africa - where in normal economic terms only Botswana of all Commonwealth members has been able to retain manageable internal and external balance and a forward, albeit slowed, development dynamic. But it is not unique to that continent. A majority of Caribbean and several Pacific and Asian economies exhibit similar symptoms of descent into economic disintegration enforced by declining import capacity.

In many of these cases global trade revival alone will not be enough to restore manageable current account balance even if it brings some terms-of-trade improvement. For economies like those of Swaziland, Kenya, Malawi, Tanzania and Mauritius one would need to assume a doubling of the real price of coffee, sugar, tea, oilseeds and cotton relative to fuel and manufactures to project restoration of early 1970s (or 1977) current account ratios without radical export-increasing and import-substituting structural shifts. Similarly, in cases of prolonged non-maintenance of directly productive and infrastructural capital - e.g. Uganda and Ghana - no trade recovery or debt deferral scenario can lead to economic viability without sustained additional external resource injections to rehabilitate and replace run-down or destroyed capital stock.

Because this group of economies - unlike the NICs - requires substantially increased net resource transfers, in most cases has little access to commercial finance, will not respond rapidly or automatically to trade recovery and - even taken together - poses no comparable threat to the global banking system to that of a Mexico or even a South Korea, it is in danger of being overlooked or set aside. In human terms the cost would be appalling; even in terms of averting additional strains on the global financial system and on industrial economy (not least United Kingdom) exports they would be severe.

Overall,developing economies lost about $85 billion in import purchasing power between 1980 and 1982: $40 billion from export falls, $37 billion from increased debt service and $10 billion from falling medium-term borrowing. Short-term borrowing increases of $25 billion merely rolled

forward part of the increase in debt service while worsening average maturity and future debt service patterns. Despite import cuts average external reserves fell to under two-and-a-half months' imports by the start of 1982 and almost certainly under two months' by its end, with the African position of reserves (under one month's imports) markedly worse in both cases. The symptoms of this deterioration as they buffet the international financial and monetary system are very apparent. About forty countries have serious payments arrears with respect to normal commercial credit for goods and services. For Nigeria the total is said to be $\$5,000$ million and for much small Zambia over $\$500$ million. Almost as many are falling into serious (in terms of volume and length of delay) arrears on government and government-guaranteed borrowing, e.g. $\$75$ million in the case of Tanzania. For some low-income countries - e.g. Zamiba, Tanzania - commercial, export credit and government arrears exceed recent annual export totals.

In terms of national economies the costs can be traced in falling per capita GDP (for four successive years in the case of Kenya, which prior to 1978 had an average post-independence per capita real growth rate of about 2.5 per cent a year) and in soaring recurrent budget deficits related to falling real revenues despite rising tax rates (10 per cent of 1982 GDP for Tanzania in 1982/83, a fourth consecutive deficit following a sustained 1961/62-1977/78 record of small to moderate recurrent surpluses). In human terms they mean falling purchasing power of peasants, wage earners, civil servants and most managers and small businessmen; deteriorating transport and housing; increasingly inadequate health, education and water services; shortages, searches and queues to get even (or especially) basic goods; parallel markets and profiteers; erosion of hope that decline will be reversed and of effective incentives to produce more. This is assuredly not a stable base for even a part of global recovery and can all too easily become a serious threat to the whole of it.

With respect to recovery the same points apply. Sustaining and broadening the base of recovery - especially in Northern capital and basic intermediate goods industries - at the least would be much easier if Southern import capacity were once again rising and might well prove impossible were it to continue to fall.

For the NICs (including Hong Kong and Singapore), plus high-income natural-resource-based economies like Australia, Canada and New Zealand, global recovery in trade in manufactured goods and a renewal of demand for natural-resource-based products may be sufficient as well as

necessary to restore growth of import capacity. To some degree this may also pertain to very large poor economies - e.g. India - and to several crisis-hit lower-middle-income ones - e.g. Malaysia, Nigeria, Trinidad and Tobago, Zimbabwe. However, even in these cases there are two caveats: it will be necessary to avoid crises resulting from current debt and to bridge cash flow lags on the trade upswing.

To assume that recovery in the North and in world trade will by itself overcome all major debt problems is mindlessly optimistic. The recent USA report, "Approach to the International Debt Situation: A Policy Overview", can be read to suggest such an outturn but only if four assumptions are made:

1. no short-term Third World debt crises before recovery takes hold;

2. no binding social and political limits to additional austerity;

3. inflation and interest rates held at (brought down to) relatively low levels;

4. sustained 4.2 per cent growth in OECD GDP.

Each of these assumptions seems rather optimistic taken by itself. As a joint set of necessary conditions for a satisfactory resolution of the stresses in the international monetary/financial system they appear most unlikely to be fulfilled (especially the second and fourth conditions) even if interim juggling avoids an intensified renewal of 1982 commercial bank loan crises which would abort both global trade and - probably - industrial economy recovery.

For the least developed and a number of other low-income economies global recovery by itself will not be enough even to sustain present import levels. Their exports are on average half of imports, Fund-Bank-bilateral resources at present far from fill the gap, access to commercial (including export) credit is low and decreasing, import levels are already too low to maintain existing productive capacity, and export mixes are unlikely to benefit massively in volume or price from trade recovery.

Clearly any long-term return to stability and growth in these countries does depend on their rehabilitating previous export capacity and expanding those traditional exports with plausible market prospects. Even that will require substantial programme support for inputs

into production, transport and processing and into incentive goods to validate nominal increases in grower prices or wages. Beyond that, however, they must identify and develop new exports with plausible prospects and markets (manufactured or primary products; Northern, Southern or regional markets depending on possibilities and contexts). That requires more capital goods imports and more consumer goods production while output is being built up - and more external finance to cover the import gap. In these cases neither three nor five years is likely to prove a standard period for external balance restructuring. Five might do for pure rehabilitation but, given the magnitude of the 1977-82 negative external economic parameter structural shifts, ten seems more normal as the requisite time-period for developing a structurally altered and at least doubled (in terms of import purchasing power) export mix.

More generally, as the Brandt Commission put it earlier this year:

> There will in any case be changes in current accounts as growth is resumed. To smooth the way for joint economic expansion there should be general agreement to finance without hesitation such growth-induced deficits.

As to the argument that such credit to validate increases in real output would be inflationary, the recent comment of former IMF Managing Director, H.J. Witteveen, is apposite:

> With present high unemployment rates and low capacity utilisation, surpluses in oil and other raw material markets and pervasive deflationary pressures in the world financial system, the risk that a somewhat higher increase in the money supply would rekindle inflation is practically nonexistent. This should be explained clearly and forcefully to overcome dogmatic and unrealistic monetarist fears.

These points would appear to apply even more forcefully with respect to global credit used to sustain/expand basic food, intermediate goods and capital equipment imports by developing countries. In the North each of these sectors is particularly plagued by overcapacity and unemployment and particularly unlikely to recover very fast purely on the basis of the present modest recovery of demand within certain major industrial economies.

Wider Still and Wider: Interactions versus Portability

To discuss the international monetary system narrowly - excluding major financial flows outside the IMF ambit - or in the abstract - outside the 1971-1983 crises and the nascent partial recovery - would be unrealistic, especially with respect to formulating proposals. The international monetary system proper, the IMF, the World Bank group, international commercial bank lending and at least some aspects of bilateral assistance need to be seen together. Finance for survival, adjustment and recovery for the low-income and middle-income economies as a group and for many individually must be mobilised as a package from all of these sources, not limited to one or two.

Moreover, it can be argued that any discussion of recovery needs to extend to trade (including terms of trade and market access). The problems of those Commonwealth countries whose exports cover less than half of imports (including invisibles together with goods) cannot be solved without very significant increases in the volume, and at least stability in the unit purchasing power, of their present exports together with structural adjustment into new exports. The market access and terms-of-trade evolution (more accurately deterioration) of 1977-1982 (rather larger for several key metals including copper), if continued, make a mockery of any such effort. Similarly, sustained renewal of adequate growth in Canada, Australia and New Zealand as well as Hong Kong, Singapore and India requires a reversal of the rising tide of the new protectionism and a less gloomy set of volume/value prospects for natural-resource-based products whether in primary, processed or manufactured form. Otherwise balance-of-payments support will prove a bridge to nowhere and structural adjustment finance only extend the range of unutiliseable capacity.

However, with respect to the monetary/financial and trade aspects it does seem practicable to make an analytical and operational separation for the purpose of sectoral discussion and programme exploration. So long as the basic need to use finance to sustain trade in the short run and to strengthen its foundations in the medium is kept in sight together with the parallel need to act on trade access and terms issues, it is practicable to discuss monetary and financial aspects of crisis containment, adjustment augmentation and recovery support separately without coupling a detailed analysis and programme of action for trade. This is a matter of division of labour with the caveat that, as in Adam Smith's pin factory, unless those responsible for the other parts of the production process carry out their tasks any individual task, however well done in and of itself, will prove meaningless.

Similarly it can be argued that examination of, and proposals for, the international monetary and financial system should go beyond short-term survival and recovery measures toward long-term reforms. Appealing as this argument is it suffers from three practical defects:

First, more immediate agreement and action on short-term measures is potentially attainable than on long-term restructuring;

Secondly, even with broader agreement than is now in sight, basic restructuring would take several years - and without interim steps now would run a very grave risk of being swept away in a tide of renewed crisis (like the 1974 Committee of Twenty Report to the IMF/IBRD);

Thirdly, as with finance/trade, a certain division of labour is both practicable and potentially efficient.

This paper posits six basic changes as desirable within the international financial system over the next decade: greater effective participation of all states (especially in the Fund and Bank or their successors), transformation of the IMF (quantitatively and qualitatively) into a body much more analogous to a global central bank, establishing the SDR as the basic international reserve asset (especially with respect to increases of international liquidity), lengthening the average period of bank and other international commercial lending, augmenting multinational and bilateral concessional resource transfers and concentrating them more fully on low-income countries, and building up more institutional symmetry especially with respect to expanding South-South official and commercial financial institutions and transactions. However, these are seen as goals which will only be attainable if increased monetary/financial disorder can be averted and recovery sustained rather than as immediate points for programmatic articulation. The proposals made are seen as consistent with, and potentially increasing the attainability of, such basic structural reformulations but not as sufficient for,nor constituting,them.

Differentiation: Contextual Divisions within Inclusive Parameters

Differentiation and equal treatment have - somewhat ironically - both developed a bad name. The reason seems to be that differentiation is perceived to proceed by exclusion and equal treatment to overlook unequal causes, contexts and possibilities for change. There is a common crisis of the international monetary system. Its resolution requires paying attention to the needs and interests of major lending centres (e.g. the UK), middle- and high-income peripheral economies (e.g. Australia, Canada, Hong Kong, New Zealand, Singapore), large poor economies (e.g. India and in a less crisis- and recession-ridden context Nigeria and Zimbabwe) and least developed and/or structurally disadvantaged economies (e.g. Antigua, Fiji, Ghana, Jamaica, Kenya, Mauritius, Tanzania, Tuvalu and Zambia). Equally any resolution must relate directly to the specific nature and causes of each group's - and each individual economy's - problems, capacities for adjustment and required time frame for adjustment. Differentiation by inclusion, like uniformity of treatment in terms of different packages toward common recovery and structural adjustment goals, is necessary.

In the case of rich industrial economies which are also major financial centres (e.g. the United Kingdom) the two principal requirements are avoiding major debt crises affecting their financial institutions (as lenders) and ensuring adequate flows of credit to developing countries to allow increased imports by them to help sustain recovery of global trade and production.

For partially industrialised medium- to high-income, but basically primary product/natural resource exporting, economies (e.g. Australia, Canada, New Zealand) somewhat different needs pertain. The first is that monetary and financial constraints should not choke off recovery in the central industrial economies and thus prevent revival of their export volumes and prices. The second is continued access to credit - preferably at lower real interest rates - to allow domestic and export production build-up and to increase investment in natural-resource-based production.

NICs (including Singapore and Hong Kong) have similar requirements - albeit their investment credit requirements centre on manufacturing and exportable services. In addition several (not including Hong Kong and Singapore) require restructuring of existing, and injection of new, external credit to avert debt crises before global trade recovery and falling real interest rates can strengthen their external balance positions.

Very large poor economies with limited - though critical - external trade dependence (e.g. India) probably need the same things from the international monetary and financial system as the NICs albeit their present exposure to debt crises is significantly lower. In addition, however, they need enhanced investment finance to restructure exports and to reduce fuel and food import dependence.

Relatively large and strong poor countries severely affected by the post-1978 phase of the global economic crisis (e.g. Nigeria, Malaysia, Trinidad and Tobago, Zimbabwe) again have partially overlapping and partially differentiable priorities. In the medium term global trade and industrial economy recovery should significantly strengthen their external current account position and, therefore, their access to long-term finance. However, in the interim some (e.g. Nigeria) require additional resources to avert an external debt and commercial payments crisis and most (notably Zimbabwe) bridging finance to sustain the import levels necessary to maintain and operate capital stock at levels consistent with ability to respond to export revival possibilities and to maintain levels of personal consumption and public service provision consistent with economic, social and political stability. A few relatively resource-rich least developed economies (e.g. Botswana, Papua New Guinea) are in similar positions.

The balance of the poor and least developed economies have significantly different and longer-term requirements. Despite significant diversities in other respects almost all need additional resource transfers both to maintain present real import levels and to restore them to the minimum levels consistent with maintaining existing production, infrastructure and public service capacity. In addition they require major support to restructure production toward new exports (their existing ones by and large have poor prospects even in the context of global recovery) and toward reduction of food and fuel import requirements. Because their present export to import ratio is low (below 50 per cent in many cases), their economies badly debilitated and their workers, peasants and entrepreneurs often fatalistic and passive after the past four or more years' battering, their requirements for monetary/financial system support, while initially smaller than those of other economies, need to be placed in a longer-term and more concessional perspective. Not only is commercial (bank or export) credit not readily available to them (except for specific, quick pay-off, balance-of-payments improving projects); but two years' grace plus eight years' repayment funds at 10 per cent interest (and even more so shorter-period, higher-cost credits) increase rather than decrease medium-term

external imbalance as evidenced by the present impact of 1978-1981 commercial bank and export credit use by several (e.g. Tanzania, Kenya). Within this category there is a special sub-group of economies which have suffered from structural malaise for eight years or more as opposed to since 1979. These include some specialised mineral exporters (e.g. Zambia), countries with a long pattern of vacillation and ineffective economic policies (e.g. Ghana over 1964-1982) and states seeking to recover from socio-political and political economic disasters (e.g. Uganda).

From these differentiated requirements it is possible to outline a set of goals for interim international monetary and financial system management:

1. Avert major international debt crises and especially significant defaults;

2. provide adequate finance to sustain recovery and expansion of global trade;

3. sustain or restore minimum necessary import levels for economies with particularly severe post-1978 (or longer-term in cases like Ghana, Guyana, Jamaica, Uganda, Zambia) declines in import capacity;

4. finance rehabilitation and restructuring to allow external balance to be regained primarily through export recovery/expansion and enhanced domestic production especially of energy and food;

5. provide financial resource injections on terms consistent with meeting the above objectives, avoiding massive erosion of basic needs and encouraging states to take positive domestic action toward regaining external and domestic balance within a framework of economic re-habilitation and restructuring.

Conditionality: Goals, Targets and Timing

Debate about conditionality is rarely about whether there should be conditions. The financial support for structural adjustment programmes represents a series of business transactions and all business transactions are conditioned by and conditional on actions by all parties concerned. The real debate is on the purposes to be served (which necessarily alter the conditions), the targets appropriate to achieving those purposes, the time required

for adjustment and the degree of flexibility appropriate in targets. One might reasonably presume that each of these varies from case to case. For example, an appropriate package for a rich manufactured goods exporting economy suffering form the impact of recent massive demand expansion would hardly suit a very poor primary exporter which had been unable to reduce demand sufficiently to counteract a fifty per cent fall in earned import capacity (and vice versa).

If maintenance of capital stock and revival of production are seen as critical goals, targets positing sharp cuts in imports or real levels either of credit to productive enterprises or of basic government spending are likely to be counterproductive - especially in a very poor country which has already experienced substantial declines in real household incomes. The same point applies even more strongly if maintaining minimum personal consumption standards, providing basic public services, avoiding increasing (already usually wider than would be tolerated in rich Commonwealth countries) income and wealth disparities and/or allowing political stability without repression are seen as among the goals of structural adjustment.

None of this implies that limits to expansion of monetary demand (especially when generated by persistent recurrent budget imbalance) or short-term external borrowing, or coherent price (including foreign currency price, i.e. exchange rate) policies are not among the targets needed. It may imply that minimum (as well as maximum) real wages and maximum (as well as minimum) basic consumer goods price increases and also real production of key basic consumer ("incentive") goods should also figure among the requirements, albeit that is arguable given the problems sure to arise from a multiplication of conditions. As an intermediate position these could be viewed as parameters with which a letter of intent had to be consistent and which were the starting point for defining practicable monetary and external debt criteria.

Because adjustment programmes tend to impose costs before they bring benefits and because very high initial costs have a shock impact more likely to shatter than to cure a fragile economy, a case exists for <u>more front-end loading of external financial support and less front-end loading of costly domestic measures.</u> This is particularly true with respect to economies with very limited potential for rapid export increases, low present ratios of exports to imports, substantial post-1978 falls in real income and significant deferred maintenance/ deterioration of productive capacity, infrastructure

and public services. Whatever the potential of very sharp shocks for inducing external balance in economies whose earnings are substantially from manufactured goods and remittances - and the Portuguese and Turkish case records are not wholly reassuring even for such economies - they are most unlikely to produce either rapid increases in production and exports or domestic political and economic stability in most low-income economies, e.g. those of sub-Saharan Africa.

The exchange rate issue may illustrate this point. Highly overvalued currencies are inefficient from any economic system's point of view. Many developing country currencies are seriously overvalued and becoming more so. The initial costs of devaluation - especially massive devaluation unless the currency has virtually lost all value, e.g. by several successive years of near 100 per cent inflation with little or no exchange rate adjustment - are massive. The gains are much more lagged and will never be achieved if the devaluation shock is transmuted (e.g. via fuel and food imports and cost-plus business practice) into hyperinflation rapidly crosscancelling the intended results of exchange rate adjustment. The costs of standing still are serious and cumulative with no likely subsequent gains but are less and less open-ended at any one time. Pressure for massive front-loaded devaluation - especially with no guarantee of massive resource injection - tends to freeze the status quo, squeezing out advocates of more gradual, phased devaluation while the underlying position worsens.

A more practicable - in the sense of achieving prompt action toward adjustment, reducing costs of immobilisme and reducing the risks of shock-induced collapse (including into hyperinflation) - approach might in many cases include:

1. phased devaluations of perhaps 10 per cent each, up to three times a year over two to three years;

2. a package of IMF-Bank-bilateral programme-oriented resources allowing enhanced capacity utilisation and rehabilitation of capital stock to have unit cost reducing and supply enhancing impact large enough and soon enough to offset the inflationary impact of devaluation;

3. phased reduction of consumer subsidies, increases in wages and producer prices, and restoration of basic public services (especially education, health and water) both to mitigate adjustment

costs for peasants and urban low-income groups and to recreate a context in which real increases in living standards are credible (a necessary incentive for increased effort and production).

Similar considerations apply to initial degree, phasing and mitigating resource transfers in support of other standard IMF criteria. Demanding too much too soon usually results in immobilisme while the situation worsens, botched compromise programmes hiding a non-meeting of minds when written but speedily collapsing in practice and/or massive social and political instability. None of these makes much sense from a financial institutional, economic production or human point of view.

How to set targets poses related but somewhat different problems. The projections of any adjustment package include assumptions as to external variables - from weather through the prices of particular commodities to the external resource inflows projected in the programme to the state of the world economy - quite beyond the control of the state entering into the programme. Further, in recent years most such projections - by the IMF, the Bank, the OECD and individual industrial economies as much as by developing and peripheral economies - have been significantly in error. Under these circumstances failure to achieve precisely set targets ("trigger clauses") on precise dates based on unstated assumptions tells very little about either the efforts of the state in question or the response of its economy to the programme package.

While programmes and their targets cannot be totally open-ended three modifications of standard target setting would seem both appropriate and practicable:

1. specify the basic assumptions (especially as to external determinants) underlying projections and targets;

2. set targets in terms of ranges (both as to quantity and as to timing) rather than in precise levels at specific dates;

3. when failure to meet targets can be analytically related to external variables worse than projection assumptions, revise the programme with a view to sustaining it rather than suspending it for target non-fulfillment.

The IMF: Proposals For Improved Economic Effectiveness

Even on its own terms the IMF's present and recent past performance record is disconcerting. It has inadequate resources to meet its requirements; it seeks to devise short-term programmes to bridge what it admits are often medium-term structural gaps; it finds many clients needing its services so little persuaded of the validity of its prescriptions or the adequacy of its resource injections as to stay away; its proposals often seem to lend themselves to immobilisme and resistance - while underlying conditions worsen - rather than dialogue and agreed packages; a very high proportion of its programmes break down very soon after initial adoption, often because projections in them were always markedly unrealistic. A merchant banker with that record would have no clients, a commercial banker would have been taken over following an emergency central bank lifeboat operation and a central bank would have had its management replaced. Since none of those options is practicable with respect to the IMF, attempts to achieve improved performance are critical, especially since a Fund programme is increasingly the necessary cornerstone for any financial reconstruction or structural adjustment programme. Eight significant areas for change can be identified.

The first is the adjustment of conditionality and of target setting and use along the lines suggested in the preceeding section. A second is lengthening of the maximum time frame for programmes where necessary to achieve stable structural adjsutment. The maximum drawing period might be extended to five years, the period between each drawing and initial repayment might be up to five years and repayments might be phased over up to seven years. These would be maximums; some programmes dealing with reversible cyclical imbalances or secondary shocks to fairly resilient economies could and should be substantially shorter.

The Compensatory Finance Facility should be made more effective in terms of its original aim of providing resources to cover the initial shock and time to adjust to (or reverse) declines in real import capacity. At present it meets under half of export shortfalls as measured, perhaps a fifth for Africa and still less if the shortfall is measured in terms of real import capacity not nominal export proceeds. The simplest way to achieve this would include totally untying CFF from quotas (or raising its limit to 250 to 300 per cent of quota), calculating shortfalls from an arithmetic not a geometric mean, measuring shortfalls in terms of earned import capacity not nominal export earnings alone and phasing

repayment to relate to recovery of import capacity with a maximum of five years from drawing to initial repayment and seven years for repayment. The positive impact on least developed and sub-Saharan African economies of such changes - which are entirely consistent with the CFF's initial purposes (adopted at a time of much lower average inflation and terms-of-trade fluctuations) - would be very considerable.

Fourth, low conditionality drawing facilities (including a CFF expanded as proposed above) should be expanded absolutely and relative to maximum drawing limits. High conditionality often deters prompt use of Fund resources; the low conditionality facilities (especially the Oil Facility) available in 1974-76 were critical in many developing countries' successful 1974-76 adjustment programmes and 1976-78 return to external balance and domestic growth. Higher average conditionality over 1979-82 has not resulted in better average programme quality, greater borrower commitment to programme goals or a lower programme failure rate - on the face of it quite the reverse.

To achieve these four goals requires a fifth - substantially expanded Fund resources beyond the quota increases now in the process of approval. Either another 50 per cent quota increase within two years (which would still leave Fund quotas a low proportion of global liquidity by 1945-70 standards) or substantial Fund borrowings from members or commercial markets is critical if Fund finance is to be adequate in size and adequately flexible in repayment period.

For low-income countries - especially those with massive structural current account deficits likely to require at least a decade to close - interest rate subsidies remain critical. Present Fund resources in this respect are fully committed and need to be replenished (and made applicable to low-income country EFF and CFF drawings). Possible means include profits from further sales of IMF gold, Trust Fund loan repayments and/or donations by richer IMF members.

Given the reduction of international liquidity of a majority of IMF members since 1979, a substantial new issue of SDRs over 1984-87 would seem appropriate. If the ratio of SDRs to total reserves which existed after the initial allocation period ended in 1972 were to be restored this would require annual allocations of SDR 10 to 12 billion for three years. To maximise the contribution to avoiding debt crises and sustaining global trade recovery it would be

helpful if industrial economy IMF members were to waive at least half of their allocations in favour of poorer IMF members and of IDA and Regional Development Banks.

Finally the IMF should reflect on a message which has been stressed by the Bank but is also implicit in much of its own analysis. Policy changes without adequate resource backing are unlikely to achieve rapid or large economic results. Indeed in the poorest or most severely damaged economies additional external resource injections are often a precondition to instituting and carrying through structural policy adjustments at all. The IMF should therefore seek more often and more energetically to secure Bank and bilateral funding in support of IMF country programmes to increase the pay-off from, and reduce the short-term costs of, sticking to agreed policy changes. It has recently done so on several major middle-income country programmes with major related commercial credit restructuring and expansion. It may be even more critical to play a similar role with respect to low-income country structural adjustment programmes for which substantial, prompt, complementary Bank and bilateral concessional finance are usually critical.

World Bank Group Lending: Desirable Structural Adjustments

World Bank group finance is critical to a significant number of developing countries. For the less poor the regular Bank window is appropriate and to date has been able to sustain increases in real disbursements and interest rates which - while historically high - are lower than those of purely commercial financial institutions. For the deeply poor economies - particularly those of India, sub-Saharan Africa and China - it is the International Development Association (IDA) which is crucial because they require a significant proportion of resource inflows on highly concessional terms. This is the case because of both limited domestic short-term capacity to generate debt service finance and external balance constraints on ability to remit it. The latter constraint is often the more binding. As the Bank's independent review of IDA has shown, on average projects supported by IDA credits have had a 21 per cent rate of return. IDA faces more severe resource constraints than the main window of the Bank and is in real danger of substantial reductions in future real resource transfers.

While the Bank has taken initiatives in programme lending and on two-way policy dialogue with recipients based on analysis of their problems, serious shortcomings - apparently substantially reducible in the short run -

exist with respect to both. Bank/IDA programme (including Structural Adjustment and Balance-of-Payments Support) lending is limited to 10 per cent of total group lending. Especially with respect to the least developed countries this limit is open to the Brandt Commission's 1983 warning: "Programmes of agricultural development, education and other poverty-oriented investment on the required scale cannot succeed if international assistance is confined largely to the capital cost of projects." Bank policy dialogues - especially at public level and when expressed generally (as in *Accelerated Development in Sub-Saharan Africa*) - have at times had a tendency to become monologues (at least if the Bank member actually wanted substantial augmentation of Bank resource flows), overemphasise the speed and efficiency of responses to price signals in the very imperfect markets of poor economies and seriously overgeneralise the causes and consequences of, and possible routes to emerge from, present economic crises. Indeed in at least a few cases the Bank has made its lending more conditional than the Fund, rejecting structural adjustment programme proposals whose acceptance had been integral to projections in agreed Fund programmes.

Several steps - both by and for the Bank - are needed to strengthen its performance over 1983-1987. The first is a *rapid agreement on the VIIth IDA replenishment at a level allowing significant increases in real per capita credits over 1984/85 - 1986-87*. Allowing for about 5 per cent annual inflation, 3 per cent annual population growth and a 20 per cent increase in real per capita terms over 1983/84 (target $3.7 billion) would require *average annual disbursements of $5.5 to 5.75 billion*.

Additional borrowing authority for the Bank proper is also needed, if a little less urgently. The most practicable route would seem to be to *raise the borrowing limit* from its present 1 to 1 ratio with guaranteed capital to 2 to 1, a ratio far below those of commercial banks, whose ratios are usually between 15 to 1 and 20 to 1 and which have higher proportions of "non-performing" loans than the Bank.

Programme finance's maximum share in total lending should be raised from a tenth to a third (or to 30 per cent as recommended by the Brandt Commission). Especially for IDA clients a 9 to 1 ratio of project to structural adjustment and balance-of-payments support finance is quite inappropriate at present. For several 1 to 1 would seem much more apposite.

The Bank should *reconsider its relationship to IMF programmes in several respects*:

a. in terms of its own longer time horizon and therefore ability to push support packages up to - say - five years' duration from the three covered by the Fund;

b. as well as in terms of its own mere supply side, developmental and poverty elimination focus and, therefore, the provision of resources designed to minimise costs of initial IMF package measures on these goals;

c. and in timing, e.g. conducting Structural Adjustment Programme negotiations in parallel with (rather than largely subsequent to) Fund negotiations to allow rapid real resource transfers following programme adoption to minimise its real cost and maximise its chances of success. (These points apply to bilateral donors as well.)

The Bank should conduct its policy dialogue with members rather more flexibly, with more attention to varying contexts, doing rather more careful listening and with a greater willingness to admit that it can be, and has been, wrong on occasion. The last point is critical in the not insignificant number of cases in which a not insubstantial portion of present problems flows from following Bank and Bank-related technical assistance personnel's advice (quite possibly advice the Bank would not now repeat); only a frank admission of error on both sides lays a basis for mutual confidence, absence of recrimination, serious exploration of what went wrong and why or faith in new Bank prescriptions and proposals as better than their predecessors.

Bilateral and EEC Concessional Transfer Improvement

For most poor countries bilateral aid is critical not simply to long-term capital stock development but to mobilising the minimum volume of resources necessary to halt and reverse their current economic decline. The implications for aid apply to volume, allocation among countries, flexibility in use, speed of disbursement and coordination. Most apply at least as strongly to European Economic Community as to bilateral concessional financial transfers.

More concessional transfers are needed. With the apparent beginning of economic recovery from very high levels of unutilised capacity and unemployment such increases on a coordinated basis by DAC members should be possible. Many industrial economies (albeit not all) are about to

enter periods of reduced budgetary imbalance, most are willing to use resources to sustain export expansion, and few can reasonably fear that modest stimulus to demand concentrated on food, basic intermediate goods (including fertiliser, chemicals and steel) and capital goods (including transport equipment) could be basically inflationary as opposed to output enhancing and capacity utilising in some of their hardest hit sectors and regions.

Whatever the quantity a higher proportion of concessional transfers should go to low-income and especially least developed countries. (At present about half still goes to middle-income countries.) These countries neither have access to, nor can they afford to use, substantial commercial finance but are precisely the economies most likely to continue to deteriorate despite global recovery unless they can secure more external finance.

The uses of aid should be made more flexible and more relevant to the recipients' context. At present a high proportion of all project aid to the least developed (and sub-Saharan African more generally) countries is counterproductive. It creates productive units requiring imported inputs and spares when there is inadequate foreign exchange to cover these items for existing units, puts new infrastructure in place while foreign exchange constraints cause existing infrastructure to deteriorate for lack of maintenance, builds up health and education capital stock when lack of books, drugs, paper and equipment prevents proper use or maintenance of what already exists and eats up nationally earned foreign exchange by failing to cover indirect foreign exchange costs or the external components of cost over-runs which - not surprisingly given recent rates of inflation - have been as endemic in the South as in the North. To be useful such aid should either be complemented by, or partially switched to, programmes supporting maintenance and capacity utilisation in key production (e.g. exports; food, basic incentive goods), infrastructure (e.g. power, transport) and public services (e.g. health, education, water) sectors. In many of the least developed countries only key export restructuring, absolute import reducing and bottleneck breaking projects should be begun or continued; the basic focus should be on sustaining and rehabilitating what already exists.

This is not to decry all projects now, much less once recovery and structural adjustment begin to take hold. It is to argue that under present circumstances the continued dominance of this element in aid programmes is often economically counterproductive. Neither is it to call for

open-ended grants of foreign exchange. Rehabilitation, output maintenance, bridging finance or local cost programmes (or projects if that terminology is preferred) can be just as target-related and conditional as project aid. For example a road transport rehabilitation programme/project can be defined quite precisely in terms of maintenance equipment and spares, construction materials, vehicle spares, workshop equipment, training and skilled personnel. Similarly import support can be related directly to sub-sectors (e.g. health, basic consumer goods, inputs into export production and processing) and categories of goods (e.g. WHO basic drug list pharmaceuticals; textile mill spares, dyes, chemicals; fertilisers and pesticides).

Given the rapidly deteriorating situation of many poor economies speed of disbursement needs to be enhanced. This is especially true with respect to programme support as discussed above, which can and should be - but is not always in practice - quick disbursing.

Better coordination of concessional financial flows is needed - especially if a major proportion is rehabilitation and payments support finance tied by sector and product. Because coordination by donors (especially the World Bank) arouses recipient fears of external manipulation both recipients and "innocent bystander" international bodies should be encouraged to take more initiatives toward coordination. Zimbabwe's convening of Zimcord exemplifies the first approach and some of UNCTAD's sub-regional least developed country/potential resource transferrer meetings the second.

EEC resource transfers have historically been particularly project tied, inflexible in use and slow disbursing. Two immediate opportunities for improvement exist. The first is to expand the proportion of rehabilitation and maintenance projects as such and similar components in other projects (e.g. the road motor vehicle and coffee development projects in Tanzania respectively). Secondly, because each EDF is funded on a commitment not a disbursement basis, the EEC had built up a very substantial backlog of unused appropriations. This balance should - on the basis of consultations between the EEC and the ACP - be allocated to eighteen to twenty-four month rehabilitation and sectoral import support programmes with the ongoing project commitments to be met out of EDF VII ("Lomé III") funds. Such an initiative - preferably negotiated in 1983/84 but if necessary as part of "Lomé III" - could have a very substantial output and export sustaining impact for many of the ACP economies over the next two years,

precisely when strains on them are greatest before global trade recovery gives them any significant relief.

Commercial Credit Flows and Structures

Commercial credit - including government-guaranteed export credits - is in fact much larger as to stocks and, especially, flows than IMF-Bank-aid finance combined. Therefore its role, especially its potential negative role, in overcoming the immediate threats to the stability of the international monetary/financial system and to the strength and sustainability of the nascent recovery in global trade and production, will be critical. With the exception of state-guaranteed export credit, commercial credit is less directly and detailedly subject to government and intergovernmental control than other sources. However, the leverage over it possessed by treasuries and central banks of major industrial economies and by the IMF should not be underestimated. Four general recommendations would appear both desirable and practicable.

First, that banks avoid trying to reduce overall exposure (except as part of an agreed adjustment package) since the net result is likely to be increased risk of severe losses and of blocking trade recovery. This requires coordinated action by governments, central banks and the IMF to deter individual cut-and-run tactics (such as those which have greatly increased the cash flow strain on the Brazilian programme) and, when necessary, to find additional finance from other banks to replace that withdrawn.

Second, to provide selective additional credit to gain time for recovery of exports and debt service capacity when serious restructuring is proceeding (e.g. Mexico) and/or global trade recovery and real interest rate declines should have a substantial positive impact (e.g. Brazil, Nigeria).

Third, to avoid providing short-term finance, including export credit, for purposes not leading to rapid, positive balance-of-payments impact. Loans and credits for such items as international airports and new capitals (e.g. Tanzania) and for real civil service wage increases in the face of falling export earnings (e.g. Mauritius) have increased, not lessened, the present problems of both lenders and borrowers whatever the long-term economic or short-term political virtues of the expenditures.

Fourth, restructure the debt profile to lengthen average maturity and reduce early redemption (or rollover)

requirements. Such restructuring should be made both less traumatic and less burdened with higher interest rates and fees which - whatever their virtues for bank accounts in the short-term - increase borrower burdens to a degree raising the likelihood of repetitive debt crises and potential write-offs.

South-South Possibilities

Because asymmetry is one of the basic problems of the present international monetary and financial system it would be short-sighted to ignore the necessity for South-South action - whether regionally or more generally. However, given the severity of the post-1978 crises' impact on almost all developing economies (not excluding oil-exporters) it would be unrealistic to view the short-term possibilities for such action as central even to the economies directly concerned much less to Commonwealth economies in general or the global monetary/financial system.

Better payments arrangements - including direct banking, insurance and related financial service links as well as more narrowly defined clearing and credit agreements - can provide some of the lubrication for enhanced South-South trade especially on a regional basis. Even in a very poor region such as that of the Southern African Development Coordination Conference (including Botswana, Lesotho, Malawi, Swaziland, Tanzania, Zambia and Zimbabwe together with Angola and Mozambique) significant surplus capacity exists or is about to exist in one or more states for over 75 basic types of manufactured goods or basic inputs of which one or more member states is a significant importer form third countries. Among the obstacles to bringing that capacity into use by regional trade is the lack of intraregional financial institution linkages and payments arrangements.

Despite - or in some cases partly because of - the present trade and payments crises there is scope for expanded South-South export credit arrangements. Those of Nigeria, Trinidad and Tobago, Venezuela and Mexico with respect to oil and of India with respect to capital goods are relevant. Where such credit both enhances present exports of the lender (and has a cash-flow element enough to cover immediate foreign exchange costs) and allows the borrower to maintain or restore import levels for critical commodities it can contribute significantly to mutual economic recovery.

Financing of bilateral aid programmes and of regional development institutions by financially stronger

South economies is clearly desirable but - given the reduced number and liquidity of such economies - unlikely to expand in real terms until global recovery improves the potential resource transferrer's external balance position.

Export finance rediscounting facilities to allow national export credit agencies (which guarantee the exporter payment in local currency) to secure foreign exchange would be highly desirable. While perhaps most logically organised on a regional basis, institutions to guarantee and market such paper will need members with substantial external financial resources among their members both as "in house" purchasers and credible guarantors. Ideally this membership would come from other South economies. In the interim such export credit rediscount schemes, like regional clearing arrangements and export credit schemes, deserve consideration because they could act as effective channels for transferring resources from the North and thereby encourage recovery.

Résumé: Toward a Beginning

The measures suggested above are not adequate to achieve long-term reform of the international monetary and financial system. Their goals are substantially more modest:

a. to reduce the risk of debt crises debilitating already weak national economies and aborting global economic recovery;

b. to allow the halting and reversal of the economic deterioration triggered by rapid falls in real import capacity which afflict a large number of low-income economies;

c. to strengthen the international financial flows basis for sustained recovery in global trade and production.

To achieve those goals requires measures which are consistent with broadly agreed economic goals and purposes, do not require major amendments to the basic articles of international institutions and do not propose huge net increases in concessional and international agency (including non-concessional Fund and semi-concessional Bank programme) resources which would need to be financed by national budgets. The foregoing proposals do in large measure meet these tests. All could be included within the present broad framework of Fund, Bank, bilateral, EEC and commercial bank programmes. While most require some

government resources or guarantees the totals involved are not massive relative either to the total GDP of industrial economies or to the gains they would derive from sustained recovery and growth of international trade. Though some of the specific proposals are controversial none is particularly radical, unique to the author, bereft of a broad range of analytical and business/political support or even very novel. Their possible merit is as a package of mutually reinforcing measures appropriate to the present context of avoiding crises and declines which would rekindle 1969-82 recession (and 1979-82 depression) and of strengthening, generalising and sustaining nascent recoveries now apparently beginning in several key economies (e.g. USA and UK).

In addition to advocating selective increases in financial resource availability, the proposals also stress the importance of greater flexibility in relating transfer use to immediate and structural priorities which vary widely among countries; of revising conditionality not to make it "easier" but more relevant to a wider range of genuine economic goals (including socio-political stability and absolute poverty reduction); and of being more realistic in relating target setting and achievement as well as programme disbursement, grace and repayment periods to what is objectively possible, to costs involved and to external influences (negative or positive) outside initial projections and borrower control. These changes are potentially as important as real resource enhancement - to which they are complementary - because viewed objectively present monetary and financial transfers (loan or grant, concessional or commercial) are constrained in ways which greatly reduce their effectiveness at halting economic decline, averting external balance (more accurately imbalance) crises and facilitating global recovery in trade and production.

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EXCHANGE RATE FLUCTUATIONS: CAUSES; CONSEQUENCES; MEANS TO GREATER STABILITY

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Summary

The standpoint of this paper is that while the present system of (more or less) floating exchange rates has in practice not always worked well there is no evidently superior alternative. The paper looks first at the explanations of exchange rate instability, its magnitude and effects. The conclusion is that the costs of exchange rate instability do not appear serious though there may be greater difficulties for some traders in developing countries. Then, various ways are considered of moderating exchange rate instability at a national level within a generally flexible system. Of these, the use of a reference exchange rate and some degree of 'leaning against the wind' may moderate extreme short term fluctuations but both can be destabilising as well as stabilising. The regional approach - as in the European Monetary System - is considered but it is not obviously replicable and to the extent that it tries to peg rates its survival is not by any means assured. There would be greater exchange rate stability if national economic policies in the major currencies diverged less. After reviewing the main mechanisms for coordination it is concluded that this is less a technical matter than a question of differing national priorities in relation to inflation and economic activity.

I. Background

Definition of the Problem

Since the breakdown of the Bretton Woods fixed exchange rate (or 'adjustable peg') system a decade ago floating has become increasingly common albeit with varying degrees of 'managed' flexibility. In addition to the dollar and the pound sterling, 31 currencies now float independently, as against 27 in 1980 and 9 in 1975. While the theoretical and practical advantages of floating continue to attract adherents there has however emerged a substantial body of criticism to the effect that the system had led to excessive fluctuations with significant economic costs. The IMF, for example, argues in its last annual report that "the desirability of reductions in the variability of exchange rates is not in doubt" but acknowledges that "there is much controversy as to how to achieve

this goal". 1/ While the problem primarily affects industrial countries, to quote the Fund: "developing countries have also been adversely affected by the variability of exchange rates". This theme is echoed by the Brandt Commission: "we would strongly support action to provide greater stability to relationships among exchange rates". 2/ And among other major statesmen - past and present - who have recently argued the need for a stabilisation of currencies are George Shultz, Helmut Schmidt, Roy Jenkins and Edward Heath.

Before looking in detail at the reasons for this anxiety and at possibly alternative solutions, we need to clarify certain concepts. First, exchange parity movements are commonly expressed in bilateral terms of one currency against another (normally the $). It may however be more meaningful - though it is much less easily measured - to consider fluctuations in effective exchange rates which are weighted according to the proportion of a country's trade (or transactions generally) carried out in different currencies. Second, a distinction has to be made between nominal and real exchange rates. Movements in nominal rates will - and should - offset differences in national rates of inflation. 3/ Thus, a trade may experience considerable instability in nominal exchange rate transactions, while the underlying real effective exchange rate relationship is stable; or vice versa. 4/ There are also divergencies in the long term purchasing power of currencies arising from other sources than relative inflation rates: developments in energy and resources; changes in political and economic management; labour market developments. Third, the existence of currency instability has to be considered against different time horizons. It can be treated as a short run phenomenon (usually defined in terms of daily, monthly or quarterly variations) or alternatively in terms of longer term deviations from an equilibrium level reflecting national competitiveness which - in the case of Japan and the UK in recent years, for example - can be both substantial and prolonged. (For simplicity we shall in future refer to exchange rates as XRs).

In looking at deficiencies in present arrangements we need to be careful in separating out causes and effects; symptoms and underlying problems. The Bretton Wood's 'adjustable peg' arrangements broke down because differentials in the rate of inflation were substantial and could not be contained within fixed XRs. Inflation remains, and there continue to be substantial national differences in rates of inflation and in macro-economic policy. These in themselves give rise to uncertainty whatever XR system is adopted, and are the source of many of the problems now attributed to floating rates.

For this reason, too, the deficiencies of the present system need to be considered not in abstraction but in relation to politically realistic alternatives. There is no prospect of a system of rigidly fixed XRs. It presumes a general commitment to the subordination of national economic policy objectives which is nowhere apparent. Nor is there any serious advocacy of a return to an 'adjustable peg' system since its inherent weakness - the 'one way' bet offered to speculators against overvalued XRs - would be even more cruelly exposed by today's highly integrated international capital markets. Even in the European Community, with the large resources available to the EMS for common intervention purposes it has not proved possible to defend XRs for long. Essentially, we are concerned with variants of the floating rate system designed to ensure greater stability:

(i) national exchange market policies which can be broadly divided into two: first, using Central Bank intervention and/or monetary policy to 'lean into the wind' and dampen fluctuations; second, setting explicit target or reference rates which define the official view of the 'correct' rate and which may then be supported.

(ii) national policies to reduce the mobility of certain types of capital flows, in or out, in an attempt to make the exchange rate more sensitive to current account conditions rather than asset market conditions.

(iii) regional currency arrangements, like the EMS, designed to introduce greater XR stability between the currencies of neighbouring countries whose economies are closely interdependent.

(iv) multilateral policies to achieve greater stability: through IMF surveillance of national XR policies; through closer coordination of monetary policy between the main trading countries.

How Much Instability?

Given the need, which we have already stressed, to be careful in defining what is actually meant by XR instability, it is possible to quantify the extent of volatility with the benefit of hindsight. Taking the period of floating rates as a whole four main (non-US) financial currencies have fluctuated on average by almonst 5% against the dollar every three months and in the past three years they have fluctuated about 6% per quarter. These are nominal rate variations, but there have been significant, albeit lesser, quarterly variations in real XRs by 2.5% to 3% (see Table 1).

Commenting on these statistics, their author notes: "only a small part of the volatility is accounted for by the longer term trend particularly since for much of the time each currency is moving contrary to the trend". 5/ Sterling, for example, has swung by an average of six times more than its trend movement on a quarterly basis and all non-dollar trading currencies have fluctuated more in the markets each quarter than their average annual trend movement (whether measured in real or nominal terms).

TABLE 1

Quarterly Changes
in Main Currencies against the Dollar, 1972-82

(% change)

	£	DM	Yen	Sfr	$
ACTUAL					
Average	3.92	4.98	4.45	5.79	-
Highest	13.45	17.05	15.10	20.43	-
Trend	-0.63	+0.88	+0.89	+1.825	-
REAL*					
Average	2.87	2.10	3.42	2.65	2.43
Highest	8.54	9.46	8.70	10.20	8.0
Trend	+0.71	+0.04	+0.09	+0.30	-0.04

* Adjusting for relative prices

Source: Lloyds Bank International Financial Outlook

Another indicator of short run XR instability is the extent of divergencies between the forward XR and future spot rates; in other wards the forward rate for a particular date becomes less accurate as a predictor of the actual spot rate on that date than when XR movements are governed by market perceptions of steadier trends. Errors for European currencies in the (dollar) forward market - the standard deviation of observed daily 'errors' measured *ex post* - rose strongly in the period 1979-81 for the DM (from about 2% to 6.5%), the French franc (2.4% to 6.2%), the Swiss franc (2.8% to 7%), Sterling (4% to 6.5%) and the lire (1% to 5.7%) though there were no similar trends observed for the yen or Canadian dollar. 6/

Other work, looking at movements in effective rates from the standpoint of individual countries, found that there was a large majority of countries experiencing greater

instability both in nominal and real terms, and indeed, that real rate was more unstable than the nominal rate. 6A/ The conclusion was the same on two different measures of instability. The sample was heavily dominated by more numerous developing countries and it was clear that instability, however measured, was much more for these countries.

The question of long term variability raises different issues but there have been major long term fluctuations in real effective XRs. In several cases - notably Britain and Italy - effective rates have diverged greatly from the trend in relative costs. Italy provides a classic case after 1977 of XR 'overshooting' in a downward direction; the UK of the opposite phenomenon. On the other hand, in several cases, XR variations follow very closely the trend in relative costs - especially Canada, the USA and (until 1981/82) France. We do not, of course, know how much more real effective XRs would have diverged from 'equilibrium' had an attempt been made to prevent changes in nominal rates under a fixed rate system.

Why Instability?

An explanation of instability has to start with a more general explanation of how XRs are actually determined in a floating rate system. The traditional view of XR determination centred on the current account - brought about by declining price competitiveness and/or excessive absorption, or expenditure - leading to a depreciating XR. Contemporary explanations give pride of place to short term capital account transactions: the 'asset market theory of exchange rates'. 7/ When international capital and money markets are well developed and integrated, asset holders are constantly adjusting their portfolios to take account of XRs (therefore, the relative prices of assets in different currencies) and differential interest rates. At any one time a country's (spot) XR will be determined by market expectations of future movements in the XR and by relative interest rates (arbitrage should ensure that the differential between domestic and foreign interest rates is matched by the currency's forward premium, or discount). XRs are thus determined by monetary and fiscal policies (which determine interest rates and mould expectations about future relative inflation rates) and by the numerous other factors,political and economic, which influence expectations.

The criticism that there is 'too much instability' centres on the belief that, in current conditions, XRs consistently 'overshoot'; that is, they fail to reflect the underlying economic 'reality', as represented by differential

inflation rates and/or the current account balance. The criticism of overshooting in 'floating' rate markets can be divided into several distinct points:

(1) short term XRs are volatile simply because the primary influence on short term rates is expectations in asset markets. Why? The value of the stock of assets involved in international markets is, at any one point in time, considerably greater than the supply and demand for currency for financing flows of goods and traded services; so a change in perceptions about future asset values and rates of return has a much greater impact on the market than a - short term - change in the balance of current transactions. Moreover, the information available to the market on a day-to-day basis may be of a very tenuous kind yet can substantially raise expectations and, thus, move the spot rate sharply. 8/ One corollary of this alleged short run volatility is that the spot markets may be more unstable than forward markets (though there is no conclusive empirical evidence to this effect).

(2) One of the main intellectual underpinnings of the floating rate system has been the argument of Friedman and others that speculation in the forward market will stabilise fluctuating rates; the reason being that speculators who are willing to take an open position in weak currencies which are temporarily undervalued by the market will make profits when equilibrium is restored. 9/ Critics argue that major institutions involved in foreign exchange dealings - banks and multinational corporations - are, in fact, risk averse and prefer to have a safe spread of currencies rather than take large net open positions in particular currencies. Moveover, their instincts are to avoid the currencies of countries with 'weak' or 'unstable' unorthodox governments, thereby contributing to cumulative crises. 10/ As McKinnon observes: "the large exchange rate swings since 1973 make it difficult to argue that the market has been dominated by positions taken in pursuit of long run profits". 11/ He argues that in order to overcome these market imperfections national limitations on foreign exchange dealings need to be lifted, increasing the amount of speculative capital available to foreign exchange markets. However even with current limitations on the amount of speculative capital - due mainly to the influence of supervisors on the banks, the main participants in the market - it has been demonstrated that speculation is not consistently destabilising. 12/

(3) A third explanation of XR instability arises from the imbalance between the rapid reaction of exchange markets to news of changes in the current account and the slower reaction of goods markets. 13/ To quote the IMF: "Once XRs start to move in response to large current account imbalances, they often enlarge these imbalances initially

because they improve the terms of trade of surplus countries and worsen the terms of trade of deficit countries, while the volumes of foreign trade flows respond slowly to changes in price competitiveness, in part owing to the difficulty of identifying the underlying direction of exchange rate movements when XRs are highly volatile. This J-curve effect may, in turn, lead to further and excessive XR changes, as has at times been observed in the 1970s". 14/ A more optimistic view would be that such 'poorly behaved' speculation will right itself as the J-curve effect is better understood (if, indeed, it is typical).

There is now a fair measure of consensus on the existence of instability of short term XRs. To quote the Group of Thirty: "Nearly all bankers, in all centres, said that the markets 'overshoot' in the short run". 15/ There is however more controversy over whether foreign exchange markets are more accurate in the medium term and about whether short term or long term over- (or under-) shooting actually matters very much.

Do Fluctuations Matter?

The alleged costs of XR volatility are of different kinds: first, disincentives to trade (and investment) as a result of greater uncertainty; second, adjustment costs as a result of 'overshooting'; third, the possibility that the system may have permitted relatively high inflation - and international differentials in inflation - leading to the economic costs associated with inflation:

(i) to the extent that there has been volatility in short term XRs, in relation to international price differentials, there is an increased risk involved for traders in the gap between contracts and settlement. Traders can insure against risk in the forward market, or they can hedge in other ways (big companies, for example, adjust their portfolios of different currencies). There is evidence that traders have learnt from experience to make more use of forward markets under floating rates. 16/ There are, however, costs involved in forward cover and in other forms of hedging. Evidence of the increased costs of hedging in the New York forward market is provided by movements in the spreads between buying and selling rates. For some currencies - the yen, the French and Swiss franc and the lire - the spread for 12 months forward cover was in excess of 0.5% in 1981, higher than at almost any time in the 1970s and while the cost of three months cover was naturally lower - exceeding 0.2% only for the French franc and Italian lire - the trend was generally upward. Forward market coverage is generally limited to a year which may

affect contracts with a long time lag and also foreign direct investment decisions (though export credit guarantees increasingly include exchange rate cover). Moreover, forward markets by no means represent a complete answer to the problem of XR instability. It is of use primarily when there is a good deal of spot market instability but not if the forward rate is fluctuating just as much.

There are also geographical limitations. Few developing countries have a well developed forward market and even if the ldc currency is linked to a major currency it may be difficult for a trader to operate at long distance in the US or London forward market or to get permission from his central bank to buy and sell forward (and if the ldc currency is linked to a basket the operations could become very complicated). 17/

The cumulative effect of these problems on the level of trade flows in general is difficult to assess but generally reassuring. Studies that have attempted to measure the direct and indirect effects of exchange rate volatility on international trade have yielded inconclusive results. 18/ GATT is sceptical about the costs of XR instability for trade but acknowledges that there are 'micro-economic' costs including those arising from the use of scarce managerial resources to XR operations. It acknowledges that anything which adds, even at the margin, to uncertainty about profitability will inhibit private capital investment especially in countries with a large traded sector. 19/

Direct evidence collected from surveys of traders does however suggest strongly that while there are doubtless costs arising from XR instability these are not an important deterrent to trade or investment.A survey of US enterpreneurs has shown them to be generally uncorned.20/ British businessmen were more negative than their US counterparts but the problem remained, for them, a small one. 21/ The Group of Thirty - a study group headed by Johannes Witteveen - reported in a survey of the largest and most sophisticated multinational companies and banks, in the main financial centres, that "businesses appear to have adjusted to the floating rate system rather well.... Most said floating rates introduced an additional element of risk in international trade and investment but that it was not material... none said they influenced the level of their company's international trade".22/

(ii) if 'overshooting' is substantial and prolonged, so that it gives the 'wrong' price signals to producers of goods and services, real economic costs result. One case where this may occur is where a 'speculative run' may drive

down the currency of a country with a current account deficit, or relatively high inflation, more than is merited by the extent of disequilibrium. In another case - Britain after 1979 - the attraction of high interest rates and the premium paid on a 'petrocurrency' sent the XR in the opposite direction from that which was indicated by relative inflation rates. The economic costs resulting from exchange rate fluctuations which are perverse in relation to current account and/or inflation trends are of two kinds: first, the efficiency costs of resources being deployed in a suboptimal way - that is, wasteful investment; second, the costs in terms of transitional unemployment as the economy 'overadjusts' by switching resources unnecessarily to or from the traded goods sector. The contraction in British (and Dutch) manufacturing in response to recent XR overvaluations is the most striking example of this.

(iii) criticism of the uncertainty engendered by floating XRs is more appropriately directed at the uncertainty engendered by inflation, and different rates of inflation. But the XR system may not be entirely passive in this respect; critics of floating rates argue that it facilitates inflation in deficit economies, and globally: "the combination of floating XRs with the flooding of world reserves by paper claims on a few reserve centres has also suppressed a major restraint on domestic inflation policies by all currencies alike". 23/ This complaint is only justified however at the global level to the extent that XRs have an asymmetrical effect: aggravating inflation when there are depreciating currencies more than suppressing inflation in economies with appreciating currencies Mechanisms have been suggested - downward 'stickiness' in respect of prices and wages - to suggest how this ratchet effect could operate. 24/ But it can be replied that assymetrical effects can only operate if governments accomodate them; which returns us to the central point that the 'problem' of fluctuating XRs is really the problem of governments pursuing divergent macroeconomic policies.

Costs for Small and Developing Economies

While the costs of XR fluctuations may be modest in global terms there may be greater costs for particular countries or groups of countries. One category of countries with a particular concern about excessive fluctuations is that of small open economies since for these countries XR changes have much more pervasive effects on the domestic economy and will impose considerable adjustment costs if movements are inconsistent with medium

and long term balance of payments equilibrium (as has occurred with Holland and Switzerland).

Ldcs have also reacted with general hostility to floating rates. Their complaints are of several kinds. First, it is said that the 'trade discouraging' effect of floating rates is particularly large because of the absence of scope for forward market operations or hedging for reasons discussed above. There is no reason to believe that the 'trade discouraging' effects are in fact large at all, especially when considered in relation to feasible alternatives. However, it must be said that there is no survey of evidence of the effects of floating rates on ldc exporters comparable to those on industrial countries. Second, it is claimed that ldcs which have economies pegged to a major currency have been 'locked into' that particular currency area because of the much lower risks involved in diverting trade to countries in the same currency area and that this works against diversification (ldcs which feel concerned about this point can, of course, peg their rates to a basket of currencies, as an increasing number are doing). Pegging to a basket, however, presents seperate problems in as much as particular industries which trade in particular markets may face substantially diverging exchange rates from the weighted average, which may invalidate the significance, for adjustment, of the price signals received by firms and industries. Third, there is a cost ldcs if the need to maintain a balanced reserve portfolio for hedging purposes causes them to hold larger reserves than they otherwise would. This complaint is acknowledged by the IMF... "Exchange rate variability ... has contributed to greater unpredictability of import prices and export receipts in both the short run and the intermediate term ... (and) has complicated the task faced by many less developed countries in the management of both their foreign reserves and their external debt". 24A/

To summarise, there may be some costs to ldcs but these have to be related to alternatives. Joshi's judgement is probably fair: "It is difficult to escape the conclusions that, on balance, the developing countries have fared better with floating XRs for developed countries than they would have with the adjustable peg". 25/ His argument is that without the flexibility and freedom to pursue divergent policies which floating rates have given the main industrial countries they would have resorted to more extensive protectionism and deflationary policies with adverse effects for ldcs. Developing, like industrialised, countries may then have an interest in moderating excessive fluctuations, but within the framework of floating rates.

II. National Action to Reduce Instability; and its Limitations

Although the main currencies have floated since the breakdown in the Bretton Woods par value system there has nonetheless remained a good deal of direct intervention in foreign exchange markets and indirect intervention through monetary and fiscal policy. This experience is a guide when confronting the question of whether national governments can act to stabilise foreign exchange markets under a floating rate system: to smooth out very short term fluctuations; to slow down rapid exchange movements; and to eliminate 'overshooting' in the longer term. Summarising the experience of Germany, Japan and the UK in the period 1973 to 1979 one study has adduced "suggestive evidence that intervention was stabilising, on balance". 26/

In discussing policy options it is possible to analyse the problem in two ways: first, in terms of the different policy instruments available - official exchange transactions; borrowing; the use of variations in monetary policy, including interest rates; the use of statements to influence expectations; direct control of capital flows. A second approach is in terms of broad rules or principles of intervention. We shall adapt a combination of these and look at two broad approaches to intervention ('leaning against the wind' and 'target' XRs) and one specific form of intervention (capital controls).

It should be stressed that there is no standard set of intervention rules available despite efforts by the IMF to define guidelines. Nor is it generally clear how the success of intervention is to be judged. It can be judged in terms of whether Central Banks make a profit though there is ambiguity over how we define profitable intervention (i.e. over what time period) and there are circumstances where unprofitable intervention can be stabilising. It can alternatively be judged in terms of 'equilibrium' which would be defined in terms of economic fundamentals (the real rate) or a long term market judgement. In either case it is easier to pass judgement in retrospect; though the evidence suggests that, on balance, Central Banks have a reasonable track record in intervention. 26A/ The approaches described below represent general tendencies or options rather than consistent sets of policies - let alone obligations - actually encountered in practice.

Leaning Against the Wind

'Leaning against the wind' would, for example, involve responding to a depreciation precipitated by the foreign exchange market by one or more of the following:

official foreign exchange sales in the spot or forward market; an increase in interest rates and/or tightening of monetary targets; limitations on capital outflows; foreign borrowing - each of these designed not to cancel out the market movement but to reduce it. This approach to intervention, described by Cooper and Tosini, 27/ aims to dampen down short term fluctuations and to prevent rapid movements occurring. A further objective could be to ease fears in trading partners about the manipulation of XRs by being consistently 'nonaggresive' in intervention. This approach accepts implicitly the desirability of floating and has both the strengths and weaknesses of any system operating from that premise. It has, however, some weaknesses of its own. The first is the difficulty of determining, ex ante, whether an XR movement is an 'excessive' short term fluctuation or a 'correct' longer term judgement by the market of a rate consistent with balance of payments equilibrium; in the latter case intervention could postpone necessary adjustment. Second, trade partners might construe intervention unsympathetically unless it were made clear that it was symmetrical - that is, as vigorous in modifying down-swings as well as upswings in the XR. However, limitations on reserves for use in breaking a fall in the XR may make symmetry difficult to achieve in practice. Third, the intervention could be destabilising if it were misconstrued by the market, causing a revision of expectations in a perverse direction. For example, intervention to arrest a falling rate could feed the belief that the rate is being defended at unrealistic levels. Alternatively, a failure to 'sterilise' the impact of exchange market intervention on the domestic money supply could have a greater impact on market expectations than the intervention itself. Failure to give clear guidance to the market as to the expected future XR may, according to critics of this approach, merely exacerbate XR fluctuations.

Target Exchange Rates

An approach which is much closer to the old 'adjustable peg' is one in which the national authorities try to stabilise market expectations by defining and seeking to defend a 'target' reference rate within an agreed band. 28/ Monetary policy as well as Central Bank or exchange market intervention would be used to keep the rates within the band, and swap agreements would be used in support to iron out short term flucations. Where

adjustment of the band was judged to be required it would be preannounced and interest rates adjusted to ensure that changes are gradual rather than sudden. The target rate would be set in relation to 'purchasing power parity' though this is easier to define academically than in practice. Despite these difficulties and the absence of internationally agreed procedures, some countries, notably Germany, have tried to maintain a target XR and have subordinated monetary (and fiscal) policy to that end.

The central weakness of the target XR approach - at least in its less flexible forms - is that it incorporates the weakness of fixed XRs; the target may be, or may appear, unsustainable. This is especially the case where the authorities are endeavouring to maintain an overvalued XR. To the extent that the maintenance of the rate depends on the use of reserves it is clearly easier to operate for countries whose currencies are likely to be under pressure in an upward direction; as is the case of Germany. A second, more technical, problem arises in the transition from flexible to the 'target' rate: choosing the 'appropriate' rate.

Finally, the preannouncement and support of an XR reduces the authorities' flexibility in meeting unanticipated transitory shocks, either foreign or domestic. Under a 'fixed' rate the shocks would have to be absorbed into the domestic money supply, requiring offsetting monetary stabilisation. Thus, reduced uncertainty in the foreign exchange market is purchased at the expense of increased instability in the domestic money market.

It would, however, be wrong and inconsistent to imply that a wholly laissez faire approach is to be commended given the evidence of short term XR instability and suggestive evidence that intervention under floating rates has been stabilising. It should be possible for governments to adopt a flexible form of 'target' or 'reference' rate as a publicly declared policy objective without the commitment to heavy and expensive intervention of the kind experienced under pegged rates. To be economically meaningful such an objective would need to be defined in terms of a real effective XR, rather than just a nominal rate.

Capital Controls

Since most short term instability in XRs originates in capital movements, capital controls seem to offer means for individual countries to dampen down fluctuations. Traditionally, capital controls have been used by countries with weak currencies seeking to prevent depreciation by restricting capital outflows. Recent examples of the restoration of exchange controls after a period of exchange liberalisation occurred with Britain in the 1960s and 1970s, France since May 1981 and Italy, France and Japan after the 1974 oil 'shock'. More recently, the attention has shifted to attempts by countries with strong currencies to restrict capital inflows in order to prevent appreciation, usually by reviving restrictions on the freedom of banks to attract foreign currency to non-resident deposits. Germany has restrictions on the sale to non-residents of fixed interest securities up to two years. Japan has traditionally retained a largely closed capital market for foreigners (in 1982 there was an estimated $7bn foreign investment in Japan with virtually no direct investment and $28bn of Japanese overseas investment). Switzerland has also tried to restrict capital inflows; again, apparently, with some success.

The traditional 'market' view of capital controls is summarised by GATT: "at the degree of interdependence the world has achieved by now, there does not seem to be any reliable, politically feasible, method of implementing such controls. Capital movements as such can be controlled only within a comprehensive scheme of direct quantitative controls over all international transactions, merchandise trade in particular". 29/ That is, evasion and fraud and the operation of 'leads and lags' militate against any neat separation between capital flows and goods (the problem is particularly acute in respect of the growing volume of intercompany trade). This does, however, appear an extreme judgement and at odds with the relative success of Japan in insulating its domestic money and credit policies from international monetary disturbances and also the ability of countries such as Switzerland and Germany to dampen down capital inflows while remaining, otherwise, open market economies. A more temperate judgement is pronounced by Argy: "part experience with controls may no longer be a reliable guide to their effectiveness". 30/

A somewhat richer vein of argument concerns the undesirability rather than the infeasibility of capital controls. The first point is that short term capital controls designed to prevent volatility can very easily degenerate into long term controls and in this way disrupt the best deployment of savings. Classic instances are the UK exchange controls of the mid-1960s which lasted until the late 1970s, and the semi-permanent barriers to capital inflow in Japan. It is, however, possible to design restrictions, like those in Germany, which isolate for control the buying (or selling) of short term securities by foreigners (or of foreign assets by residents). Second, there is the argument advanced by McKinnon and others that one source of XR volatility has been the risk averse behaviour of banks and other investors in taking open positions in the foreign exchange markets; a conservatism which is reinforced by capital controls.

In practice the trend in almost all major trading countries - except, at present, France - is to remove remaining capital controls, and to integrate capital markets more fully. Any system of XR stabilisation which relied on capital controls would be flying in the face of a well established trend.

Eclecticism

One reaction to the diversity of XR management policies which has evolved and been given *de jure* recognition by the IMF in 1978, is to rationalise its merits as a system; one which allows variation based on such country characteristics as openness, capital mobility, external sector diversity and degree of development. It can, in general, be argued that individual countries should choose a policy which involves more rather than less floating if they have a relatively low share of trade in GNP and/or macro-economic policies which are particularly out of line with their trade partners. 31/ A study of XR management in practice also reinforces *a priori* judgement that "for economies that are highly integrated with foreign capital markets, flexible XRs appear preferable for stabilising output and prices than efforts to stabilise the real XR through monetary policy" but that "exchange controls... may be most effective ... in sheltered economies". 32/

Discussion of the best mechanisms of stabilisation in one country do however beg the question of how effectively one country can act in isolation.

Limits of National Action

There are important senses in which attempts by governments acting independently to reduce variability in nominal XRs are either futile or actually destabilising in the absence of a closer convergence in policy objectives and coordination of policy. First of all, wider inflation differentials are bound to produce greater variations in (nominal) XRs in the long run (and probably in the short run as market expectations affect XRs immediately). This cannot be suppressed indefinitely by market intervention or controls. Second, increased divergencies in interest rates will increase short term XR instability. To a degree, interest rate divergencies merely reflect expectations about future inflation differentials resulting from diverging rates of monetary expansion. However, the position is greatly complicated by some countries pursuing restrictive monetary policies with high real interest rates but expansionary fiscal policies (the USA) and others with the opposite combination (Japan) leading to XR movements in the opposite direction from that indicated by actual or likely current account balances.

The upshot of this discussion is that "on balance, the stability of XRs could be enhanced by a more balanced and coordinated mix of monetary and fiscal policies in industrial countries". 33/ This could be achieved at both a regional and a global level.

III. Regional Approach to Exchange Rate and Economic Coordination: The EMS

The European Monetary System is designed to create "a zone of monetary stability", though it falls well short of complete monetary union. Launched in 1979, as a successor to the post-1972 'snake', the EMS has the following distinguishing features 34/: XR stabilisation within bands of $\pm 2\frac{1}{4}\%$ around central rates which are fixed in relation to a matrix of cross rates; the ecu as a currency for denominating common debts and credits and defining exchange rates; automatic intervention by Central Banks when currency divergencies reach their bilateral limit, backed up by large and automatic currency swaps and also large (conditional) credit facilities; a 'divergence indicator', which has been designed to give an early warning to central banks to take remedial action.

While the EMS is designed to be a fixed rate system, XR changes in response to fundamental disequilibria are not excluded. Once divergence indicators are consistently exceeded and intervention barriers strained, negotiated parity changes are agreed. In essence the EMS combines fixed (but adjustable) XRs within the system with flexible rates outside of it.

Evaluation

The EMS has three basic objectives: the reduction in uncertainty brought about by the elimination of short term XR fluctuations and fewer, more consistent, major changes (ie. a reduction in 'overshooting'); a reduction in inflation; and support for the wider aspects of European economic and political units. 35/

1. Reduced Uncertainty. Some stabilisation of short term fluctuations has occured, attributable to the EMS's influence on market expectations that parities would be maintained and to skilful technical management. Also changes in the parity grid have been infrequent and consistently in the same direction. The advantage to traders of the infrequency and smoothness of these parity changes has been that XR uncertainty is reduced (to the extent that that matters). To set aside the advantage of predictability, however, is the cost of postponing realignments which are overdue (very large sums were spent defending the franc before the latest realignment).

For greater XR stability to become possible on a more permanent basis, however, domestic policies must be so adjusted as to reduce the volatility of expectations and this means a convergence in macroeconomic policy. At first sight there is little evidence of convergence. When the EMS was launched there was a gap between Germany and Italy in inflation rates of around 10%, and this had widened to one of 13% between Germany and both Italy and Ireland in late 1982. Table 2 below shows a more mixed picture. Comparing the years 1979-81 with 1975-78 there has been a regression to the mean in respect of the volume of credit and money supply, though not in respect of interest rates, real or nominal or, yet, of price increases. While there is little evidence of divergence there is little evidence of convergence either. Another study using other indices - current balances and growth of GDP - comes to the same conclusion. 36/ One advance, however, is that habits of consultation and coordination between Finance Ministers have been developed which are leading to a greater willingness to subordinate domestic to international objectives.

TABLE 2

Average and Standard Deviations of Rates of Increase in the Cost of Living and of Monetary Aggregates in the EMS Countries (1)

	1975	1976	1977	1978	1979	1980	1981
Rate of Price Increase (2)	11.54	9.56	9.33	7.04	7.96	10.75	10.74
	(4.16)	(3.78)	(4.62)	(3.81)	(4.31)	(5.24)	(4.74)
Capital Market Interest Rate (3)	9.9	10.13	9.98	9.86	10.84	12.92	15.13
	(1.87)	(2.30)	(3.17)	(3.28)	(3.14)	(3.28)	(3.92)
Real Capital Market Interest Rate (4)	-1.64	0.57	0.65	2.82	2.88	2.17	4.4
	(3.86)	(3.03)	(2.12)	(2.00)	(3.13)	(3.52)	(2.26)
Rate of Growth of the money supply (5)	13.47	13.69	11.08	12.55	10.29	5.97	7.46 (7)
	(6.22)	(7.04)	(5.41)	(6.77)	(7.43)	(5.43)	(5.45)
Rate of Growth in Volume of Credit (6)	15.96	18.97	13.23	14.28	13.4	13.0	12.72 (7)
	(5.36)	(5.12)	(6.06)	(5.63)	(3.32)	(2.27)	(3.06)

The figures in brackets are the standard deviations.
(1) Excluding Ireland. (2) Cost-of-living index; unweighted average of changes for the last month of each quarter over the same month of the previous year. (3) Unweighted average of current yields of public authority bonds at the end of each quarter in per cent. (4) Difference between the "capital market interest rate" and the "rate of price increase" in per cent. (5) Unweighted average of rates of change in the money stock narrowly defined (primarily cash in the hands on non-banks and the sight deposits of non-banks) at the end of each quarter compared to the same quarter of the previous year, in per cent. (6) Unweighted average of rates of change in the volume of credit outstanding at the end of each quarter over the same quarter of the previous year, in per cent.
(7) On the basis of the first three quarters.

Sources: IMF: International Financial Statistics; OECD: Main Economic Indicators; Wolfgang File and J. Kuhlmann, European Monetary System as a Factor of Integration; Intereconomics, Nov/Dec 1982.

2. Reduced Inflation. One major motivation in the establishment of the EMS was the belief that if European currencies were linked to the German Deutschmark and the mark established a target rate with other major currencies the authorities in the EMS group would come under pressure to reduce their inflation rates to German levels. Pessimists have argued the other way; that Germany would be forced to accommodate to the higher inflation rates of its partners as a result of de facto XR flexibility within the EMS; and that the credit facilities available to deficit countries would introduce an 'inflationary bias'. The evidence suggests that the EMS has simply had no effect one way or the other.

3. European Unity and the Dollar Counterweight. One underlying theme in the high level political support given to the EMS is the belief that it will strengthen the EEC. Linked to this is a belief that it will strengthen Europe in its political and economic dealings with the USA.

There is, however, a specifically economic point here; whether any gains in internal monetary stability within the EEC are achieved at the expense of wider international monetary stability, particularly in terms of relations between the dollar and the EMS zone. One view, widely expressed, is that EMS could - and should - be an 'oasis of stability' which would shield Europe from the vagaries of a dollar whose external movements are regarded by the US authorities as a secondary consideration to domestic monetary management. 37/ An alternative view is that US and the EMS nations have a common interest in both stability and policy coordination since large divergencies in US/EMS zone price levels and interest rates would undermine the EMS by encouraging a movement between the dollar and whichever EMS currency was strong or weak, bringing pressure to bear on parities within the EMS itself. Thus the European Council resolved "the durability of the EMS ... requires a coordination of XR policies with third countries ..."38/ Another optimist is Triffin: "success of the EMS and US/EEC cooperation could break the deadlock ... to restore a workable world monetary order" 39/

Future Developments by the EMS

The benefits and costs are so far minor. It is possible however that the EMS could develop stronger features which would amplify both the benefits and costs. 40/ One proposal yet to be agreed is a European Monetary Fund which could considerably increase swap and loan possibilities linked to the coordination of policies (including loan conditionality) in a more firmly fixed XR system. 41/

An EMF could strengthen the capacity of the EMS to withstand strains but it could, equally, increase the risk of economic costs from postponed adjustment. It would, also, in part, supplement the IMF. 42/ Another proposal is to extend the range of the ecu, most radically to include non-official private transactions. It would, by the same token, imply a substantial commitment to a greater interrelation of monetary and other economic policy. If such developments created greater uncertainty within Europe they might, however, destabilise the dollar by creating an attractive new alternative asset - backed by all European countries - for speculators to switch in and out of. The ecu could also be seen by European countries and Europe's main trading partners as an alternative to the SDR and in this way weaken the demand for a truly international currency.

These are, however, at present, academic questions.

Summary, and Replicability

To summarise: the EMS type of arrangement offers the possibility of reducing short term XR instability to the extent that this is important and costly; it offers especially to small open economies, the advantages of support for a fixed linkage to the currency of major trade partner(s); but its potential as a zone of monetary stability is limited by the extent to which overall economic policies are harmonised (at present, very little); and there is a danger that internal monetary stability is offset by greater instability in external monetary relations.

The possibility of the EMS being replicated elsewhere is small. To the extent that XR stabilisation is important, in general, the EMS is able to contribute to stability because of the high level of intra-group trade (Ireland being an anomaly here). There are few comparable cases. The EMS is also inspired by and, in turn, reinforces a broad commitment to regional unity which is almost unique.

IV. International Monetary Coordination

Since the effective breakdown of the Bretton Woods system several attempts have been made to achieve a greater degree of mutual understanding under IMF auspices about the forms of direct and indirect foreign exchange market intervention under floating rates which minimise short term fluctuations. And at the Versailles summit in 1982 it was acknowledged that the problem of XR instability was inseparable from that of coordinating economic policy since it was divergent monetary policies - inducing capital flows - which lay behind instability. Heavy official intervention, by contrast, dealt with the symptoms rather than the causes of the problem.

IMF Surveillance

The first major attempt to reestablish effective IMF surveillance over national XR policies was made in the 1974 'Guidelines for the Management of Floating Exchange Rates', which was part of the 'Outline of Reform' programme put forward (but not subject to consensus agreement) by the Committee of Twenty. The 'Outline' expressed a general belief in the desirability of "an XR regime based on stable but adjustable par values and with floating rate recognised as providing a useful technique in particular situations". No agreement was however reached on a unified approach to intervention (the 'leaning into the wind' approach or the 'target band') or in drawing up a list of circumstances in which foreign exchange market intervention would be internationally acceptable.

What evolved was a case by case approach to IMF surveillance which has been formalised in the 1978 second amendment to the Articles of Agreement of the IMF. This legitimised the variety of XR practices adopted, by abrogating all par values established under the original IMF rules. It did, however, set out in a new Article 4, a set of obligations in respect of XR policies and a requirement that the IMF should exercise "firm surveillance" over members. In order to clarify the objectives of surveillance, the Fund's Executive Board adopted a set of principles for the guidance of XR policies:

> "A. A member shall avoid manipulating XRs of the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.
>
> B. A member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterised _inter alia_ by disruptive short-term movements in the exchange value of its currency.
>
> C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene".

The way in which the IMF exercises surveillance at present occurs through regular Article 4 consultations with members (plus the consultation required under different articles with members which maintain payments restrictions). This is at present extensive but not complete: "The Fund's

goal has been to attempt to cover three quarters of the membership within any 12 month period while maintaining an annual consultation cycle with major countries and with countries that have Fund-supported programmes ... However, the number of consultations per year has declined since 1978/79 while membership has increased. A consultation cycle of 13 months or less has, however, been maintained for more than 40 countries including most of the major industrial countries". There is, in addition, provision for a supplementary surveillance procedure for discussion in national XR policies in particular cases. The aim of the IMF is to widen the significance of bilateral consultation into a multilateral system by making reports available to other members and by including members in the World Economic Outlook discussions.

At present, however, IMF surveillance represents a very weak form of XR discipline in the absence of any clear enunciated view of what type of XR system should be generally adopted (fixed or floating) or of what type of intervention strategy is most effective within a floating rate system. One factor which has made XR surveillance increasingly difficult is the growth in the number of IMF members (from 20% in 1975 to 36% in 1981) operating composite currency pegs, or 'baskets', whose operations are not always transparent. To the extent that surveillance is in any way influential its effects are likely to be asymmetrical, being more effective with deficit countries requiring conditional standby credits. As for policy coordination, the IMF's rôle is currently very underdeveloped; far weaker than, say, the formal and informal consultation which has grown up in the EMS.

Towards Closer Economic Coordination

Economic summits regularly proclaim the need for economic convergence as a means to greater XR and monetary stability. It is, however, far from clear what this would mean in practice. There is no shortage of institutional mechanisms for coordinating policy as between the main individual countries (via the OECD and, within the OECD, the EMS) or more generally (via the IMF). There is no shortage of means of rapid communication. The problem is, at heart, political and centres on underlying differences as to what economies should be converging *towards*. There are three fundamental points which need to be resolved before any system of closer economic coordination can be made meaningful or useful:

(i) whether the *primary* purpose of convergence is to initiate action to expand production through increases in demand (the Brandt Report argued that "the dangers of

depression now greatly outweigh those of inflation") or to continue to aim for both lower average inflation rates as well as smaller inflation differentials (the view of the authorities in the US, Britain and Germany)

(ii) whether the underlying objectives should be to make free floating work better (by increasing freedom of capital movements; by reducing the scope for 'dirty' floating) or to move towards greater fixity of rates in both the long and the short run.

(iii) whether 'coordination' of policy with the US should be conducted on the assumption that the dollar should have a greater or lesser role as an international currency in relation to SDRs, gold or a miscellany of national currencies.

In the absence of agreement on these fundamental issues there is something to be said for the present 'messy', hybrid, but essentially floating rate system. But this still leaves us with the problem with which we started, of apparently excessive short term fluctuations (and some large longer term fluctuations) which may impose some economic costs and generate uncertainty. These costs do not seem large but, if they are felt to be, the most useful way forward in the short run which could be made acceptable to the more freely floating economies (notably the US and the UK) would be the use of real effective XRs as a key policy indicator in economic management (though not as a fixed target to be defended). If there were regular and close consultations between the main governments, preferably under IMF auspices, it could be more easily established than at present which governments were pursuing policies inconsistent with (agreed) economically justifiable parities and which merited support in foreign exchange market intervention. And use of such indicators could show up the extent to which controls (on trade and foreign exchange transactions) often widen the gap between nominal and real effective XRs, an illumination that would be welcomed by both GATT and the IMF and bring both somewhat more to the centre of the policy stage.

V. Summary of Conclusions

1. Floating XRs may have deficiencies in practice - notably short term instability - but these problems are likely to be less than would arise from re-introducing greater fixity.

2. Evidence from traders suggests that the costs of fluctuations - in terms of discouraging trade - are not large.

3. Traders in ldcs may have particular problems in utilising forward XR markets. There is no survey evidence comparable to that available in industrial countries and it would be a useful exercise to gather some. But in general the problem of floating XRs - if it is a problem - ranks very low in ldcs' international economic priorities.

4. A variety of techniques exist for national intervention to moderate fluctuations though they are not free from the risk of aggravating instability, and of being inconsistent with other governments' objectives. A flexible system of publicly proclaimed reference rates, defined in real, effective, terms merits further consideration.

5. Capital controls have in the past moderated short term capital flows but can become semi-permanent. The general movement, in any event, at present is towards exchange liberalisation.

6. The regional, EMS, approach to XR stability has some merit, in principle, for countries which trade extensively with each other. It seems to have had some effect in reducing XR fluctuations in Europe but has come under growing strain and has made little progress in producing macroeconomic convergence.

7. Macroeconomic policy convergence between major economies could reduce XR instability. But the obstacles to convergence are political rather than institutional, and stem from different national preference in economic policy. Policy convergence among industrial countries, if directed to yet more 'deflationary' policies, could even be more damaging to ldcs than the costs of current uncertainty about XRs.

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THE OIL EXPORTERS AND WORLD FINANCIAL MARKETS

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This note considers the prospects for investment in overseas financial markets by the oil-exporting countries.* It examines the implications of a declining oil price both for the total amount of new investment, and its composition.

Total Investment

The flow of investment funds from the oil-exporting economies into world financial markets depends primarily on the size of the oil exporters' current account surplus. This is shown in Table 1.

Table 1: Oil Exporters' Current Surplus and Overseas Investment, $ billion

	1978	1979	1980	1981	1982
Overseas investment:	19	63	113	65	18
Of which:					
current surplus:	-1	60	106	59	4

Source: Bank of England Quarterly Bulletin, June 1983.

The sharp reduction in overseas investment between 1980 and 1982 reflected the deterioration in the oil exporters' combined current account surplus. The main factor behind this was a decline in oil consumption and stockbuilding in the OECD area, resulting in a cut of about 30 per cent in OPEC production (to around 18½ million barrels per day in 1982). At the beginning of 1983 OPEC reached agreement on a ceiling of 17½ mb/d but by July it was apparent that actual production was running at 18.4 mb/d.

The current prospect is for continued weakness in the world oil market. Against the background of a modest 2½ per cent growth in real OECD GNP this year, oil consumption is likely to decline further. There may well be stockbuilding

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*The oil-exporting countries referred to in this paper are: Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, United Arab Emirates and Venezuela. Bahrain, Brunei, Oman and Trinidad and Tobago are not members of OPEC. Ed.

in the last quarter of this year but, given the relative firmness of the OPEC agreement, this is unlikely to produce an actual increase in output. The most likely outcome for 1983 overall is an OPEC production of perhaps 17½-18 mb/d (year average). This could increase to 18-20 mb/d in 1984.

The main difficulty in gauging the implications for the oil exporters' current account lies in assessing the prospect for oil prices. The combination of a disintegrating cartel, a large margin of surplus capacity, and a low short-run price elasticity of demand implied at the beginning of 1983 that there was a real possibility of a major crack in oil prices. It is difficult to estimate where the price might have come to rest under such circumstances, but a $15-20 range was then widely discussed. The relatively successful implementation of the March 1983 agreement has kept the Saudi marker price stabilised at $29 per barrel and maintenance of price at this level seems the most likely prospect in the near future.

Nevertheless, the table below considers two alternatives: a $28 price, and a $20 price. Under either of these price assumptions, it is virtually certain that the OPEC countries as a group will record a substantial current account deficit in both 1983 and 1984. Compared to 1982 a cut in the oil price to $28 would result in oil revenues in 1983 being about $40-45 billion lower; a cut to $20 would generate a further $50 billion reduction. Some of this reduction would be offset by a squeeze on imports, particularly those from the OECD area. However, there would still be a marked further deterioration in the overall current account position. The likely outcome is show in Table 2.

Table 2: Forecast of Oil Exporters' Current Account Surplus, $ billion

	Oil at $28 p.b.	Oil at $20 p.b.
Actual		
1981	59	
1982	4	
Forecast		
1983	-25 - -35	-55 - -65
1984	-10 - -20	-25 - -35

Source: Morgan Grenfell & Co Ltd estimates.

Under these circumstances, it is likely that most members of OPEC will be in current account deficit for 1983 even if the oil price falls no further than the present account

marker price of $29. The only oil exporters likely to remain in surplus this year are Kuwait, Qatar and the UAE. The UAE is likely to record a relatively modest surplus, which would probably be removed by a fall in the official marker price to around $26 - 28. Kuwait has not only a trade surplus, but also a surplus on invisibles trade, and a fall in the oil price to as low as maybe $4 - 6 would be required to eliminate the Kuwaiti surplus. Qatar, like the UAE, uses a substantial portion of its trade surplus to fund a deficit on trade in invisibles, and it is estimated that a fall in the official oil price to $24 - 25 would reduce the Qatari current account to a position of balance. Estimates of the current account positions of OPEC countries relevant to this analysis are shown for each year in the period 1981-1983 in Table 3. Details are given for those countries whose current accounts are believed to have been in substantial surplus in 1981, before the downward pressure on oil prices evident in 1982.

Table 3: Current Account Balances of some selected Oil-Exporting Countries, 1981-83, $ billion

	1981	1982 (est)	1983 (forecast)
Saudi Arabia	+45.1	+3	-10 - -14
Kuwait	+13.7	+6	+ 3 - + 6
UAE	+ 3.5	0 - -1	- 1 - - 3
Venezuela	+ 4.0	+1 - +2	+ 1 - + 2

Source: IMF statistics and Morgan Grenfell & Co Ltd estimates.

Most OPEC members will have to finance deficits, probably implying a rundown of existing assets. Those countries still in current surplus will on the other hand continue to invest. In either case an estimate of the effects on financial markets of the move by OPEC as a whole towards current deficit needs to take account of past OPEC portfolio preferences. Estimates of the likely use of their surpluses by those countries still in surplus can only be made on the basis of the past behaviour of OPEC as a whole, since data disaggregated by country is not available.

Asset Mix

Information on the existing assets of the oil producers is extremely sketchy. Bank of England estimates suggest that total assets may have been over $400 billion by the end of 1982; however, this could be a substantial underestimate owing to the difficulty in identifying private

capital flows. Perhaps three-quarters of this total was accounted for by Saudi Arabia, Kuwait and UAE.

In terms of asset composition, the statistics on identified deployment suggest the following breakdown as at end-1982 (Table 4).

Table 4: Identified Deployment of Oil Exporters' Surpluses

	Per cent, end-1982 (est)
Bank deposits	35 - 40
Government securities*	10 - 15
IMF, IBRD and loans to LDCs	15 - 20
Other (including equities)	30 - 35

*NB Government securities percentage relates only to US and UK.

Source: Bank of England Quarterly Bulletin, June 1983.

Within the overall total, the proportion denominated in US dollars is thought to be around three-quarters.

In assessing the likely allocation of the prospective rundown in the total asset holdings of OPEC as a whole, the experience of 1978 is relevant, since that was also a year of combined current account deficit for the oil exporters. In that year, holdings of government securities were reduced, particularly in the US. All other major asset categries were increased, although the net increase in bank deposits was extremely modest compared to the previous year ($4 billion compared to $13 billion in 1977). Lending to LDCs, the IMF and IBRD held up well in total.

In 1983, it is likely that both bank deposits and holdings of government securities will be reduced. Indeed, the rundown in identified bank deposits has been under way since last year. However, unlike 1978, it also seems likely that new "aid" lending will be sharply reduced. Such a cutback was already apparent last year. Longer term investments in the industrialised economies were also sharply reduced in 1982, and a reduction in holdings is likely this year.

With respect to the three countries expected to achieve a current surplus in 1983 however, the question remains how they are likely to invest, rather than what assets will be realised. Because data on the past deployment of OPEC financial surpluses disaggregated by investing

country are not available, the assumption has to be made that the surpluses of the UAE, Kuwait and Qatar in 1983 will be invested broadly in line with the portfolio preferences demonstrated by OPEC as a whole in the past. On this basis bank deposits and "other" are likely to absorb the greater part of the expected surpluses.

In the four years to 1982, the surpluses of oil-exporting countries, totalling $259 billion, were invested in the manner shown in Table 5.

Table 5: Investment of Oil-Exporting Countries by Category of Investment, 1979-82

	Per cent
Bank Deposits	25.4
Government Securities	12.5
IMF, IBRD and LDCs	14.0
Other	48.1
Total	100

Source: Bank of England Quarterly Bulletin, September 81, March 82 and June 83.

In the same four years, the geographical distribution of investment was as shown in Table 6.

Table 6: Investment by Oil-Exporting Countries, 1979-82, Geographical Distribution

	Per cent
United Kingdom	17.5
United States	19.5
Other Industrial Countries	26.9
LDCs, IMF & IBRD	14.0
Residual	22.1

Source: Bank of England Quarterly Bulletin, September 81, March 82 and June 83.

Both the geographical and category distributions of the oil exporters' supluses in these years display a shift of portfolio preferences compared to the period 1974-1979. Bank deposits have taken a lower proportion of the overall surplus in the later period, and "other" investments, including direct investment, have taken a larger share. At the same time, the oil exporters have effected considerable geographical diversification of their portfolio. The share of the surplus invested in the UK and the USA has declined

sharply between the earlier and later periods; at the same time, a greater proportion of available funds has been invested in other industrial countries.

The investments as a whole display a strong preference for liquidity. Over 60 per cent of funds invested by oil exporters in the UK in the four years to 1982 were placed in Eurocurrency deposits, while approximately 60 per cent of the funds invested in the US were invested in readily marketable US Treasury securities. Nearly half the funds placed in other industrial countries were deposited with banks.

Although these various portfolio preferences are likely to be evident in the investment by the UAE, Kuwait and Qatar in 1983 and 1984, it is well to remember that OPEC as a whole is expected to be in deficit, a user rather than a source of funds in the world financial markets. In 1984, the current account position of OPEC as a whole is likely to improve somewhat, but no single country is likely to show a substantial surplus which is not expected to do so in 1983. OPEC as a whole is expected to remain in deficit. Further reductions in asset holdings are therefore to be expected.

From the viewpoint of the world financial economy, one important aspect of this outlook is the prospect of additional pressure on the banking system. More fundamentally, a reduction in the assets of oil exporters reduces the flow of investment funds into world financial markets, and tends to increase upward pressure on real interest rates. Thus the downward pressure on nominal interest rates from the reduction in oil prices and inflation rates is partly offset by an upward twist to real interest rates.

FUTURE FINANCING OF THE CAPITAL NEEDS OF DEVELOPING COUNTRIES

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The decade of the seventies was characterised by an enormous expansion in commercial bank lending and a decline in the relative importance of official capital flows to developing countries. The growth of commercial bank lending reached its peak and spreads over LIBOR became their narrowest in 1979. In 1981, the failure of Poland to make timely payment of interest and principal on its outstanding debt resulted in a nearly complete halt in lending to most Eastern European countries. The Mexican crisis of 1982 and the financial difficulties of Brazil and Argentina led to an end to voluntary new commercial lending to countries in Latin America.

The International Monetary Fund, supported by the US Federal Reserve, the Bank of England, and other Central Banks, helped avert a very serious financial and economic crisis by using IMF influence to ensure that commercial bank creditors would make funds available to some of the most important debtor countries and would reschedule outstanding loans on reasonably favourable terms. The likelihood of a collapse of the international financial system has been reduced for the time being by these actions and modest amounts of new financing have been made available to major debtor countries. Some developing countries in Asia and Western Africa still have access to Eurocurrency loans on a voluntary basis. Nonetheless, there has been a very severe contraction in commercial bank lending to developing countries. It is unlikely that the easy lending of the seventies will return during the eighties. Instead, new forms of lending will emerge but on a more modest scale. The role of governments and official international financial institutions will very likely again grow in relative importance.

The purpose of this paper is to describe some of the likely trends in the external financing of the capital needs of developing countries and to suggest some constructive steps that might be taken by governments and official international financial institutions to facilitate financial flows to the developing world.

Export Finance. Manufacturers of capital goods in the developed countries increasingly recognise that their major markets for the future lie in the developing countries. They also know that their chances of winning sales contracts will depend in many cases on their ability to raise funds for the purchase of their products. Thus, as commercial loans to developing countries become less freely available, new forms of export financing will emerge.

Supplier credits will probably again grow in importance. Suppliers may have to assume some of the lending risks themselves by guaranteeing loans or by accepting delayed payment terms. Official export financing is also likely to increase as capital goods exporters lobby more vigorously for official export credits and guarantees. Countries willing to provide official export credit support will have an increasing advantage in winning export contracts.

Project Finance. A greater proportion of commercial bank loans will finance specific projects rather than provide general balance-of-payments support. Project lending has a number of attractions to lending banks. First, banks often want reassurance that loan proceeds will finance investment in directly productive enterprises rather than consumption.

Second, because typical project loans rely on indirect credit support rather than sovereign government guarantees, the fees and spreads over LIBOR tend to be more generous than for loans made directly to sovereign governments. As provisions for loan loss reserves have reduced bank profitability, they search for more profitable lending opportunities such as those provided by project finance.

Finally, project financing can provide alternative forms of security to sovereign government obligations, enabling a greater diversification of risk. For example, project financing often involves movable assets, such as ships, drilling rigs, or planes, which can be pledged as security for a project loan. Some of the sponsors of a project may be creditworthy foreign private investors whose credit support or equity contributions can add considerable strength to the security package. Projects often generate exports, the proceeds of which can be assigned as security for a project loan.

Political Risk Insurance. The growing caution of commercial bank lenders towards developing countries has encouraged some private insurance companies to develop new political risk insurance programmes to support both loans and equity investments in the Third World. One interesting example is a new programme being developed by the

American International Group (AIG) to finance short-term and medium-term export receivables. A new company, the Trade Financing Company (TRAFCO), has been established to package export receivables from developing countries. The receivables are 90 percent guaranteed by AIG and 10 percent by the developed country exporter. Notes evidencing an undivided interest in the receivables are sold in the US private and public securities markets. The notes generally receive AA or AAA ratings, depending on the note maturity and the quality of the exporter's guarantee.

Official institutions, such as the World Bank and some of the regional development banks, have also been discussing expanded use of guarantee authorities to provide political risk insurance. In the past, these institutions have been reluctant to be very aggressive in the use of gurantees since their existing articles of agreement require that direct lending limits be cut dollar for dollar by the issuance of guarantees. In the future perhaps the use of guarantee authority may have to be expanded to enable total lending to less developed countries to grow at a reasonable pace.

Public and private political risk insurance programmes might be combined. For example, one of the most serious problems with private political risk insurance programmes is their limited maturity. For many countries, the maximum length of policy that most insurance companies will write is two or three years because of the high degree of perceived risk. Maturities are also limited by reinsurance treaties which provide for automatic reinsurance only for policies written with maturities less than a specified maximum.

The World Bank could help extend the effective maturity for privately insured loans by standing ready to take responsibility for political risks beyond the maturities that private insurers are willing to take. For example, a seven-year note could be issued and guaranteed as to political risk by private insurance companies for a three-year period. The World Bank would agree to provide its guarantee, if necessary, for the remaining four years. If the private guarantee is extended each year for four years, then the World Bank's standby guarantee obligation would cease after four years.

Official Guarantee Programmes. The World Bank is now prepared to provide partial guarantees as a way of utilising the World Bank guarantee authority more effectively to generate additional financing for developing countries. Syndicated bank loans can be guaranteed in part with the lending institutions also taking part of the risk. For example, the World Bank is willing to take the credit risk

for late maturities if commercial banks are willing to take the early maturities.

The new World Bank proposals, however, do not provide for separating responsibility for different kinds of risk. For example, many private lenders might be willing to take commercial risks but look for government or official support on political risks. Private lenders for projects may be willing to assume risk after a project is complete, but look for official support regarding completion risk. Private lenders may be able to avoid market price risk through long-term fixed-price contracts, but may seek official support regarding delivery risk. If official guarantee programmes are to be effective, they must more adequately differentiate the kinds of risk that private lenders are willing to bear and should bear from those risks for which official government support is essential.

Sale of Bank Loan Assets. Commercial banks are severely constrained in their future lending by country limits, imposed either internally by management or boards of directors or externally by regulatory authorities. If commercial bank lending to developing countries is to expand, it may be necessary to enable banks to sell off part of their loans in order to bring or keep asset levels below country limits.

World Bank or governmental guarantees, partial guarantees or standby guarantee obligations could be combined with private insurance to create marketable securities out of syndicated loans on the books of commercial banks. For example, medium-term to long-term existing loans on the books of banks or new loans originated by them could be pooled so that the sovereign risk is diversified by country and by georgraphical region. Private insurance companies would be more willing to insure a diversified package than an individual loan. Private insurance would be complemented by partial guarantees or standby guarantee obligations of official institutions and the securities might be rated by Moody's Investors Service or Standard & Poor's. The rated securities could be sold to institutional investors such as insurance companies or pension funds or to regional banks. In this manner the large banks which are more active internationally could continue to originate new loans, sell them into the pool at a price which covers the cost of the various guarantees, and still keep under their country limits.

Commodity Price Supports. One of the reasons why many countries find it difficult to obtain financing is that they are dependent for exports on one product or a few products whose prices are highly unstable. Similarly, a new resource project, regardless of location, may be very difficult to

finance on a project basis, i.e., on the expected cash flow, because of commodity price instability. The risks of lending can be substantially mitigated if the price risk can be removed by a medium-term or long-term fixed-price sales contract. Such a contract can provide security for the loan in that the borrower can amortise the loan and pay a fixed amount of interest with the sale of a specified amount of commodity, regardless of what happens to market price. Such a contract protects not only the lender, but also the borrower, from adverse commodity price movements. The market-price risk is borne by the purchaser of the commodity. The purchaser's credit, not the credit of the borrower, can be used to support all or a part of the loan.

Another variation is one in which the contract specifies a minimum guaranteed price rather than a fixed price for future delivery. A contract of this sort provides even more security to the lenders since the borrower is protected against downside price movements but benefits fully from any increases in price.

The growing volume and liquidity in commodity futures markets and the recent introduction of exchange-traded options on futures is opening up a wide range of new possibilities to provide price supports or guarantees which can be used as security for lending to resource-oriented projects, companies or countries. Although liquidity in commodity futures markets rarely extends much beyond six months, techniques are being developed which enable a commodity trading firm to offer a medium-term fixed-price contract for which the trading firm can hedge itself by selling forward the full amount short term and rolling over the short-term sales, much in the same way medium-term Eurocurrency loans are funded by rolling over short-term Eurocurrency deposits.

One of the problems with medium-term fixed-price contracts is the production and delivery risk. If delivery does not occur, either because a project is not completed, because a strike, civil disturbance or natural disaster stops production, or because the producer chooses not to deliver, the purchaser can sustain very substantial losses, especially if the purchaser has hedged his position by selling forward at a fixed price and prices have increased. Guarantees or insurance against failure to deliver may be essential in order to enable price support contracts to be used to secure loans to resource-oriented projects or countries.

<u>Counter-Trade and Barter</u>. As developing countries find it increasingly difficult to export into a depressed world economy, they will be turning more frequently to counter-trade and barter as means of financing their imports of capital goods. Counter-trade involves an agreement to

make cash sales and purchases between two trading parties in such a manner that a balance is achieved over an agreed period of time. Barter involves a direct swap of goods without cash settlement by either party. While barter and counter-trade may lead to inefficient pricing and hidden trade subsidies, these techniques may be the only feasible alternative means of stimulating trade in a severely depressed economic environment.

Perhaps more importantly for developing countries, counter-trade and barter often contain an implicit or explicit financing element. If there is a time lag between the receipt of imported capital goods and the export of items to pay for the imports, then the counter-trade or barter provides a financing vehicle for the importing country. In some instances, this financing burden is borne by the supplier who keeps a receivable on his books. In other instances, commercial bank financing is sought to cover the gap.

Commercial bank financing of a counter-trade or barter transaction may be far preferable to the lending bank than a straight, unsecured, sovereign-risk loan. A counter-trade transaction produces an identifiable and contractually agreed stream of foreign exchange earnings. The counter-trade contract rights of the parties and the foreign exchange earnings under the contract can be assigned as security to the lenders. Security of this sort may provide the only basis on which some developing countries may be able to obtain commercial credit.

Cofinancing. Another likely trend in financing the capital needs of developing countries will be the growth of cofinancing of various types. Cofinancing can refer to the financing of a project by several different official sources, including official export finance agencies, international development lending institutions, and bilateral aid agencies. The funding of these official institutions has not kept pace with the loan demands that have been placed on them. These demands will grow in the coming years and the only manner in which many projects will be financed in developing countries will often be through the cooperative efforts of a number of official financing institutions.

Achieving cooperation among a variety of official agencies to finance a capital project is a formidable task. Each institution has its own objectives, each requires different security and commitments from the host country, and each usually has an entrenched bureaucracy that is resistant to providing the kind of flexibility and imaginative financial engineering required to arrange a multi-source project financing. An awareness by political leaders of the need for official institutions to be flexible can help in this process.

Another form of cofinancing is that between official lenders and commercial lenders. This is likely to grow in importance as commercial lenders seek the comfort of official participation in their lending efforts. Since cofinancing is usually tied to specific projects, this form of financing could have added attractiveness for commercial banks. A major problem in the past has been the unwillingness of official institutions to provide the kinds of comfort sought by commercial lenders, especially in respect to cross-default clauses.

INTERNATIONAL MONETARY REFORM: AN AGENDA FOR THE 1980s

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The establishment of the Commonwealth Study Group to examine the international financial and trading system is one more sign that the international monetary non-system that emerged from the negotiating failures of the 1970s is no longer viewed with the same complacent satisfaction as formerly. Global stagflation, repeated acute misalignments of exchange rates, breakdown of the recycling process and the threat of a financial collapse have combined to create widespread dissatisfaction with present arrangements. But that raises the question as to what arrangements might be preferable.

The present paper is intended to offer a view of those areas where changes might be particularly worthwhile. The paper takes up five areas: the coordination of macroeconomic policies; limitation of exchange-rate misalignments; non-concessional real resource transfers; expansion of compensatory financing; and promotion of the SDR. These topics are central to any medium-run reconstruction of the international financial system. The paper does not attempt to cover the related topics of trade and aid.

1. Coordination of Macroeconomic Policy

The simultaneous world recession is the principal source of the current setback to world development, just as it is the principal source of economic dissatisfaction to the people of the industrial countries. A decade ago, the simultaneous world boom of 1972-73 was the principal cause of the acceleration in world inflation. At that time it had become fashionable to argue that the Keynesian orientation of macroeconomic policy in the postwar world was not a major part of the explanation for the prolonged period of near-full employment that the world had experienced. That contention looks a lot less persuasive now, following a period in which Keynesian stabilisation policies have been quite deliberately abandoned and the world has gone into the deepest recession in half a century. If the world is ever to get back to anything approaching the prosperity of the 1960s, it will surely have to revive demand management.[1] And given the degree of interdependence that now exists, that will almost inevitably require recreation of a degree of policy coordination at least as great as that resulting

* The author is indebted to Sidney Dell for a number of useful comments on a previous draft.

from OECD surveillance within the context of the Bretton Woods system in the 1960s.

It is not only "Keynesians" who ascribe a significant part of the blame for the severity of the current recession to failures of policy coordination. Arguing from a "global monetarist" perspective, Ronald McKinnon (1982) has pointed to the sharp deceleration in the rate of aggregate monetary growth of the major convertible-currency countries as the principal source of trouble. He argues that this deceleration was unintended, and would not have been desired ex ante, but that it resulted accidentally as a byproduct of asymmetrical sterilisation policies. Tight monetary policy in the United States - reinforced by various confidence factors - led to a shift by money holders out of other currencies into dollars. These movements led the monetary authorities in Europe and Japan to intervene, and, as is customary, their intervention was incompletely sterilised. But in the United States the pursuit of a monetary growth rule involved full sterilisation of all exchange market intervention. The argument is that the stock of dollars in the hands of the public therefore remained unchanged following (for example) German intervention to limit the fall in the DM, while the stock of DM declined, so leading to contraction in the world money supply.

Coordination can be pursued either by laying down a set of rules[2/] intended to ensure consistency if they are pursued by all parties, or by periodic discussions intended to promote the adoption of mutually consistent policies. The main advocate of a rule-based approach has in recent years been McKinnon. He has urged monetary coordination between the three major countries (the United State, Japan, and Germany), to take the form of an agreement to a common[3/] rate of domestic credit expansion (DCE) and pegged mutual exchange rates maintained by unsterilised intervention. Such an agreement would prevent shifts in the demand to hold dollars, yen and DM affecting either the mutual exchange rates of the three currencies or the aggregate money supply of the three countries. If one believes that demands depend more on total money supply than on its currency breakdown as a result of asset-holders substituting among the three currencies, and that there is little gain from allowing exchange rates to change so as to promote the price changes needed to adjust to real shocks[4/], such a rule would be attractive and could be expected to stabilise the world economy. The rule could be extended to accommodate more countries and even to accommodate differential inflation rates (with a higher rate of DCE being allowed to a more inflationary country, whose exchange rate would be depreciated through a crawl).

Most advocates of coordination have, however, envisaged periodic international discussions to coordinate either the objectives or the instruments of economic policy. At one level, international gatherings have no difficulty in agreeing on objectives like price stability, full employment, and sustained and balanced growth, but this does not take one very far. The Versailles Summit declared that the countries whose currencies comprise the SDR accept a special responsibility to work for greater stability of the world monetary system, and to that end undertook to strengthen their cooperation with the IMF in its work of surveillance. There is no published record of what that has involved so far, but it has been asserted that the only proposal to have been made is that the five major countries seek to achieve convergence of their inflation rates in the range of 3 percent to 5 percent. If correct, that report is indeed disquieting, for it is by now well established that the one thing exchange rate flexibility really can do rather well is to neutralise the effects of differential inflation. (Moreover, a minimum inflation rate of 3 percent would actually require Japan to increase its inflation!) There is a case for seeking to limit real exchange rate fluctuations, and a good case can be made for coordinating current account targets or real growth rates, but it seems that the authorities have started off by seeking to coordinate the one objective that is better left uncoordinated.

Proposals to agree to a consistent set of current account targets were much discussed in the OECD in the 1960s. At that time the exercise was rather academic, in as much as countries did not actually wield any effective policy weapons intended to influence the current account outcome if this appeared likely to differ from the target. The subject reappeared in more acute form at the time of the Smithsonian, where some rough compromise was achieved. A number of writers (e.g., Solomon, 1975) reopened the subject after the first oil price increase, arguing that attempts to pass on the oil deficit could lead to competitive devaluations, payments restrictions, or deflation. Nothing was done, and the lack of overt signs of competitive policies in the late 1970s led to a general belief that the absence of agreed targets had not mattered. With the hindsight provided by the debt crisis, one might wonder whether agreed current account targets would not have provided a valuable early warning signal when the large industrial countries passed on the entire oil deficit. Similarly, if international lending is no longer to be left entirely to the atomistic decisions of individual bankers, one way of introducing some collective guidance as to how much borrowing is appropriate would be to have the Fund develop a set of current account targets. That would have the advantage of providing some reassurance that attempts by deficit countries to adjust would neither be

thwarted by the reactions of surplus countries nor lead to a further downward spiral in world income.

It is the concern to stabilise world income around a full capacity trend that has occasionally provoked proposals to coordinate target growth rates - most notably at the time of the locomotive debate. More commonly, however, the emphasis has been placed on coordinating the fiscal and monetary instruments that are major influences on the growth of demand. This had indeed traditionally been perceived as the central issue in policy coordination (Cooper, 1968, 1982). It is an ambition that is out of favour with the authorities of the leading countries at the moment for ideological reasons, as a result of which the international organisations have largely abandoned any attempt to give a lead. In an attempt to fill the resulting vacuum, the Institute for International Economics convened a conference in November 1982, where the measures called for to support a concerted global recovery were discussed. The resulting statement of 26 economists (1982) provides a model of the type of policy coordination that some of us believe the international organisations ought to be aiming at. In order to do that, what is needed is a change of heart rather than any institutional reform.

It has been argued in this section that policy coordination is vitally important but is presently obstructed by the dominant ideological predisposition of the major countries. As and when these countries permit the international organisations to resume a positive role in policy coordination, one might hope to see both an attempt to set consistent current account targets and guidance to monetary and fiscal policies in the major countries. (But the one thing that is an official target for convergence at the moment, inflation, is best left uncoordinated. This is not to say that it would not be nice if all inflation rates converged on zero, but rather that one country's success or failure in that regard has absolutely no bearing on what any other country should be aiming at.)

There may also be a case for more formal monetary coordination of the McKinnon type and for exchange rate targeting, but those topics are best dealt with under a separete head.

2. Limitation of Exchange Rate Misalignments

It has lately been found useful to distinguish between exchange-rate volatility and misalignments. By volatility is meant the short-run variability of an exchange rate. There is abundant statistical evidence that volatility has increased several times over, on any measure,

since the advent of floating. But the evidence that this has had a serious adverse impact on economic efficiency is rather slim: there is some evidence that it has had a modest effect indiscouraging trade (Williamson, 1981, p. xvii), and continuing worries that it may reduce investment and ratchet up inflation, but little hard evidence of either effect. By a misaligned exchange rate is meant a rate that results in a level of competitiveness far from an appropriate medium-run norm, or equilibrium. The past few years have witnessed repeated major and persistent misalignments of all the major currencies (except the French franc), involving overvaluations and undervaluations in some cases larger than those experienced in the breakdown phase of the Bretton Woods system. Naturally this had led those who were critical of the adjustable peg because of its inability to prevent the emergence of misalignments to take a jaundiced view of present arrangements.

In contrast to the apparently limited costs of exchange rate volatility, the costs of misalignments are clearly substantial. An overvalued rate causes recession, bankruptcies, protectionist pressures, and deindustrialisation. An undervalued rate causes inflationary pressures and provokes protectionist pressures abroad. Alternation between overvaluation and undervaluation is likely to increase the overall rate of inflation (through ratchet effects), reduce productive potential (through bankruptcies and the closure of capacity), and encourage protection.

Any attempt to limit exchange-rate misalignments would have to start off some notion of a correct level, or at least range, for the exchange rate. A first question concerns the concept of "the exchange rate" that is relevant for expressing target rates or, less ambitiously but more realistically, target zones. There are two dimensions here: bilateral versus effective exchange rates, and nominal versus real rates. The choice between bilateral and effective rates becomes important only when some rates are misaligned; choice of a bilateral rate target would mean that in that situation other countries would encourage their rate to move out of line with the generality of currencies along with the currency in terms of which their target is expressed, which would be counterproductive. An effective exchange rate target therefore seems natural. Given that the desire to limit misalignments stems from concern for the impact that misalignments have on inflation and recession, it would make no sense to fix target zones in nominal rather than real terms. (For purposes of short-run management targets would of course have to be translated into nominal rates, but those nominal targets would be automatically revised in the light of accruing price data.) One may therefore assume that target zones would be

expressed in real effective exchange rates.

A second question is where target zones should be calculated/negotiated. The natural forum would be the IMF. The Fund could start making such calculations on an experimental basis in advance of any agreement that they would influence the policies of Fund members in any systematic way.

A third question is whether target zones should be publicised or not. Provided that target zones were in fact set on the basis of an evaluation of where rates ought to be to avoid distorting prices, rather than on "prestige" grounds, it would seem highly desirable to publicise target zones so as to provide a focus for stabilising speculation.

A fourth question is the principles on which target zones should be calculated/negotiated. Bergsten and Williamson (1983) argue that the correct conceptual criterion is what they term the "fundamental equilibrium rate," using that term to connote an absence of "fundamental disequilibrium" in the Bretton Woods sense. That is, the Fund should be asked to estimate the real effective exchange rates that would be expected to produce reasonable current account outcomes over the cycle as a whole. Naturally these will depend upon the employment levels that countries expect to achieve on average over the cycle. "Reasonable" current account outcomes would of course be the set of coordinated current account targets discussed in the previous section, if these existed; if they did not exist, they would have to be invented. No one imagines that a calculation like this would give a pinpoint answer that would deserve any credibility, but it would be reasonable to hope for an estimate that would be meaningful within a range of plus or minus 5 percent. That is indeed one argument for preferring target zones to target rates. (Note that the Fund already routinely makes such calculations when advising its small borrowing members how much they should devalue, while a multilateral negotiation along these lines was once successfully concluded at the Smithsonian.)

The final question concerns the policy adjustments that countries should be expected to make in order to limit deviations of their rates from the target zones. Although mere proclamation of target zones might have some effect in providing a focus for stabilising speculation, one would expect this effect to be rather small (and it might conceivably be perverse, given the track record of governments in making pronouncements about exchange rates). It is natural to think of intervention as a major instrument for influencing exchange rates. The Versailles Summit commissioned a study of the effectiveness of intervention,

which by all accounts is going to report that, while sterilised intervention has some effects and can at times be a useful tool in curtailing volatility, it is unreliable and its longer-term effects are weak.* This implies that if one wishes to limit misalignments - which are by definition rather persistent deviations from target - then it will be necessary to resort to some more forceful instrument.

The natural candidate is monetary policy (this is the element of truth in Mundell's (1962) "assignment" of monetary policy to external balance). A systematic way of directing monetary policy to the task of limiting misalignments would be to intervene to that end and then to avoid completely sterilising the monetary impact of intervention. This might encounter objections both from monetarists who believe that the key to macroeconomic stability lies in stable growth of some aggregate measure of the domestic money supply and Keynesians who would wish to maintain national autonomy over interest rates. Both groups would view an exchange rate target as a constraint on domestic monetary policy. There is admittedly an alternative viewpoint, represented by McKinnon's argument presented in the previous section and by all those who advocate stabilising domestic inflation through a nominal peg for the exchange rate, which regards an exchange-rate peg as a use of domestic monetary policy rather than as a constraint on it. But that alternative view rests on the presupposition that international arbitrage can control domestic inflation without creating the type of price distortions that give rise to concern about misalignments. Thus if one worries about misalignments, one is perfectly entitled also to worry about the trade-off between the monetary actions needed to limit misalignments and the actions needed to promote domestic stability. One argument[5/] for McKinnon's proposed monetary rule of having the major countries agree on DCE targets and then not sterilise is that this would offer hope of securing an international environment where the competitiveness/monetary ease tradeoff is not acute.

The potential constraint on monetary policy will presumably limit countries' willingness to enter into firm commitments to curb misaligned exchange rates. But it need not lead to rejection of any initiative in this area. There would be absolutely no constraint on monetary policy in adopting the "reference rate proposal" of Ethier and Bloomfield (1975), under which intervention that had the affect of pushing the rate away from the reference rate - presumably the centre of the target zone - would be

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* Report of the working group on Exchange Market Intervention, Chairman, Philippe Jurgensen, Jan. 1983. Ed.

prohibited. Furthermore, intervention tending to push rates toward the target zone whenever they lay outside it could be encouraged without being mandatory.

This section has argued that a second important area for reform lies in making a reality of what is now an empty process, IMF surveillance of exchange rates. To that end the Fund should negotiate (and revise as necessary) a set of target zones for exchange rates. Intervention tending to push exchange rates away from the centre of their target zones should be prohibited, while intervention pushing rates outside the target zones toward those zones should be encouraged. Such intervention should not be completely sterilised.

3. Non-concessional Real Resource Transfers

Even before the first oil price rise, the commercial banks had become significant lenders to developing countries. All the parties involved found it convenient to allow such lending to expand greatly after 1974; the developed countries, because this enabled them to pass on the oil deficit while limiting the recession; the developing countries, because this enabled them to maintain investment and growth without accepting conditionality; OPEC, because this enabled them to acquire liquid bank deposits; and the commercial banks, whose deposits and profits grew. The commercial banks thus came to dominate the recycling process.

The commercial banks lent on relatively short maturities (no more than 8 or 10 years) and with floating interest rates. The inevitable result was that debt service payments built up relatively rapidly and could rise as a result of a rise in world interest rates, independently of the policies of the borrowing countries. So long as real interest rates remained low or negative, financial markets remained liquid, and the exports of the borrowing countries were booming, banks had little hesitation in rolling over maturing debts and extending new credits. But, because of the high and unpredictable level of debt service involved in any given level of borrowing, it was a process that was inherently vulnerable to any reversal of confidence.

As we now know, such confidence reversals hit Eastern Europe in early 1982 following the Polish crisis, and Latin America in late 1982 following the Mexican moratorium. Even though Asian borrowers have been largely unscathed, it now seems to be generally accepted that the flow of new bank credit to developing countries will be roughly halved in the next few years, from a figure of over $40 billion per annum to something in the region of

$20 billion per annum . This is significantly below the level of interest payments by the developing countries to the commercial banks, which implies that developing countries in aggregate will be transferring real resources. Given the greater marginal productivity of capital that theory implies and evidence suggests to exist in developing countries, this is not consistent with an economic allocation of world investment. There would be a net world benefit in repairing the recycling process so as to allow the developing countries to resume net borrowing.

There would seem to be three general ways of seeking to achieve this (none of which will be at all feasible unless developing countries continue to make strenuous efforts to meet their existing debt-service obligations). One would be to continue to look to the commercial banks for the bulk of the lending, though no doubt at a more measured pace than in the 1970s. Various guarantee schemes have been proposed to this end. On the other hand, it can be argued that it is neither probable nor desirable that the commercial banks resume the leading role. It is not probable because the scare that the banks got in 1982 will not be quickly forgotten, either by the banks themselves or by the authorities that are responsible for supervising them. It is not desirable because banks have short-term liabilities denominated in nominal terms, and therefore have to acquire assets with corresponding attributes: the rollover loan permitted a degree of maturity transformation, but (a) the acceptable maturities are still limited relative to the time-scale of development, where anything under 30 years maturity is essentially short-term; and (b) borrowers are exposed to the risk of arbitrary variations in the real rate of interest on their debt.

A second solution is through the official sector. Those who deliberate on questions of international finance tend to have an occupational bias toward calling in the public sector to remedy perceived deficiencies in the operation of the private sector. Accordingly, most proposals for increasing the flow of resources to developing countries have envisaged creation or expansion of some international financial intermediary, like the World Bank, the Brandt Commission's World Development Fund, the regional development banks, and sundry proposals for massive resource transfers. But however sympathetic one may be to doing what is feasible in this direction, realism dictates recognition of the fact

that there are two constraints which may mean that this is fairly modest. (1) Most of these institutions operate primarily by providing project aid, and there are limits to the number of worthwhile projects, and especially to the foreign exchange component of the capital value of such projects. This constraint should surely be relaxed where possible, e.g., by raising or abolishing the ceiling on the proportion of the World Bank's lending in the form of structural adjustment loans, but it is doubtful that countries will be willing to authorise large enough changes to achieve a major impact. (2) The political climate is not propitious to major new commitments by Northern governments on behalf of Southern development. It can of course be countered that it is the job of politicians to change such political constraints rather than to accept them as data, but acceptance of that riposte need not preclude economists from seeking approaches less out of tune with the ideology of the moment.

The third general approach to repairing the re-cycling process involves attempting to tap private-sector lenders who would be in a position to lend on more suitable terms than commercial banks can. Given that most savings are now institutionalised, this means essentially trying to tap the portfolios of pension funds and insurance companies, institutions that have long-dated liabilities and that are more interested in real yields than in being assured of a given nominal book value at each moment of time. (Until recently the low-absorbing OPEC members would also have been natural targets for assets with assured real yields but fluctuating nominal values.) I have developed a possible scheme intended to appeal to such investors (Williamson, 1982b) with the following principal features:

- indexed long-term bonds issued by an international financial institution like the IMF or World Bank acting as the agent for a collective of developing countries;
- partial guarantees provided by the stock of IMF gold and/or non-interest bearing bonds to be donated by graduating developing countries, as an initial step toward their assuming aid obligations:
- the volume of bonds issued each quarter to be determined by the intersection between the demand prices bid by potential bond purchasers and the supply prices offered by eligible borrowers, with the permissible level of borrowing by each country being limited by

(a) a constraint on its proportionate participation in each bond issue, so as to ensure that each issue represents a well-diversified package of risks, and (b) a rolling limit on total cumulative borrowing, designed to ensure that borrowing countries make proper use of their borrowings to support investment and growth.

Although the various features of the above proposal were intended to complement one another, there is no intention to claim that this is the only way, or even the best way, to tap the portfolios of the pension funds and insurance companies. The subject has received far too little consideration to justify any such claim. It is possible that individual countries would be able to issue long-term bonds if they were prepared to index. My own guess is that the attractions of a highly-diversified bond with a measure of international support would be much greater than those of bonds issued by individual countries, but at the moment that remains a conjecture. The subject is one that merits far more consideration than it has received.

It has been argued in this section that there is a general international interest, as well as a strong developing country interest, in repairing the recycling process, interpreted as a significant transfer of real resources to developing countries on non-concessional terms. However, it is doubtful whether it would be desirable to do this by placing major reliance on the commercial banks or whether the political will exists to do it by expanding official institutions. A third approach, in which an official institution would act strictly as a manager in organising sales of long-term indexed bonds issued to the private sector by a collective of developing countries, was sketched.

4. Compensatory Financing

The first change in the rules of the international monetary system that the developing countries succeeded in securing was the introduction of the IMF Compensatory Financing Facility in 1963. This provided for low-conditionality drawings to finance temporary shortfalls in earnings of exports of primary commodities below the estimated medium-term trend caused by circumstances beyond a country's own control, subject to limits set by the size of a country's quota. Those limits were so strict that the total sums drawn under the facility were distinctly modest until the limits were liberalised at the Jamaica meeting of the Interim Committee in 1976. That resulted in a

substantial increase in the scale of lending. Nevertheless, borrowing under the facility remained modest by comparison with the terms-of-trade deterioration experienced by developing countries in 1979-82, for two reasons: the quota limitation, and the ineligibility to draw against terms-of-trade losses occasioned by price increase, e.g., of oil.

One of the most persuasive reform calls to have been advanced in recent years is for an extension and rationalisation of the low-conditionality facilities of the IMF to encompass all cases where a country's balance of payments on current account goes into deficit for reasons beyond its control. This case was argued by Dell and Lawrence (1980) following the UNCTAD study on the balance-of-payments adjustment process in developing countries after the first oil shock. They argued that the bulk of the payments deterioration suffered by developing countries after 1974 had resulted from circumstances beyond their control, notably the oil price increase and the Northern recession. For the world to extend automatic credit to developing countries that encounter such adverse exogenous shocks was only an extension of the logic already embodied in the Compensatory Financing Facility and the Oil Facility.

The Fund has made a small step toward recognising the logic of this argument, through its introduction in 1981 of temporary excesses in the cost of cereal imports as a second criterion, parallel to export shortfalls, for qualifying for compensatory finance. But it has resisted any more comprehensive extension of low-conditionality finance (and deliberately avoided creating a new Oil Facility following the second oil price increase), despite the fact that the existing Compensatory Financing Facility financed no more than 4 percent of the catastrophic terms-of-trade losses suffered by sub-Saharan Africa between 1979 and 1982 (Helleiner, 1982).

The logic used to justify this resistance is that deficits that are not inherently self-correcting need to be adjusted rather than financed, even if they are caused by events exogenous to the country involved (Nowzad, 1981). That is a perfectly reasonable position in itself, but it does not dispose of the case for providing a greater capacity to finance those exogenous shocks that _can_ be presumed to be temporary. One may also argue the desirability of providing low-conditionality finance on a _tapering_ basis when a country encounters what is judged to be a permanent adverse exogenous payments shock (Williamson, 1982a, p. 16). That would preserve the appropriate incentive for countries afflicted by permanent shocks to initiate promptly the adjustment policies that are called for, while providing the finance to permit the adjustment to be undertaken gradually

and in a manner of the country's own choosing. Countries that did not make effective use of this grace period to achieve adjustment would still be thrown back on the high-conditionality facilities of the Fund in due course.

A rationalised low-conditionality facility would presumably involve projecting countries' trend import capacities, and spelling out the assumptions underlying those trend projections <u>ex ante</u>. If the assumptions about variables exogenous to the country proved adverse to the point of reducing import capacity by more than 10 percent (say), then the country would be entitled to draw some percentage of the value of the shortfall in import capacity. The eligible percentage rate of entitlement would presumably increase with the percentage extent of the shortfall. (For example, countries might be eligible to draw 50 percent of any shortfall of between 10 percent and 20 percent of the projected trend, and 100 percent of any excess over 20 percent.) If the shortfall was accompanied by a downward revision in the projected trend (i.e., if the deterioration was due to factors judged to be permanent rather than temporary), then drawings equivalent to the difference between the prior and revised projections would be tapered over time.

It would be necessary to consider whether the entitlement to draw under such a scheme should be limited by the size of a country's IMF quota. The logic of the scheme would seem to argue against such a restriction, since the scheme embodies an alternative objective criterion for rationing access to Fund credit. But the need to safeguard the liquidity of the Fund argues in favour of retaining such a restriction (though perhaps in a liberalised form). If the Fund were to be reformed to be based entirely on the SDR (Polak, 1979), this objection would disappear, which is an important argument for seeking such a reform.

It would be logical to provide that the repayment obligations under an extended Compensatory Financing Facility should be based on similar principles as the entitlement to draw; i.e., that repayment should depend on ability to pay, as measured by import capacity relative to its projected trend, rather than on a fixed schedule. For example, countries with outstanding debt under the facility might be expected to use 50 percent (100 percent) of their earnings more than 10 percent (20 percent) above the projected trend. To ensure that borrowing did not build up cumulatively even if the trend projections were on average somewhat over-optimistic, one might add an asymmetrical requirement that 20 percent (say) of earnings above trend by less than 10 percent should be devoted to repayment.

If the world had a conscience, one might dream of adding a provision whereby the drawings of very low-income countries produced by exceptionally severe shortfalls in import capacity - say, of greater than 20 percent - would take the form of grants rather than loans, financed by some special international Trust Fund. Despite the STABEX precedent, the cynical indifference with which the world has disregarded the suffering inflicted on the poorest sub-Saharan countries by the decision to curb inflation through unaided monetary restraint forces one to conclude that it would be unwise to expect much from appeals to the conscience of the rich. Perhaps the best chance of getting some redistributive element into such a scheme would be by way of interest subsidies on drawings by low-income countries. It could be argued that interest subsidies on drawings from such a facility would be largely free of the customary moral hazard objection (which argues that the availability of a subsidy gives an incentive to countries to adopt policies that would qualify for a loan), as well as being largely immune to concerns for the rather arbitrary redistributional impact of most interest-subsidy schemes.

5. Promotion of the SDR

The criteria adopted when the SDR was created for determining the volume of SDR allocations referred to the Fund seeking "... to meet the long-term global need ... to supplement existing reserve assets in such a manner as ... will avoid economic stagnation and deflation as well as excess demand and inflation in the world" (Article XVIII, Section 1(a)). By that criterion, there is a far stronger case for an SDR allocation now than there has ever been before since the SDR was invented. Given the need for financial reconstruction and a stimulus to real activity, there is a good case for a very substantial allocation. But given the equally important needs to avoid undermining the incentive to persevere with determined adjustment policies in the large debtor nations and to avoid restimulating inflation, there is a case for making that allocation on a once-for-all basis rather than in a series of installments over a "basic period."

While the author has traditionally sympathised with the demand for the link, on the ground that the assorted technical arguments for and against are marginal and unpersuasive while the distributive effect would be progressive, this is not a topic that merits any further investment of scarce negotiating capital. Now that the SDR interest rate has been raised close to a commercial level, the redistributive impact of the link would be modest. Furthermore, pressure for the link is jeopardising the prospects of the SDR and is in that way ensuring that the

seigniorage benefits of reserve creation all accrue to the large industrial countries. Withdrawal of the traditional LDC negotiating position on this issue would be an act of statesmanship.

However, any major development in the SDR is going to require more than new allocations or a willingness to end the controversy over the link. There seems to be increasing support for the proposition that any major role as a reserve currency, and even as a currency peg, will require the SDR to become usable as an intervention currency. That in turn would require that the SDR both become widely held in the private sector and transferable between the official and private sectors. If that were to occur, it would make the option of pegging to the SDR vastly more attractive, since it would dispose of the current objection that an SDR peg buys the advantage of greater macroeconomic stability at the microeconomic cost of depriving one's traders of any link with a major international currency in terms of which they can invoice and cover. And clearly countries that pegged to and intervened in the SDR could be expected to seek to hold a substantial part of their reserve portfolio, including their working balances, in SDRs.

The key step required in order to open up the possibility of such developments is the introduction of clearing arrangmenets that would permit SDR transactions among private banks and between private banks and the official sector. It has long been assumed that the present Articles of the IMF, which prohibit private SDR holdings, rule out official transactions with the private sector and also any official involvement in private clearing. Accordingly only those daring enough to contemplate a third amendment to the Fund Articles could envisage steps that might permit a major expansion in the role of the SDR. But recently Coats (1982) described a scheme which would permit use of the SDR as a means of payment among commercial banks. This scheme involves commercial banks opening SDR accounts with their central banks, which would net out intra-national transactions and then settle international balances by drawing on their SDR accounts with the Fund. But the Coats Plan would still not permit SDR intervention.

A proposal that would permit both clearing of SDR transactions among commercial banks and SDR intervention is developed in a new paper by Peter Kenen (1983). He proposes to create a Clearing House, which would be an official institution eligible to become a holder of official SDRs but also prepared to accept SDR deposits from commercial banks. Banks could acquire SDR deposits at the Clearing House through their national central bank, which would purchase national currency from the bank and transfer an equivalent

value of SDRs to the Clearing House. Transactions among commercial banks would be cleared on the books of the Clearing House with no change in the assets of the Clearing House, while official intervention would be settled by countries transferring SDRs between their account at the Fund and the Clearing House. At no time would official SDRs be owned by the private sector, so that an amendment to the Fund Articles would not be needed.*

6. Concluding Remarks

This paper has outlined five major developments in international monetary arrangements that appear feasible and desirable in the circumstances of the 1980s:

- macroeconomic policy coordination, covering the articulation of consistent current account targets and guidance to fiscal and monetary policies in the major countries;
- the negotiation of a set of target zones for exchange rates, backed up by a measure of intervention that is not completely sterilised;
- the issue of long-term indexed partially-guaranteed bonds by an official institution on behalf of a collective of developing countries;
- extension and rationalisation of IMF compensatory financing to provide low-conditionality finance for any substantial shortfall in foreign exchange earnings below the projected trend as a result of exogenous developments;
- creation of an SDR Clearing House to facilitate private use of the SDR and permit SDR intervention.

These proposals are mutually consistent but operationally independent. Any one (or more) initiatives could be pursued in isolation as and when a groundswell of support for such a change should develop. They could equally well be adopted simultaneously, if there were a widespread will to make sweeping changes in existing arrangements. In that event it would no doubt make sense to convene a "second Bretton Woods conference." But in the

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* See also R.N. Cooper, "The Evolution of the International Monetary Fund toward a World Central Bank", in this volume. Ed.

absence of a general consensus on the broad outlines of desirable change, a conference would be more likely to waste time and engender acrimony and disappointment than to agree on constructive changes. This suggests that diplomatic efforts would be better directed to pressing for such of the above speicfic reforms as commend themselves than to calls for a new Bretton Woods.

Footnotes

1. "Demand management" is sometimes libelled by treating it as a synonym for demand expansion or the pursuit of high levels of demand regardless of the consequences for inflation. That usage is not adopted here. The term is used to connote a policy of varying fiscal and monetary policy with a view to achieving a target pressure of demand, and at least some of us take it as axiomatic that target has to be chosen with a view to controlling inflation.

2. It is convenient to use the term "rules", even though in international relations these normally take the form of guidelines rather than of hard obligations, transgression of which brings automatic retribution.

3. The agreed rates of DCE might need to differ somewhat to accommodate differences in trend real growth rates or income elasticities of demand for money.

4. One might believe that because one doubts either the importance of real shocks, the need for prices to change to offset real shocks, or the ability of an exchange-rate change to facilitate price changes.

5. An argument that does not depend on McKinnon's faith in the power of goods arbitrage.

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BRETTON WOODS II: AN AGENDA

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Four subjects are suggested as the core agenda of the world financial and monetary conference:

(a) debt reorganisation;

(b) reconstruction of the international monetary system;

(c) reform of development finance; and

(d) organisation of international financial institutions.

Debt Reorganisation

At the end of 1982, short-term debts of developing countries, i.e. with a maturity under 1 year, were estimated at US $ 160 billion, compared to 60 billion in 1978. 1/ These debts used to be almost automatically rolled over, prior to 1981. In the debt crisis of 1981-82 this practice stopped, and a number of developing countries experienced a sudden need to repay massive sums out of dwindling or non-existent exchange reserves. Many were compelled to request postponement of payments, and the accumulated short-term liabilities now hang as a sword over their heads and, in a sense, over the heads of their creditors as well. No solid financial structure in the future can be envisaged without a conversion of a large part of the short-term debt into long-term.

The other side of debt reorganisation concerns the rate of interest. At least US $ 300 billion of the debt of developing countries is contracted at floating interest rates. These rates, consisting of the base rate (LIBOR or US prime) and the margin to reflect country risk, are now running at 12 per cent on the average. As the export prices of developing countries have long since stopped increasing, the nominal 12 per cent rate equals the real rate for them. At this rate, the debt burden will be rising with almost mathematical certainty. Debtors will be compelled to borrow at 12 per cent interest just to pay interest; and debt will virtually automatically increase faster than real output, leading to a rising proportion of national income being absorbed by debt service abroad, until either debt principal is scaled back, or the rate of interest is reduced. In the case of bank loans, renegotiation of interest rates

will involve the somewhat complex matter of renegotiating the rates of interest with the depositors.

For the next year or so a great many individual debt negotiations will be going on. Judging by recent experience, they will result mostly in temporary arrangements. It is in the interest of debtors as a group that eventually an organised multilateral settlement is negotiated. Judging by a number of proposals made by prominent financiers and economists in the western world, it is felt in the creditor countries as well that such an organised settlement would be in the collective interest of all parties. Consultative negotiations would have to start quite early, hopefully to be finalised in a formal multilateral agreement with appropriate institutional arrangements at Bretton Woods II.

Reconstruction of the International Monetary System

Three major matters are involved here: first, the size and allocation of future issues of Special Drawing Rights (SDRs), improvement in their marketability and their future role as an international reserve asset; secondly, future organisation of balance-of-payments support to meet disturbances of the size and severity experienced in recent years; and thirdly, modalities of international monetary cooperation aimed at reduction and stabilisation of interest rates, stabilisation of exchange rates and reduction in international speculative capital movements.

The future of SDRs is becoming a central issue for several reasons: because the US financial authorities are showing an increasing unwillingness to supply dollars to the outside world to meet its liquidity and reserve needs in view of the US domestic budgetary problem and the pressures on its balance of payments; because the authorities of other reserve currency countries, or potential reserve currency countries, the Federal Republic of Germany, Japan, Switzerland, the United Kingdom and Saudi Arabia, are unwilling to play individually or even collectively the role which the US Treasury had played for decades, that is being a *de facto* lender of last resort; because the confidence in the private international banking system continuing to supply liquidity and reserves on a wide geographical basis has been severely shaken after the collapse of bank lending to the newly industrialising countries in August 1982; and because nobody in power, and rightly, is prepared to take the risk of attempting to restore the gold standard. Issues of SDRs seem the only way out, barring world deflation. How much, to whom and how to make them become an international currency rather than a hybrid of credit and money they are now?

The experience since 1973, and particularly since August 1982, has shown that the present system of balance-of-payments support in a crisis, centered around the IMF as now organised, is one of too little and too late. The IMF was established to act momentarily in periods of balance-of-payments stress in order to prevent such stress from having the devastating effects on trade, employment and welfare, because the experience in the 1930s had shown that ad hoc deals among central banks to provide support were difficult to make in a hurry. We are now back at ad hoc deals, perhaps only worse: a large number of private banks are now involved, on top of central banks, BIS, IMF, export credit agencies, name it, each with its own objective and pulling in its direction. In the meantime, crisis and deflation spread. An overhaul is indicated.

The issue of international monetary cooperation is probably most difficult, conceptually and politically. Without it, exchange rate stabilisation is probably impossible; and without the latter, competitive depreciations and trade conflicts will increase sharply. In 1981, the estimated exports of funds through the exchanges from the US alone were some US $ 100 billion. At the end of 1982, the foreign assets of Swiss banks were estimated at Sw. fcs. 350 billion, or about US $ 175 billion: these assets in part represent holdings of US, other European, Arab, Latin American etc. nationals and companies which prefer Swiss intermediation and protection. 2/ A large proportion of these funds is in constant move across exchanges in response to interest rate and exchange rate changes, in addition to other factors. While the BIS seems optimistic that central bank intervention in exchange markets could be helpful, it is a major question whether any central bank has enough resources to cope with the flows of private liquid funds of the magnitudes now being encountered. The remedies are either controls over capital movements or reduction of international differences in interest rates. The developing countries do not have much of a choice but controls, particularly after the experience of Mexico and some others in recent years. The developed countries, whose financial markets have reached an unprecedented degree of integration, will resist controls. The only choice left is coordination of monetary policies in order to reduce international differences in interest rates. However, as interest rates are a result of much deeper forces than monetary policy in anything but the very short run, and as there is an enormous political pressure almost everywhere to reduce the world level of interest rates (in addition to reducing their fluctuations and their inter-country differences), what we are really talking about is international coordination of fiscal, expenditure and broad economic policies, probably to a degree never tried before.

The issues of SDRs, new IMF and a feasible degree of coordination of monetary etc. policies will inevitably absorb much energy and intellectual effort before and at Bretton Woods II.

Reform of Development Finance

The Brandt Commission Secretariat had identified, in 1979, 3/ six gaps in the financing structure, mostly in development finance:-

(a) long-term programme lending;

(b) lending for energy and minerals;

(c) export credit;

(d) assistance for cooperation among developing countries, such as support of payments arrangements, regional and subregional reserve schemes, and ECDC joint ventures;

(e) commodity stabilisation finance; and

(f) finance for debt reorganisation.

Progress has been made in programme lending and energy finance, but it is small in relation to needs and the gaps have largely remained. The Common Fund for commodities is still in the process of signature and ratification.

Currently under way is work on the feasibility of a Bank for Developing Countries (South Bank), handled by the Group of 77. If established, the Bank may take upon itself the task of filling some of the gaps, particularly as they affect ECDC finance, export credit, and perhaps commodity stabilisation. Much will depend on the amount of resources the Bank would be able to mobilise. It is safe to assume, however, that the unfilled needs left over for consideration at Bretton Woods II, i.e. in a world-wide rather than south-south context, will be large, particularly in programme lending, energy finance, and debt reorganisation.

The removal of restricitive clauses and precedents which have dominated the past policies of multilateral development finance institutions would also be for consideration at Bretton Woods II; included here are: inability to finance local currency expenditures to the degree needed, difficulties or inability of issuing guarantees, and arbitrary ceilings on certain classes of assets, such as programme loans.

Many students of development finance have noted the institutional gap in the Bretton Woods structure, gap between the long-term project loans of the World Bank (and subsequently the regional banks) and the short-term balance-of-payments lending of the IMF: the architects of Bretton Woods I had almost forgotton, or did not fully believe in, long-term balance-of-payments (programme) lending. The Bank Charter provides for non-project lending only as an exception, and this has been a problem ever since. Bretton Woods II would provide the opportunity to close this gap: the needs for long-term programme loans and the conditions on which to meet them will be central issues in development finance.

Organisation of International Financial Institutions

The growing exposure of international financial institutions to a variety of development problems of increasing complexity and rising numbers of developing country nationals on their staff have made a difference to their operations, attitudes and image. The control has remained firmly in major developed country hands, however, and this has been decisive for the scope of operations and lending policies. Furthermore, the institutions have retained virtually without change their theory of economic policy, the view, the "mind-set", which have been their hallmark since the beginning, setting them apart from the views held by large numbers of developing country membership and bringing them into frequent country conflicts, particularly concerning conditionality.

It is the persistence of this adversary relationship and the existence of unfilled gaps in the financing structure which have led, from 1950 onwards, to numerous proposals for the creation of a new world-wide financial institution or new facilities in the existing institution, or both. The last of these was a call by the Brandt Commission for consideration by the international community of a World Development Fund, specifically designed to fill the gaps the Fund and the Bank have been unable to meet, and to do it on the basis of partnership of lenders and borrowers which would be a novel feature in international economic relations.

This entire set of issues - conditionality, reform of existing institutions, management structure, modification of control commands, creation of a new institution or facilities, in short the possible ways in which the "mind-set" can be transformed into a many-minded approach and replaced by participatory management while retaining the capacity to act and mobilise funds - will inevitably be at

the centre of political considerations at Bretton Woods II. If these issues can be satisfactorily settled, much of the North-South dispute will have been resolved.

Another organisational issue of major importance is the place and role of socialist countries of Eastern Europe and some elsewhere in the system of international financial institutions. Yergin has shown that the formal beginning of the cold war in 1946 coincided with George Kennan's appeal not to make a special effort to persuade the U.S.S.R. to ratify the Bretton Woods Agreement.4/ Another opportunity for everybody concerned would arise at Bretton Woods II: if universality of financial institutions can be agreed, it may in many different ways contribute to the end of cold war and thus to reduction of spending on armaments. This would be the ultimate success of Bretton Woods II.

Preparations

Powerful forces are now at work likely to lead to a decision to hold the world financial and monetary conference in 1984: the call by the Non-Aligned Summit in March 1983, the view of the US Secretary of the Treasury of December 1982, and the call by the President of France in May 1983, supported by the other social-democratic governments of Europe (Austria, Finland, Greece, Spain and Sweden). The perspectives of these different powers are different, however, and so are the objectives. There is no chance of success of Bretton Woods II without a broad, precise, methodical and virtually fulltime technical preparation on the part of each of the major country groups and then of all groups together. The history of preparatory work for Bretton Woods I, described by Sir Roy Harrod, 5/ shows the magnitude of the job even when only a few dominant powers and even fewer dominant personalities were involved. The present situation and relations of forces are much more complex, called for even greater sustained efforts.

Footnotes

1. Federal Reserve Bank of New York, November 1982, as reported in the *Wall Street Journal*, 5 November 1982 and *Journal de Geneve*, 6 November 1982.

2. Report of the Swiss National Bank quoted in *Bank for International Settlements Press Review* of 30th December 1982.

3. See *The Brandt Commission Papers*, Independent Bureau for International Development Issues, Geneva, 1981,pp. 608-634.

4. Daniel Yergin, *Shattered Peace: The Origins of the Cold War and the National Security State*, Boston, 1977.

5. R.F. Harrod, *The Life of John Maynard Keynes*, New York, 1951.

COORDINATION OF POLICIES ON TRADE, FINANCE AND EXCHANGE RATES WITHIN THE INTERNATIONAL INSTITUTIONS

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Background and Outline of the Problem

The growth of international interdependence has increased the number of ways in which the activities of economic decision-makers in one national economy impinge on those in another as well as the size of the effects. In short-term economic management, the most powerful remain trade, monetary flows and exchange rates, but in recent years the freeing of capital flows and the growing role of international banks have greatly increased the relative importance of the second two; greater emphasis on monetary economics and the role of expectations, combined with increasing empirical evidence of the slow response of trade to relative prices have affected perceptions of their relative effects. Partly for these reasons, but also because of growing domestic emphasis on monetary policy and sectoral programmes, the extent and forms of government intervention affecting the three variables have altered. At the same time, the continuing depression has reduced the tolerance of national governments for the effects of behaviour by other countries or of international conventions that may damage their short-term interests. One response has been to take a purely national stand adapting or even unilaterally abrogating existing international restraints and rejecting new ones. The principal alternative to this has been to suggest new international agreements or institutions taking a more unified approach to the various international issues than is possible within existing bodies. A final one which should be considered is a return to the old system of separate organisations or sets of rules, but with some adaptations.

The problem that this paper discusses is increasingly significant for developing countries as well as for the developed. They have participated particularly strongly in the increased openness and international dependence of economies in particular through the growth of their trade in manufactures and of private capital flows. They also find themselves obliged to place more emphasis than in the past on the short-term management of their economies because the pressures of the depression have reduced their access to financial resources that would permit them the more

traditional long-term view. Their lack of some of the financial institutions and mechanisms of a developed economy may make handling the effects of external influences more difficult, and their generally weaker bargaining power has handicapped them in the ad hoc arrangements that other countries have made.

The analysis in this paper will begin with a brief recapitulation of the ways in which the different types of international effect operate, and how these may be related to each other, indicating some of the differences in present views on the importance of these effects. This will, however, focus less on the theoretical possibilities than on recent changes in economic conditions and institutions that alter the actual effects. The following section will describe present international arrangements and discuss how far these are still adequate for present conditions. Consideration of what changes may be required will need to take into account the different interests of the developed and developing countries and the relationship between coordination of actions or policies at national and international level.

The policy recommendations that can be drawn from this analysis must also take account of the requirements of different solutions in terms of substituting international for national control and the acceptability of this. Another closely related question is the location of the chosen policy along the spectrum from complete planning to complete independence. This depends not only on the conventional divisions of opinion about intervention in the economy, but also on judgements about how permanent any solution can be, and therefore how far continuing rules can substitute for ad hoc intervention. Perhaps most important, recommendations must recognise that any solution in economic (or political) analysis is inevitably a partial one. The scope of this paper is one way of combining certain questions, but it excludes for example both the longer-term effects on production structures of the international relations it does discuss and many other types of international effect whose influence is exclusively long-term, as well as domestic issues of production and distribution that may be closely related to the international questions. It also, of course, places particular emphasis on the joint effects and interactions of these relations, which necessarily reduces the attention to the direct effects of each of them. A basic question to be considered, although there can be no general answer, is whether the relationships considered here are so much more important or closer than the others that finding a general solution for them is worth the practical costs including sacrificing other

possible combinations. That these particular issues are related to each other is not a sufficient proof either that they must be treated in a common institutional arrangement or that such an arrangement would be broad enough.

How these Issues are Related

Trade, exchange rates and finance are related both directly through economic mechanisms and through government responses. Some of the latter may be sufficiently automatic (intervention to hold a formally fixed exchange rate is an obvious example) that they can be treated as effectively economic ones. The relationships include the effects of the level, and possibly composition, of trade on the demand for trade credit and other financing and of the supply and cost of such finance on trade; the effects of exchange rates, operating as an influence on relative prices, on trade and of trade balances on exchange rates, or if these are 'fixed', on interest rates and financial flows; the effects of interest rates and financial flows generally on exchange rates if these alter exogenously; the effects of trade and trade policy on balances of payments; more broadly, the effects of trade on total demand (or its composition), of financial flows on domestic monetary variables, and of exchange rates on absolute and relative costs. All also influence the whole economy, and therefore at subsequent stages the other international effects, and similarly any 'purely domestic' event or policy will eventually affect all the international ones.

The potential importance of some of these effects clearly depends directly on the size of the external sector relative to the rest of the economy: trade relative to other sources of demand or elements of cost; international monetary flows relative to others. For some, it may depend on the relative importance of different types of international transaction: whether trade or capital flows are more important to the exchange rate. From a national point of view, some effects will vary with the size of the country: its ability to affect international prices or the total demand for funds. All these determinants, except the last, suggest that the potential importance of these relationships has risen as trade has grown more rapidly than other components of demand and liberalisation of controls on international capital has increased its mobility.

The actual importance of the effects depends also on both the elasticities in the economic relationships suggested and on how these actually operate, including their

speed of response. For example, the size of exchange rate change needed to correct a trade imbalance or the interest rate response necessary to meet pressure on the exchange rate will depend on the elasticities. The amount of short-term finance that is needed will depend on how quickly trade and capital respond and for trade on the size of the J-curve effect, which occurs because the effects of an exchange rate change on the prices of traded goods are significantly more rapid than these prices' effects on trade. The expected size of effects also depends on whether the response is simply to the particular event or takes account of the whole sequence of responses by others, i.e. the role of expectations. It is difficult to identify any general trends here, but it appears that a wider range of possible effects and possible scales of response to them is now perceived; this must influence the views of decision-makers both on their own appropriate response and on the need for an international system that can allow for these wider reactions.

The switch from fixed to floating exchange rates among the major economies, as already indicated, affects some of the interrelations directly. It has also been argued that floating removes pressures for controls on trade by allowing the exchange rate to be used instead to bring trade into equilibrium or alternatively that it increases them because it makes it impossible to use the exchange rate to improve the trade balance. The weakness of both arguments is that they treat the change of policy on how the exchange rate should be managed as equivalent to a change in policy on the objectives for which it is managed. At any time a country may have a policy for promoting demand which may rely on trade as an element of it, or it may be satisfied with a market-determined equilibrium. If it does intervene, the instruments it uses will be determined by its judgement on the size and predictability of the economic relationships discussed above. Such claims about floating also look at protection only as a form of macroeconomic intervention although in practice it is more important in sectoral policy.

There are two effects of floating on other international relations which may be relevant to this paper. First, if it does not respond as efficiently as a fixed rate system to pressures on it, it may require larger changes in the other international flows as a substitute. This would increase the importance of interrelations. Secondly, it may operate differently on other variables. Rate changes are not instantly identifiable. Responses may therefore be slower. This may increase financing needs for traders, but reduce them for governments by removing

the obligation to respond to temporary strains with financial support. More generally, it may slow or reduce the response to relative price changes by making these less obvious and by emphasising the effect of exchange rates in offsetting them.

Conflicts can arise between different countries either because of a direct incompatibility of policy, over the exchange rate between them or their relative interest rates, for example, or because of inconsistent combinations of policies for different variables, a high interest rate policy in one and a high exchange rate, low interest rate policy in the other. Thus an international difference creates a conflict of domestic interests.

Insofar as this is perceived to be the result of normal economic events or forces in the other country, or the 'rest of the world' it is not a new problem: domestic economic policies may well prove inconsistent given international constraints, and domestic adjustment is an acceptable solution. If, however, the domestic conflict is seen as the result of the other country's choice of policies or instruments rather than of inevitable economic forces, it may give rise to demands for restraints on countries' behaviour. In the absence of these, it may lead to greater intervention in response. Examples that are frequently cited are the monetary and exchange rate policies of Japan and the United States. Japan in the late 1960s and again more recently pursued policies of low exchange rates which contributed to (although clearly not explaining completely) its exceptional competitiveness. Other countries, unwilling to adjust their exchange rates, responded in part by trade restrictions. The high interest rate policy of the United States in 1981-82 conflicted with the high exchange rate policies being pursued in order to damp inflation by the major European countries and brought these countries' exchange rate policies into conflict with their (less tight) monetary policies. More generally the high interest rates brought about by the monetary policies being following in the developed countries generally have increased the cost of all credit which includes loans to developing countries and brought unexpectedly tight limits on their financing.

<u>The Present International Institutions</u>

Some of the details of conflicting economic policies may be new but the existence of conflicts, and the particular acrimony arising from government intervention and depression are not, and indeed they were behind the establishment of the IMF and the GATT after the War.

The experience of institutional policies and depression in the 1930s, accompanied by a rapid decline in world trade, was the major force, but the more indirect effects of government intervention in domestic economies were also recognised: The Economist noted that 'We are moving into an era of purposive direction of economic forces and those who think that international trade can remain an exception to this worldwide trend are cherishing an illusion' (19 February 1944,cited Rossen 1981, p.2). The post-war solution to the problem had two elements. Formally it was intended to set limits of national intervention, and thereby reduce the scope and number of international conflicts. It established mechanisms for resolving conflicts or renegotiating the rules when necessary, but the understanding was that as far as possible international economic relations would be governed by rules not *ad hoc* decisions and negotiations. The second characteristic was that both the IMF and the GATT had a presumption built into their rules (for example on progress toward convertibility or extension of most-favoured-nation treatment) that any changes in the rules would be in the direction of less rather than more direct restriction on international flows. This reinforced the risk-reducing advantages from certainty and stability given by the rule-based system by indicating to a private decision-maker in which way any change would be made. Both of these characteristics were particularly beneficial to those who could not expect to have a direct or significant voice in negotiations, that is to private traders or investors and also to the weaker countries in the institutions.

The General Agreement on Tariffs and Trade was explicitly set up to administer an Agreement on what types of trade barrier were acceptable (the only element of the more ambitious International Trade Organisation to gain approval). It took on as a natural extension the role of arranging, and encouraging, multilateral negotiations to lower these. It does not have any (formal) function beyond administering and enforcing the agreements made by member governments. It does not establish any special position for developing countries: these were, it should be remembered, a majority of the original signatories (Gold, 1978 p.2), and have remained so although some of the largest have never joined. The protection of fixed rules and the principle of non-discrimination were themselves a gain for them. The possibility of positive discrimination for them was first raised in the acceptance by the GATT of the Generalised System of Preferences in the 1970s, but this remained in form a unilateral concession by the developed countries, not an amendment to GATT rules. One type of derogation from non-discrimination was accepted

from an early date: the formation of regional trading organisations, in both developed areas (the EEC and EFTA) and developing (especially Latin America). (Existing arrangements, such as those within the Commonwealth were accepted because they existed, reflecting the overriding principle of stability.) This suggests that non-discrimination has never been regarded as so basic a principle that it cannot be violated if it conflicts with other benefits.

The rules and enforcement provisions of GATT have not altered in recent years, but their scope has been greatly reduced by the practice of governments making informal agreements to break the rules and not appeal to GATT. GATT cannot deal with agreements which frequently have no legal force behind them, and which will by intention not be brought to its notice by either side; and even its informal statements of disapproval can have little force coming from an organisation that is no more than the representative of its members' interests. These agreements have taken the form of 'voluntary export restraints' (on steel, cars, machine tools and other engineering trade, electronics, textiles and shoes), industry-wide 'Arrangements' (as in textiles), and a variety of other informal non-tariff barriers. In the last two years, there has been a partial return to mechanisms within GATT, with the growing use of anti-dumping investigations. GATT rules do permit countries to control goods being exported to them at below a reasonable cost price if they are causing 'material damage'. In these as well there has been a considerable element of agreement between the governments directly concerned: not to contest the dumping allegations or to restrain exports following advance threats of an anti-dumping action (the steel trigger prices in the United States). Two central elements of these new barriers break the most important aspects of the GATT system: they are discretionary, not based on fixed rules; they are discriminatory among GATT members. Other characteristics also conflict with the basis of the post-war international system: they are based on government-to-government agreement, effectively on the use of greater economic power by one negotiator to compel the other not to rely on an appeal to the rules; they are not set out in legal form, and are therefore not certain in their effect (they have frequently been subject to disagreement) and are sometimes semi-secret; they are changes in the direction of increasing, rather than reducing, controls. All of these effects act against the advantages for non-governmental traders and relatively weak governments of the GATT system.

The International Monetary Fund was established with a slightly stronger independent and discretionary role than the GATT, an extension into international institutions of the greater powers and discretion considered normal in most 'market' economies in their national management of financial and monetary affairs. Except for financing directly related to trade, the presumption built into it was that capital flows would be subject to controls, and that governments would certainly intervene in exchange-rate setting. The parallel to the GATT rules was that the exchange rates should be fixed and non-discriminatory, but an important difference was that when a change was necessary it was the IMF organisation itself, not multilateral negotiation as in the GATT trade rounds, that took on the international supervisory role; and while GATT permitted (even welcomed) unilateral or restricted area tariff reductions this degree of national freedom does not exist under the IMF rules. Effectively, however, the constraint of IMF acceptance of exchange rate changes was not important, except when the IMF was involved in a financing role, even during the period of fixed exchange rates; under floating rates its responsibility for supervisory rates is even more tenuous. The switch to floating rates was thus a breakdown in the accepted rules of national behaviour, but not a major change in international authority.

The more important element in the IMF's independent power was its role as a provider of finance for temporary difficulties. Again there was an effort particularly in the years before 1973 to make the provision of funds as far as possible subject to rules rather than discretion. Some finance was available without question (the 'first credit tranche'). In the earliest extensions of the availability of finance, the commodity-based compensatory financing arrangements were an attempt to tie both the availability and the amounts to fixed criteria. The 'oil facility', after the first oil price rise, however, permitted greater judgement, not merely in the amount (given that the total available was so much less than any possible measure of the 'oil effect') but in the IMF's conditions of lending. One informal link between the GATT and the IMF rules had been that the IMF required avoidance of new trade restrictions as a condition for credit (although there were exceptions). The conditions for the oil facility were less tightly drawn.

In the late 1970s and particularly since 1979, it has become increasingly difficult to separate balance of payments difficulties which can be attributed specifically to commodity exports or oil prices from those caused by the depression generally. The latter include both direct

effects and the cost of any mistaken initial responses to it. Identifying some causes as particularly deserving, which in any case has no theoratical support, is therefore increasingly impractical. It has also become less relevant to lending decisions because of the reduction in the share of funds based on such considerations. Combined with the changes in the IMF's more general funding arrangements, particularly the failure to increase the first credit tranche as much as all borrowing rights, this has strengthened the role of discretionary lending.

Outside the GATT and the IMF, a variety of other organisations provide elements of international coordination of national policies. The World Bank has moved (since 1979) to supplement its concern for long-term development and particular projects with 'Structural Adjustment Loans'. These in turn are now subject to coordination with IMF finance to a particular country for more immediate adjustment problems. The intention is to ensure that the specific and general adjustments and long- and short-term problems are not looked at separately. The organisations consider coordination superior to placing both types of credit under one of them because they have different types of objective (and expertise) and can remain individually responsible.

The shortage of IMF funds relative to the needs of the largest members prompted the establishment in 1961 of the General Arrangements to Borrow, administered by a club within, but outside the control of, the IMF: its ten largest members. Its discussions of international monetary reforms and its effective control of access to IMF funds by the group's members weakened the universal role of the IMF (Tew, 1977, p.141) and its non-discriminatory character. The considerable overlap between this Group of Ten and the OECD, which was extending its role in organising discussion of international issues among the developed countries, encouraged this tendency. In contrast to the GATT, the OECD has always included more general areas of economic policy with trade in its discussions (Rossen, 1982, p.11), but although it therefore can take account of a more comprehensive set of influences on trade (Commonwealth Secretariat, 1982, p.118) it does not have (unlike either the GATT or the Group of Ten) any powers, on its own or as representative of its members.

The growing use of international summits among the developed countries is another forum for discussion, again without power. The EEC, for its members, does link trade and exchange rates within the Group.

The present system has thus departed from the post-war system's principal characteristic of attempting to reduce the possibility of conflicts by providing permanent rules and criteria to guide international arrangements and by discouraging direct government intervention. The existing rules are broken by agreement and changed informally either by single governments or in international fora restricted to some of the developed countries, in ways which leave them uncertain and unenforceable, and in unpredictable directions.

The growing importance of the IMF relative to the GATT reflects the greater role of capital flows and the increased importance of money and finance in national policies. The parallel increase in sectoral rather than macro-economic intervention in national policies also militated against a stronger role for the GATT, and the reduced importance given to macro-economic management in the developed economies reduces the gains expected from the dynamic, demand, effects of trade. The existing organisations did not offer obvious ways of dealing with the new economic conditions and objectives. These include in addition to the different types of government intervention cited above the new aspects of private participation, for example the growing role of multinational corporations, with implications simultaneously for trade, domestic development, and finance, and of international banks (Stewart, Sengupta,1982) whose deficit financing shifts the borders between official and private activities. The greater variations in economic performance, across all countries (Commonwealth Secretariat, 1982), and between countries (Llewellyn and Potter in Boltho, 1982, p.140) made a system of permanently fixed rules and relationships seem increasingly inappropriate. The depression probably helps to explain why most of the modifications to it substitute national controls and discretion for international.

Differences between the Interests of Developed and Developing Countries

One of the advantages suggested for the rule-based, multilateral post-war system was its protection of relatively weak governments from those with stronger bargaining power. The loss of this and such modifications of the present system as the growing importance of country-to-country trading relationships and holding exchange rate and financing discussions in developed country groups suggest that developing countries may have lost more and gained less from the institutional changes of recent years. At the same time, the relatively rapid expansion

of their trade, the greater external 'openness' of some of them, and their growing dependence on international funds for general finance have all increased their interests in a satisfactory international system.

The move from fixed to floating exchange rates was expected to be difficult or damaging to them because their capital markets are smaller, and therefore more vulnerable to any flow of speculative funds, and because they lack the institutions such as forward markets that normally blunt the effect of financial markets on traders and investors. Because of their weak bargaining position, their traders normally are required to bear the entire exchange risk of any transaction, so that their need for risk-reducing mechanisms is likely to be greater than in developed countries. There are technical solutions to these problems, including tying the exchange rate to one developed country currency and using its markets or attempting to match payments and receipts in a variety of currencies, probably requiring a net increase in reserve holding (Bird, 1978, p.28). The growing number of developing countries using floating rates and the increasing diversification of both their trade patterns and their holdings of reserves indicate that these have been used. They must, however, have some transactions costs that do not arise for countries with their own forward markets, and in dealing with other developing countries, the absence of intra-regional or other developing country institutions means that two sets of these costs may be incurred (Anjaria _et al_ 1982).

Fixed rates may not be a practical solution in present economic conditions, so the alternative to incurring the costs of operating in a largely floating system may be not reforming the system but either finding an international solution to compensating the developing countries for their increased share of the running costs of international payments or for them to reduce their international exposure. The first possibility raises the question of the principle of non-discrimination. This has not been considered as central as other GATT rules in the past, and has its theoretical justification in theories of justice or legal systems rather than in economics (Johnson, 1976, p.18). It was intended to protect the weaker governments in the system, but the easy substitution of smaller clubs on the IMF side and government-to-government negotiations in trade suggest that it has failed to do so during the depression. On the other hand, it may have been the maximum, not the minimum, developing countries could get in a fixed rule system, and the other advantages of that may well have compensated for lack of

a special position during the period of growth of the 1950s and 1960s. The present system, in which there is both direct discrimination, in trade, exchange rate and payments mechanisms, and indirect, through the lack of full developing country participation in consultations about finance and reforms of the system, within and outside the IMF, is clearly less satisfactory.

The increase in domestic costs in managing international exposure under present economic conditions and arrangements is one element in determining the desirable level of exposure to external risks and benefits for developing countries, but it is necessary to distinguish this more general question from the effects of a particular international system. Problems such as different movements of different exchange rates with damaging consequences for terms of trade or the depression and consequent lack of external demand cannot be solved by new forms of international organisation.

The difficulties faced internationally by the developing countries clearly put pressure on their national coordination of different policies. This may already differ from that in developed countries. The trading and financial sectors, although undeveloped relative to the role placed on them by floating or dealing with developed countries, may be wealthy and extensively planned relative to the rest of their own economy. This may make potential conflicts between international constraints and domestic objectives particularly acute: taxes on trade or trade-related activities may be a significant part of government revenue (IMF, 1982, p.52), although this is not a problem unknown in developed countries. The practical difficulties of coordinating different international questions may be less because of the normally greater degree of centralisation of planning, with the central bank likely to be regarded as an agent (Ghatak, 1981, p.38) and not an independent operator, but the willingness to accept externally imposed changes in a programme may be reduced (or more realistically, the resentment at being forced to accept may be greater) by the government's greater direct involvement. This may also be true of accepting imposed structural changes, including the shift to floating itself, or alternative trading or financing arrangements. In addition to the transactions costs mentioned above, the use of floating is particularly likely to mean a change in methods of control of international relations because of the relatively high use of exchange controls by the developing countries.

Proposals for New International Systems

The first proposal after the War was for the International Trade Organisation, which was to have had a role in trade and all related issues parallel with that of the IMF in finance. It would have had explicit responsibilities in employment and development (Rossen 1981, p.5). It was never formed mainly because the United States was not prepared to accept this degree of international intervention, and the interim arrangements made for trade only, the GATT, remain in force.

There have been various proposals linking some of the international issues. The suggestion of a link between the general provision of world liquidity and the particular need for additional finance for the developing countries, in particular the SDR-aid link, has taken several forms. It would, unlike a proposal such as the ITO, be an extension of automatic arrangements to a new field, not a substitution of international planning. It was suggested in the earliest plans for the IMF, as the Stamp plan in 1959 (Bird, 1978, p.257), when the plans for the Fund issue of Special Drawing Rights were first discussed, and at each subsequent SDR issue. It was implemented on a very limited scale when the IMF sold some of the gold reserves which had been allocated to it by its members as part of its capital, and distributed the difference between the selling and the official price. The proposals to distribute SDRs either directly to the developing countries, on the basis of aid needs (rather than to all members on the basis of quotas, effectively, in proportion to their wealth) or to make them available to aid agencies were rejected by the developed countries, and by most economists commenting on them, as illogical because of the lack of any relationship between the world's need for greater liquidity and developing countries' need for aid (Srinivasan, 1982, p.89). This type of argument is in some ways as wrong as the opposite extreme of treating all international issues as inextricably linked. If both needs exist simultaneously there is no reason not to link them, and as someone must receive the benefit of the 'social saving' from more adequate reserves (Bird 1978, p.253) it is arguable that the bias should be to the poorest, not the richest. More directly, as certain elements of the international payments system were exacting an increased share of their costs from the developing countries, they had a claim to a greater than proportional share of any available benefits from international monetary reforms. On the other hand, such a scheme might have further reduced the interest of the developed countries in the general benefit of increasing

international liquidity (it was already lower because of the advent of floating), and therefore have reduced developing countries' actual receipts of SDRs below what they received as their share in general allocations. As the amounts involved were never large, the advantages or disadvantages of this partial solution are of little significance.

The financial difficulties that developing countries have experienced in the last year have led to various proposals that some organisation, perhaps the IMF, should have a general supervision over not merely the short-term adjustment policies of those borrowing from it, with the usual conditions which may, as has been mentioned, include observance of rules about trade or exchange rates, but their medium- and long-term financing as well, and possibly their development programme regarded more broadly. This would not be a general international programme for two reasons: the lack of developing country participation in the setting of the IMF programmes and the apparent concentration on national and financial objectives only. To have reestablishing the financial position of each country as the objective fails to take into account either aggregate world objectives or the interrelationships between the objectives for different borrowers. (It may not even form the basis of a good national programme as with the increase in the number of countries under IMF programmes the implicit assumption that each can be treated independently, with the rest of the world assumed constant, becomes increasingly unrealistic.) The extent of international 'interference' involved is likely, however, to make such plans as unacceptable as the ITO.

There have been efforts to establish organisations or systems based only on the developing countries to deal with the linkages in their relations among each other or to strengthen their demands for a more general solution. The first is the same reason that has led the developed countries to use the Group of Ten or the OECD. The latter reflects the view that their interests in the international system are different from those of the developed countries, and cannot be met in the existing organisations. UNCTAD like GATT is a temporary arrangement that has lasted, but unlike GATT began and has remained basically a consultative organisation, with no rules or powers. It is noteworthy that it included only Trade and Development, not Finance in its original definition of responsibilities (although this has been extended), reflecting the international concerns of 20 years ago: like the decline of GATT and the modification of the IMF this suggests one of the difficulties for any 'comprehensive' international organisation: it will

only cover the issues considered important at the time of its formation, unless it is given unlimited powers of expanding its role. The proposals for a New International Economic Order were more an agenda for the international community than a proposal for a particular type of system, but they embody both in their formulation together and in some of the proposals themselves a general approach: if the proposals are rewritten in such terms, they include linking income redistribution to export of commodities and aid to national development in the developed countries and to liquidity, in addition to the more single issue proposals of industrialisation, technology transfer, and debt relief. The difficulties its supporters have faced have arisen mainly from the unacceptability of such general international obligations and in particular the costs of some to developed countries, but also from conflicts of interests among the developing countries, over the priorities and over the desirability of some of the components, and from declining general interest in some of the issues. These are the difficulties of basing reform proposals on specific issues rather than an organisational approach.

Conclusions

The international system must reconcile not only different targets or programmes within the same or related international relationships, but differences in countries' views of the priorities among these, and between these and their own domestic plans, and differences in their desired structure for the economy, in general and on a very specific level for the particular elements of it that impinge directly on international trade, finance, or pricing. It is impossible that any system will satisfy every participant completely because both goals and structures may be simply irreconcilable, and the system must impose one or modify all of them. The greater the number of countries, and the more disparate their economies and their national systems, the greater the likelihood of inconsistencies. The tighter the constraints imposed by the economic situation and the greater the importance of international transactions to the national economies the less willing will countries be to accept compromises. It is probably not practical, therefore, particularly at present, to think in terms of finding a generally acceptable proposal for a complete reform of the present system. It is possible to identify some areas in which it appears to be particularly unsatisfactory and some groups which have particular needs which are not being met.

As was suggested in the introduction, it is necessary to consider how important the inability to resolve these issues is. It is argued (for example Bergsten, Williamson 1982) that the present economic difficulties, particularly the problems for trade policy arising from floating exchange rates, make some progress on solutions 'essential'. It is clearly true that the growth of national intervention and restrictions can become a spiral of controls, which becomes increasingly difficult to reverse, or even stop, the longer this is delayed. Even if this is true of trade controls, a general solution and policy coordination are not the obvious answer, first because there would be no agreement on the interrelations involved (the depression or sectoral domestic policies or the rejection of macro-economic goals are at least as likely candidates as floating exchange rates in this example); second because this would probably be the most difficult and slowest solution, because it would involve more types of interest and institution than a single issue one.

A second general issue to consider is whose interests the system (and any modifications) is designed to serve and specification of the alternative. Compared with the model GATT/IMF system of rules, inter-government coordination may increase certainty for governments, but reduce it for private participants; increase it on outcomes (if it is efficient) but decrease it on mechanisms and types of intervention. Compared to the present regime of some rules and some government-to-government negotiation, it may reduce it on outcomes (if the strongest no longer always prevails) and increase or decrease it for private participants, depending on which elements of the present system it replaces.

The present system does appear to offer more scope for the developed countries to coordinate their interests among themselves and to some extent control interrelations, than it gives to the developing. This suggests that there is a place for a more formal UNCTAD or perhaps several smaller groupings for different areas or economic interests. One of the clear trends among the developed country organisations is for the largest to spawn more effective subgroups. There are issues in relationships among developing countries, and the impact of these on their own economies, which cannot fit into the general organisations.

The effective participation of the developing countries in international management of the system has declined since the original establishment of the IMF and

GATT because of the growing role of the purely developed country groups and because of the growing removal of some issues from international organisations to bilateral negotiations. Reversal of these trends could involve some conflict of interests with the more powerful groups, but the structure and the principles (including non-discrimination) are still in existence, and might provide a starting point for such a move. In a wider sense, it is clearly desirable for all because of the potential for distortion and economic inefficiency if the interests of the majority of nations are not actively represented.

There has been a decline in the role of rules and automatic mechanisms. A revival of GATT rules, or the use of its mechanisms for setting disputes, a return to the level of automatic financing given by the initial levels of the IMF first credit tranche, or by increases, even general ones in liquidity through SDRs (especially now that bank financing has withdrawn from its temporary assumption of this role) would not be seriously against the interests of any country. The GATT rules may run into national sectoral interests, but even a modest recovery from depression or change in the nature of domestic policies would reduce these pressures.

Greater recognition of where potential conflicts of interest may exist, and of the dangers of cumulative reactions may be one of the most useful reforms. The experience of the EEC has shown on a regional scale how far consultations can be an effective substitute for formal policy coordination in ensuring that inconsistencies are if not avoided, at least foreseen and their effects mitigated. Although they retain complete independence, the staffs of the World Bank and the IMF have always worked closely together, both in individual countries and on general questions. On a more specific level, the possible conflicts on structural adjustment lending were made subject to a Memorandum of understanding between the two organisations.

There is, however, a surprisingly total lack of formal coordination between the IMF and the GATT. Even the limited potential for joint action in their terms of reference has not been used. The IMF conditions limiting further restraints on trade follow a standard form with no provision for involving GATT in suggesting reforms in line with current trade negotiations. Although some of the balance of payments difficulties faced by borrowing countries may be at least agrravated by restraints by other countries on trade, the IMF does not attempt to secure changes in these through the GATT

machinery (or any other means). The one part of the original concept of the GATT which did provide for both the use of trade restrictions for balance of payments purposes and a direct role for the GATT organisation, the 'scarce-currency clause', has not been used. It was designed to deal with a special problem, dollar scarcity after the War, but it was never adapted to provide a semi-automatic discriminatory weapon against other countries in special trading positions, thus leaving all balance-of-payments problems to the IMF.

As with the IMF and the World Bank, the GATT and the IMF should be required to consult each other on particular issues in their relations with individual countries where both trade policy and balance of payments questions arise and also to discuss on a regular basis the general economic situation and the broad orientation of their organisations' policies. These discussions could also include the OECD and UNCTAD (or the suggested little UNCTADs)as recognised pressure groups for their respective members on the issues facing the two world organisations.

These changes could ensure that consultation was regular, not crisis-related, and that it involved representatives of all the members. The present reliance on overlapping memberships of the most important committees gives too much weight to the developed countries.

In general, a problem-by-problem approach, using the existing organisations, but more effectively and consistently, is likely to be more acceptable to all countries at a time when they are particularly concerned to protect their own interests than setting up new more powerful international organisations. Maintaining the present responsibilities, of both the international organisations and national governments also offers some assurance that the new arrangements will not embody new gaps in coordination, within a particular subject or country.

Renewed use of the existing organisations will in itself shift the balance back from national to international approaches, and from arbitrary and unforeseeable policy changes to a more stable environment. A more radical reform would at once be harder to achieve and in itself create uncertainty, perhaps only temporarily, but at a particularly dangerous time.

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THE EVOLUTION OF THE INTERNATIONAL MONETARY FUND TOWARD A WORLD CENTRAL BANK

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I. Introduction

Sooner or later one country after another developed or created a national central bank to preside over its national monetary system. As the world becomes more interdependent are we likely to see a similar evolution at the global level? Should we encourage it? This paper will try to address the parallelism between central banking at the national level and at the global level, and also the differences, focusing on the International Monetary Fund. It will suggest the incipient characteristics of a world central bank in the IMF as it is currently constituted, and it will suggest how these characteristics might be developed to transform the IMF into a full-fledged central bank.

The next section of the paper sketches the principal characteristics and objectives of national central banks. That is followed by a discussion of the IMF as it is currently constituted. Section IV then draws a number of parallels between the present IMF and central banks. Section V considers the possible evolution of the IMF into a full-fledged central bank along several different dimensions.

II. National Central Banks

The notion of a central bank has evolved over time, and it is still not completely well defined. Some central banks emerged from leading commercial banks, like the Bank of England. Others, such as the Federal Reserve System, were brought into existence by statute with a central banking role in mind. But even in the latter case the actual functioning of the central banks has evolved extensively with the passage of time.

We must look at the structure, objectives, instruments, and governance of national central banks. The structure of most central banks is like a commercial bank, from which many evolved. Like a bank, but unlike a business enterprise, the activities of central banks revolve around their balance sheets. On the asset side are its financial investments - typically of very short

maturity - allocated among domestic assets, claims on government, and claims on foreign countries (its international reserves). The liabilities of a central bank are typically deposits of commercial banks and the government, plus the notes issued to the public. The core of central banking is the manipulation of these assets and liabilities. Central banks have other functions as well, however, notably regulation of commercial banks to assure their soundness.

The instruments used by a typical bank include buying and selling securities against its own liabilities, in the process of which it creates money. This can be done at the initiative of the central bank, as in open market operations, or at the initiative of the seller of the securities under rules and conditions laid down by the central bank, as in rediscount operations. The central bank may change the conditions, and especially the interest rate, under which it rediscounts. It may also commit itself to a regular pattern of purchases or sales of securities. It implicitly does this when it adopts a fixed exchange rate between its currency and that of some other country, implying that it will buy or sell foreign exchange against its liabilities to limit movements in the exchange rates. Or it may engage in steady predetermined purchases of some assets to provide for a steady growth in the domestic money supply.

Under the laws of many countries the central bank can also instruct commercial banks or other regulated financial institutions on their portfolios, for example, as regards their foreign exchange holdings (as under exchange control regulations) or credits to private business.

It took about two centuries for the Bank of England to evolve from a commercial bank with special responsibility for financing the government to the exclusive issuer of notes to the public (except for the Scottish clearing banks), holder of the nation's gold reserves, and lender of last resort to the banking system. The last function involves a willingness to buy high quality assets from commercial banks against its own deposits - at a penalty interest rate. John Maynard Keynes complained in the 1920s of the limited role of the Bank of England, and urged it to manipulate its balance sheet so as to stabilise the price level rather than focusing exclusively on the exchange rate. 1/

The Federal Reserve System came into existence in 1913 as a consequence of the banking panics of the 1890s

and of 1907. It was designed to provide an efficient clearing system, to regulate the commercial banks, and to provide a lender of last resort. The note issue in the United States had in practice already been taken over from commercial banks by the U.S.Treasury, but the Federal Reserve System was given that function for large denominations as well. As early as the 1920s the Federal Reserve System adopted practices different from those that had guided the Bank of England: it "sterilised" the impact on the domestic money supply of the inflow of gold from abroad to prevent excessive monetary growth from raising prices and destabilising the economy. Thus it began the process of economic stabilisation.

By the mid-1960s modern central banking seemed to have settled down into a pattern. The main instrument of policy was open market operations, although central banks had other instruments as well. Part of the art of central banking has been to maintain an aura of mystery around its objectives and how it pursues them. Most central banks have succeeded in creating a certain ambiguity about their objectives and the weights they attach to them. Nonetheless, based on testimony before the Radcliffe Committee, Richard Sayers could describe the objectives for the open market operations of the Bank of England in the following way: 2/ (1) the Bank seeks to protect the discount market and the banks from violent oscillation between stringency and glut of cash; (2) the Bank seeks a certain level of treasury bill rates, primarily in the interest of influencing international short-term capital movement so as to maintain the gold and foreign reserves at an adequate level; (3) the Bank seeks to influence the liquidity of the commercial banks; (4) the Bank has to manage the national debt in the sense that it has to arrange for issue and redemption of government securities and maturity distribution of the debt in such a way as to insure that the government can always meet its obligations, and to do this in such a way as to avoid an unnecessarily high burden of interest rate; (5) the Bank encourages an upward or downward movement in long-term interest rates according to which direction it considers appropriate to the underlying investment/saving propensities in the economy, although this is still probably a subordinate aim.

Notice that the focus here is on stability of interest rates, both short- and long-term, an objective that in recent years has yielded to much more focus on steadiness of growth in some variant of the money supply. The third objective stated by Sayers is ambiguous as regards the focus on long-term secular growth of bank liquidity as opposed to relatively short-run variation in liquidity to

counter business cycle tendencies in the private economy. The emphasis on managing the public debt is also noteworthy, the traditional function of the Bank of England, but one that is not shared by the Federal Reserve System.

The objectives of the Federal Reserve System are basically similar except regarding management of the government debt, for which it has accepted no responsibility since 1951, beyond the maintenance of orderly financial markets which make possible Treasury management of the public debt.

The Federal Reserve System is of special interest in the current context, because its creation entailed much controversy over the role of the Federal government in banking in the United States. The resulting structure of the Federal Reserve System reflects a compromise: it is composed of twelve regional reserve banks, whose stockholders are the commercial banks subject to regulation. In the early years of the Federal Reserve System these regional banks even maintained separate rediscount policies and rates. A seven-member Board sits in Washington, appointed by the President for fourteen-year terms, but responsible only to the Congress. Key monetary decisions are made by an Open Market Committee, which consists of the Board augmented by five of the twelve presidents of the regional reserve banks on a rotating basis. The Open Market Committee meets every three weeks. Regulations governing the commercial banks are promulgated by the Board, but executed by the regional banks. Unlike in some other countries, foreign exchange operations are under the control of the U.S. Treasury, but the Treasury has no decision-making powers with respect to monetary policy (except insofar as it can influence new legislation).

In contrast, the Bank of England is formally responsible to the British Treasury, although by tradition it has much autonomy. Central banks around the world run the spectrum in independence from the sitting government. In many cases central banks are merely the agent of the Minister of Finance. At the other extreme, the German Bundesbank is fully independent of the government in power, both as regards monetary policy and as regards foreign exchange rate operations, although of course it is sometimes in consultation with the government.

III. The International Monetary Fund

Although the IMF has sometimes been called a central bank for central banks, and it does perform that function to a limited extent, its role both in conception and today

is much more limited than is the role of a national central bank. It is worth stating in full the formal objectives of the International Monetary Fund as stated in Article 1 of its Articles of Agreement:

> The purposes of the International Monetary Fund are:
>
> (i) to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
>
> (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economy policy.
>
> (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
>
> (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
>
> (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
>
> (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

Four features of the operation of the International Monetary Fund are noteworthy:

(1) Member countries, which now number 146, including virtually all countries apart from the Soviet Union and some of its satellites, Switzerland, and Taiwan, deposit their currencies in the IMF in an amount defined by quota, which also defines each countries' voting rights. By recent agreement, the total quotas will be increased to 90 billion SDRs, just short of 100 billion U.S. dollars.*

(2) Member countries can draw on the currencies of other countries when they have a balance-of-payments problem. Allowable drawings are linked to quotas, with a current limit of 150 percent of a country's quota per year, and a maximum normal drawing of 450 per cent of quota. For extensive drawings, a country must work out a balance-of-payments adjustment program acceptable to the IMF.

(3) The IMF has general responsibility for "surveillance" over the rules and functioning of the international monetary system. The rules involve, *inter alia*, convertibility of currencies for current account transactions. Originally the rules also required that exchange rates be relatively fixed, but now they require only that national exchange rate policy is consonent with smooth functioning of the international monetary system. More generally, in accordance with its charter, the IMF is concerned with assuring relatively smooth balance-of-payments ajdustments to avoid persistent disequilibria in international payments.

(4) Since 1969 the IMF has been empowered to create a new international money for transactions among official monetary institutions, the SDR, and has actually created SDRs on two occasions, 1970 to 1972 and 1979 to 1981, to the total extent of about 24 billion U.S.dollars.

The governance of the IMF is unique among international organisations, along with its sister institution The World Bank, in having a representative form of government. Day-to-day management of the Fund is in the hands of a managing director, who reports to a board of 21 executive directors that meet thrice weekly. The 21 executive directors represent all the 146 members of the IMF. The Managing Director is formally responsible to a full Board of Governors, which meets once a year and whose votes in the ultimate decisions governing management of the Fund are weighted according to a formula (embodied in each country's quota) which is designed roughly to reflect both the importance of each country in the world economy and the importance of world trade for each economy.

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* The Board of Governors of the Fund reached agreement in early 1983 to increase quotas by 47.5 per cent, from SDR 61 billion to SDR 90 billion by end-1983, subject to ratification by members holding 85 per cent of votes. Ed.

IV. Parallels Between the IMF and a National Central Bank

One can see in the structure of the IMF faint glimmerings of a world central bank, but on close examination it falls far short of the role played by central banks in national economies. Like a national central bank, the IMF can effectively create international money in two ways: (1) through its lending operations, at the initiative of a borrowing country, because the Fund's use of currencies creates a "reserve position in the Fund" for the country whose currency has been drawn, and this reserve position in turn can be freely drawn upon by that country when it needs to; (2) through the allocation of SDRs, at its own initiative (i.e. following a vote of its members). In this sense the IMF is already a bank of issue. But in the case of the first channel of money creation, roughly analogous to the rediscount facility in a national central bank, the IMF's medium is national currencies. It issues its own liabilities, not to the borrowing country, but to the country whose currency has been borrowed. Polak has argued that the IMF could function with considerably greater simplicity, both of mechanism and of language to describe what is happening, by consolidating its General Account, which is available for normal drawings, and the SDR Account, which deals with creation of SDRs[3]. This would avoid the intermediating use of national currencies in Fund operations. We will return to this possibility below.

The IMF can even perform the lender-of-last-resort function as that term has been used historically. In particular, it can lend large amounts to a particular country that is in balance-of-payments trouble. True, normal borrowing is limited by each country's quota. But in extreme circumstances these limits can be waived by a vote by the Executive Board. Then the limit is simply total available IMF resources (that is,its usable currencies) for these purposes.

The SDR-creation mechanism cannot be used for such emergency lending, because the decision-making process for creating SDRs is a complicated and prolonged one. And SDRs must be allocated to all member countries, not selectively. But we should recall that while the Bank of England and other central banks historically could issue their own liabilities as lender of last resort, they could not do so without limit. In some cases there were legal limits on the creation of their liabilities; but even when there were no such limits, they feared the loss of gold, or other reserves, which were held in limited supply. Thus the IMF

in this regard stands at a certain point of the historical evolution of national central banks, but it has not reached the present state of national central banks where there is in principle no limit to the support that they can give to their banking systems. We will return to this point below, to clarify certain misunderstandings about the lender-of-last-resort function.

On the regulatory side the IMF also performs the function of a rudimentary central bank, but here its authority is even more limited than it is as a bank of issue. Its members are sovereign states, bound in principle by the Articles of Agreement, but with no enforcing authority. The IMF can enforce to a limited degree by making its loans conditional on specified changes in behaviour by the borrowing countries. This practice, known as conditionality, is resented around the world, but it follows closely, *mutatis mutandis*, the behaviour of national central banks. National central banks universally set down the ground rules on which they will lend to commercial banks. Often they designate certain high quality paper as "rediscountable" without question - the analogue to low-conditionality lending by the IMF, although without the collateral that the rediscountable paper offers - but even those designations can be altered. Beyond that a central bank will examine the portfolio of a commercial bank that desires to borrow, and perhaps will require alterations in it. In addition, central banks have the authority to direct portfolio changes by commercial banks even when they do not come to the central bank to borrow - by changing reserve requirements (in the United States), by requiring special deposits, by placing ceilings on certain kinds of credit, and so on. The legal set up within nations requires compliance by the banks if they want to continue to operate. The IMF has no analogous authority at the international level. Its Articles do however decree certain general norms of behaviour that members are expected to follow, and it does have the authority to designate national currencies for its own use in its lending operations.

There has been a debate from the beginning over the balance to be struck in the IMF over the degree of IMF guidance on economic policies appropriate for member states. The original (1943) American plan for what later became the IMF, proposed by Harry Dexter White, the chief American delegate, gave the proposed new institution wide supervisory powers over domestic economic policy, even the power to alter exchange rates. Writing in January 1944, J.M.Keynes described the then U.S. views: "In their eyes (the new Institution) should have wide discretionary and policing

powers and should exercise something of the same measure of grandmotherly influence and control over the central banks of the member countries, that these central banks in turn are accustomed to exercise over the other banks within their own countries."4/ Keynes' reference to "grandmotherly" was no doubt a gentle allusion to the role that the Bank of England, the "old lady of Threadneedle Street", played with respect to the British banks; and on occasion "grandmother" was more like a stern father. What actually emerged in the IMF involved a good deal less discretion and power than White had originally proposed - on reflection Americans could not accept the wide powers involved in his plan either - but a good deal more than Keynes would then have preferred, and than he thought he had negotiated. Some form of conditionality, that is, tightening down on the economic policies of countries that borrowed from the IMF, was necessary because the IMF resources were much more limited than Keynes had proposed. Moreover, even Keynes was prepared to see quite strong IMF discretionary powers with respect to borrowing countries once they had drawn more than 50 percent of their very large quotas under his plan.5/

V. Possible Evolution of the IMF Toward a World Central Bank

In speculating on how the IMF might evolve further toward a world central bank, it is necessary to specify the institutional setting in which this is to take place and the motivations for economic behaviour that can possibly be influence by an XIMF - an expanded IMF.

The relevant time horizon is taken to be roughly the next 20 years. In this period the world will continue to be made up of sovereign nation states with autonomous national monetary policies. Exchange rates among currencies will in principle float against one another, but there will be increased perception of economic interdependence and the need to coordinate various aspects of economic policy. This perception will lead *inter alia* to heavy management of exchange rates and acceptance of the implied restraints on the exercise of full monetary autonomy.

The key behavioural assumption is that world reserves can influence world economic activity, at least for a time. The mechanism operates through national government policy, rather than directly on private transactions, although if the SDR's use is broadened to include private holding there might also be some influence directly on commercial bank lending and hence on private economic activity.6/ More will be said on this point below. A more

generous level of world reserves will result in less restrictive economic policy by member countries, and vice versa. The process is limited in time, however, because of the presence of "reserve sinks", that is, large countries that determine their policies more or less independently of reserve levels, and who if necessary are willing to accumulate reserves without relaxing their economic policies.7/ Most countries, however, are assumed to be constrained by foreign exchange, so that an augmentation of reserves will permit relaxation of trade controls and/or macroeconomic restraints. By the same token, a reserve contraction will have the opposite effect, where "contraction" need not mean a literal decline in world reserves, but only reserve growth less than the normal growth in demand for reserves.

So long as the IMF does not have a monoply on international liquidity, however, its influence will be heavily conditioned by what is happening in private financial markets as well, since most countries can add national currencies - mainly the U.S. dollar, but also other currencies such as the German mark, the British pound, the Japanese yen, the Swiss franc - to their reserves by borrowing or by earning them from other countries that have borrowed them. This possibility raises the interesting question of whether there is an asymmetry in influence. Perhaps the IMF can stimulate world demand, but cannot restrain it when private markets are ebullient. This would reverse the British economist Dennis Robertson's dictum concerning national monetary policy that "you cannot push on a string". He thought monetary policy could restrain demand but could not stimulate it.

The exact role of the SDR is crucial in assessing potential IMF influence on world monetary conditions. At present it is only a minor supplement to international reserves, amounting to less than 5 per cent of world reserves even if gold is valued at (artifically low) official prices - and considerably less if monetary gold is valued at (artifically high) market price. Nor is it used extensively except in transactions with the IMF itself. Indeed, by late 1981 a quarter of total SDRs created were in the Fund's own general account. There is no general disposition at present to increase vastly the role of the SDR.

Professor Kenen has correctly pointed out that the SDR is not likely to be wanted extensively by central banks until it is integrated into the actual method by which international settlements take place, that is, through intervention in foreign exchange markets. Kenen would have the IMF encourage more extensive private use of SDRs.

To this end he proposes setting up a new Clearing House to which central banks could transfer SDRs in exchange for deposits of national currencies by their commercial banks with the central bank.[8] In this way commercial banks would effectively have access to SDRs and could begin to deal in them. Once private use of SDRs was widespread, central banks could intervene in foreign exchange markets through the medium of SDRs, and demand for SDRs as reserves would rise relative to the desire to hold national currencies as reserves. Kenen's proposal is ingeniously designed to avoid an amendment to the Articles of Agreement, which now limits holdings of SDRs proper to official institutions, of which the Clearing House would be one. If the commercial banks began to trade extensively in SDR-dominated claims, based on their SDR claims on the Clearing House, that would represent the beginnings of fractional reserve-based deposit banking on a world scale, and IMF issuance of new SDRs(or transfers into the Clearing House by other official holders) could then influence bank credit, and hence economic activity, directly rather than only indirectly through alterations in government policies.

As noted above, Polak has sketched a revised IMF that integrates the general account and the SDR account, basing both on SDRs, and shows that this could simplify the IMF considerably without changing fundamentally its mode of operation. SDRs would replace the current reliance on national currencies. This change would however require an amendment to the Articles of Agreement, and if that were done the amendment could be extended to allow private holders, in particular commercial banks, to hold SDRs directly in the IMF, rendering Kenen's Clearing House unnecessary as a device to avoid amendment. The implied division of labour between the Fund, dealing with official institutions, and the Clearing House, which would deal with commercial banks and other private financial institutions, might still be desirable even if the Articles of Amendment could be altered to permit private holdings of SDRs.

Polak's scheme does entail one important substantive change: the IMF would no longer depend on contributions of national currencies to support increases in quotas. It could simply, under the amended Articles, create SDRs in order to meet calls on it by would-be borrowers. In this respect it would represent a strong move closer to a true central bank. However, its ability to create SDRs in this way would (under Polak's scheme) still be limited by the quotas of the member countries, which would be added to their acceptance limits under the current provisions for SDR creation.

We turn now to five central bank functions and ask how the IMF might evolve during the next 10-20 years toward a world central bank with respect to each of them. Some have already been covered implicity in the discussion above; others involve new elements.

Lender of Last Resort

As noted above, in important ways the IMF already performs the function of lender of last resort. It cannot, however, create its own liabilities without limit under emergency circumstances, as a national central bank can. The scheme outlined by Polak would effectively permit it to do this, although full freedom to do so would also require elimination of acceptance limits on SDRs. But a word should be said about this central bank function, for it has been used too loosely in much recent discussion. The phrase arose, and is still used, in the context of meeting a liquidity crisis in a commercial bank, whose liabilities are more liquid than its assets and may be called faster than the bank can mobilise its assets to meet the calls. The central bank then steps in and "liquifies" the bank's assets by making a market for them, perhaps at a penalty interest rate. The function is not designed to bail out an insolvent bank, where liabilities exceed assets in value. Different remedies are necessary for that. In macroeconomic terms, applying the lender-of-last-resort function to the entire banking system, it is designed to accomodate a shift by the public in its demand for money, typically toward money issued by the central bank (e.g. currency). It is not designed to finance a run from all financial assets, including money, into goods.

The distinction between liquidity and solvency does not apply cleanly to countries. A country can find itself illiquid in the sense that it is short of ready-at-hand cash to meet its pressing obligations. But how is a country involvent? The natural extension of this concept, which is not without its problems, is that the country has borrowed abroad more than it can service in the long run. That is, national solvency involves maintaining some maximum relationship of external debt to GNP, properly measured; in terms of growth, debt should not grow more rapidly than the capacity of the borrowing country to service it.

By analogy with national central banking, the lender-of-last-resort function of the IMF should be to meet liquidity needs that arise in some context other than external borrowing in excess of what a country can service in the long run. The IMF is not designed to finance an excessive demand for foreign goods over the long period. In playing

its role of lender-of-last resort today, the IMF does not make this distinction explicitly,but presumably it is reflected in the adjustment programme worked out with each particular borrowing country. The main limitation on the IMF's ability to function today as a lender of last resort is its limited resources; it is simply not large enough to handle the United States as a borrower, or several medium-sized countries that need to borrow at the same time. The General Arrangements to Borrow had to be created in the 1960s to deal with the possibility of a U.S. borrowing; and in some of its recent programmes the IMF has made going ahead conditonal on substantial additional lending also by commercial banks.

A final remark is desirable to clear up a misunderstanding: the term "lender of last resort" has never meant "only lender of last resort." Central banks have often lent funds, directly or through the market, to the commercial banking system before it encountered a liquidity crisis. Similarly, the IMF can and should be able to lend well before a country reaches a liquidity crisis. The term simply conveys the notion that if a country has a liquidity crisis, an institution is available to lend what is necessary to see the country through a difficult period.

Secular Growth in International Liquidity

With a mechanism in place for creating the SDR, the IMF is able to add to international liquidity on a secular basis. Indeed, that was the rationale for the creation of SDRs in the first place, to supplement and ultimately perhaps to substitute for gold and national currencies in the growth of international reserves. Being able to influence international liquidity, however, is not the same as being able to control it. Control is impossible so long as countries are free to add national currencies to their reserves, as they are likely to be able to do for a long time. Within the 10-20 year time horizon of this paper, a prohibition on increments to foreign currency reserves is highly improbable. A more likely development is that countries whose currencies are used as foreign exchange reserves will come increasingly to appreciate the cost of this role for their currencies, especially in terms of their own loss of national monetary autonomy. They may even take steps to discourage expanded use of their currency abroad. But return to a one-reserve world, even if an extensive private use of SDRs is encouraged, is unlikely in the remainder of this century. The IMF can thus contribute to the growth of international reserves, and because it generates a claim that is no country's liability

it can control the growth of net reserves. But it will not in this period be able to control the growth of gross reserves without major and probably undesirable changes in the ways nations interact with financial markets.

Stabilising the World Economy

As noted above, the role of central banks in stabilising economic activity, as opposed to financial markets, came relatively late in their evolution. And even today it is not fully accepted as a legitimate function. Indeed, monetarists contend that central bank efforts to "fine tune" their actions in the interests of economic stabilisation are more likely to be a destabilising influence than a stabilising one, because of lags and uncertainties in the economy's response to a given monetary action. Be that as it may, the IMF could play a modest role in global economic stabilisation within the framework described earlier, of nation states constrained by external payments. In particular, three mechanisms for helping to stabilise the world economy are possible with only modest extensions of the present IMF.

First, the IMF could consciously vary the conditions on which it lends according to the state of the world economy. In times of world economic boom, the IMF could somewhat tigthen its conditions to all borrowers on the two-fold grounds of helping to cool the world boom and encouraging the borrowing country to adopt a stabilisation programme that does not rely for its effectiveness on a continuing world boom. By the same token, in periods of world economic slack the IMF would ease up on the conditions it imposes on all borrowers, compared with what otherwise would be imposed, thus helping to cushion or reverse the world recession. Such adaptation of IMF conditionality to world economic conditions might also include the interest rate charged on loans, although that would be less important than the stabilisation targets agreed with the borrowing countries. This kind of adaptation to world economic conditions would be analogous to a central bank's altering the conditions for rediscounting in response to the business cycle. Those adjustments have historically focused on the rediscount rate of interest, but other conditions, particularly as regards the quality of rediscountable paper, have also been altered as well.

Such behaviour by the IMF could not eliminate booms and recessions in world economic activity, for IMF lending would not be large enough in the foreseeable future to do that. But it could help to damp down fluctuations.

There are practical difficulties with this proposal. Countries would have to understand that, depending upon world economic conditions, they might be required to undertake stiffer actions than they did on some past borrowings, or than another otherwise comparable country did in the previous year. Acceptance of this variation would require exceptional understanding on the part of high turnover Ministers in the borrowing countries. Similarly, it is not easy to induce a bureaucracy of country desk officers to alter their criteria in a more or less uniform way according to general instructions from top management based on world economic conditions. But these are difficulties, not insuperable obstacles, and such variations in conditionality would be well worth introducing.

One feature of the present IMF does automatically alter lending conditions with world economic conditions: the compensatory financing facility. In a world slump, if export earnings fall below the projected level as defined by a five year moving average, countries can borrow under the compensatory financing facility with little or no conditionality. Recently this facility has been extended to cover increases in the prices of imported cereals. The facility has worked well, and over $11 billion had been borrowed under it by early 1983. But many countries exhausted their borrowing rights, which are limited in relation to quota, during the 1981-82 world depression. The compensatory financing facility should be enlarged to deal with such severe recessions. As the IMF is presently constituted, its resources ultimately pose a limit to the degree of liberality of the compensatory facility, along with other IMF lending. Adoption of the Polak scheme would deal with that. The IMF could lend SDRs through the compensatory financing facility as well as in its normal lending operations, and its total lending capacity would then be limited only by the willingness of member countries to accept SDRs in payment for their goods, a limit that is not likely to be binding during periods of world recession.

A number of proposals have been made for extending further the coverage of the compensatory financing facility. These include measuring export earnings, for purposes of drawing from the compensatory financing facility, in real rather than nominal terms.9/ Whatever the merits of this idea purely in terms of stabilisation, extension of the CFF in this direction would be imcompatible with the evolution of the IMF toward a world central bank. Banks of issue must deal in nominal, not real, values. Automatic unlimited financing of export shortfalls in real terms could lead to an acceleration of world inflation, with the IMF financing an ever increasing world price level in an attempt to compensate for a change in relative prices. This particular

reform is therefore undesirable in a setting in which evolution of the IMF toward a world central bank is considered desirable.

Third, the XIMF could issue SDRs on a counter-cyclical way, providing more in periods of slump and fewer or none in periods of world economic boom. If commercial deposits are developed in SDRs, along the lines discussed above, such variation in SDR issues could influence economic activity not only through its influence on government policies, but also by making the commercial banking system more or less liquid in terms of SDRs and thus by influencing private bank lending.

To move in this direction would require streamlining the procedures for SDR allocation to allow for year-to-year variations and to permit relatively quick decisions, instead of the prolonged process of bilateral consultation that now occurs for allocations that are to cover a period of 5 years.

Regulating National Economies

An important role for national central banks is regulating the behaviour of the commercial banks under their jurisdiction. The extent and visibility of this regulation varies greatly from country to country. The analogous role for the XIMF would be to regulate the economic, or at least the monetary, policies of its member states - in Keynes' words to exercise "a measure of grandmotherly influence and control over the central banks of member countries ". As discussed above, the degree of this control has been a source of controversy and disagreement from the inception of the IMF. Yet it is not conceivable to have a central bank that lends to its members, and creates money in the process, at the member's initiative, without some degree of control over the policy actions that influence the need for member borrowing and ability to repay. If this is granted, then the discussion must focus on the practical and detailed implementation of this general authority, and it is difficult to do so intelligently at a level of high generality. The particulars of the individual cases are decisively important. Given the strong resentment that exists, wrongly, in many parts of the world concerning IMF conditionality, however, it is difficult to imagine a consensus developing that would endow the IMF with more direct authority than it now has over national economic policies, which in their totality strongly influence world economic conditions. This means that the IMF's influence over world economic conditions is likely to remain relatively indirect, exercised along the lines already sketched above,

through alterations in conditonality and variations in SDR allocations. Direct coordination of national macroeconomic policy by the IMF, as Harry Dexter White once envisaged, does not seem likely in the forseeable future.

There is one dimension of policy coordination in which the IMF could perhaps play a more active role: management of exchange rates. There is widespread dissatisfaction with the last 10 years of floating rates. Much of this dissatisfaction is misplaced, in that it attributes to floating exchange rates difficulties in the world economy that were quite different in their origin. A return to fixed (adjustable peg) exchange rates among all major currencies is neither feasible nor desirable in the near future. At the same time, there is little doubt that some international cooperation in the management of exchange rates is desirable, and indeed it has already occured among some countries on occasion. The IMF is charged with the responsibility of exercising firm surveillance over the exchange rate policies of its members, to assure that they are consistent with the purposes of the IMF, set out in Article 1 reproduced above. The IMF could move more aggressively than it has to identify inappropriate exchange rates and even to define target zones or reference rates for member currencies. These designations would have operational significance insofar as they guided exchange market intervention by member states and insofar as they influenced market perception of where exchange rates ought to lie. The IMF could identify publically exchange rates that were out of line, whether or not it had specified reference rates, with a view to influencing both government and market behaviour.

The focus on exchange rates is not so narrow as it at first may seem, since the level (in a market system) and sustainability of any particular exchange rate depend <u>inter alia</u> on the entire array of member country economic policies but especially monetary policies. Thus a surveillance mechanism which narrowed variations in exchange rates would do so by implicity coordinating national monetary policies.

<u>Stabilising Markets</u>

A final function of national central banks has been to help maintain orderly markets. By analogy, in respect to member nation policies this issue has already been covered in the proceding section. But one might go further and ask whether the IMF should not invervene <u>directly</u> in currency and/or short-term financial markets when necessary to help maintain orderly markets. This activity would

require a major institutional overhaul of the existing IMF, which is not set up either for direct market intervention or to select and handle the financial assets that it would have to hold in its portfolio if it were to be a regular participant in financial markets. In a run longer than that under consideration here, such direct intervention might be something to keep in view as a future step in the evolutionary process toward a world central bank, but it goes even further in allowing the SDR to be held by private banks, and will not be considered further here.

Governance

If the IMF is to be moved toward becoming a world central bank, with greater authority and operational flexibility than it now exercises, who is the IMF to be responsible to for its actions? Under its present structure, it is responsible to its member governments as embodied in their Finance Ministers meeting annually. No doubt that could remain the basic arrangement for some time to come. But if the IMF is to be more actively involved in global economic management, judgments on the state of the world economy will have to be made more often than once a year, and Ministers are not likely to be willing (or politically able) to delegate responsibility for decisions on such weighty matters to the managing director or his board of executive directors. It will probably be necessary to institute some intermediating arrangement for making key economic decisions. Adaptation of the Interim Committee of governors, sitting on a representative basis, would be a natural way to accomplish this, although it is by no means the only possible way. The Interim Committee could extend its meeting times from two or three or even four times a year and sit as a kind of open market committee to guide the XIMF in its enlarged responsibilities.

VI. Concluding Observations

The IMF has already evolved extensively, and in general toward an international central bank, during the first 35 years of its existence. Its creators would be surprised at the authority it has developed during this period, especially as regards conditionality and its ability, albeit limited, to create reserves through its lending operations and through the allocation of SDRs. (They would probably be astonished, however, given its general success, to discover how small its resources have become relative to the value of world trade and other international transactions).

By the mid-1970s it was beginning to take a global view of its lending activities, rather than simply viewing them as a series of individual country problems. And by 1982 the IMF was insisting successfully that commercial banks must increase their lending to particular countries in support of IMF lending and stabilisation programmes if they were to be effective. By the year 2003 the IMF could have advanced much beyond this in its authority, unless its evolution is stunted by sharp disagreements over the basic philosophy that is to guide IMF actions, and over how it is to be governed.

THE REFORM OF THE INTERNATIONAL MONETARY FUND, WITH SPECIAL REFERENCE TO CONDITIONALITY

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Given a need to be brief, it is impossible for this paper to give adequate coverage to all possible reforms of the IMF. For example, no more than the briefest treatment is given here to questions of global exchange rate determination, the future role of the SDR, and specifics of increasing the usable resources of the IMF. What follows falls into three parts: (i) a statement of the case for reform; (ii) a discussion of the longer-term, 'systemic' directions of reform; and (iii) detailed consideration of desirable changes in the IMF's conditionality.

I. The Case for Reform

The general case for international monetary reform in contemporary conditions can be argued along the following lines. First, there has in recent years been an apparent ossification in international monetary arrangements even though the economic realities with which they have been striving to deal have been changing very rapidly. Not only has world trade grown much faster than total world output in the post-war period, but the last decade has seen an enormous expansion in international bank lending, with a well-known set of associated problems, not the least of which being the difficulties of ensuring adequate official supervision of some of this activity. An impression that arrangements and policies have become ossified is conveyed vividly by a re-reading of the 1974 report on International Monetary Reform of the Committee of 20, which identifies and seeks to deal with problems that remain unresolved today, and which contains many suggestions for change which have not been acted upon. In consequence of such neglect, we have today an apparent increase in the fragmentation and 'nationalisation' of policies impinging upon the international system, even though the underlying reality has been of increasing economic interdependence.

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*Much of this paper draws heavily upon the results of a research project recently concluded at ODI, with the participation of the present writer, Graham Bird, Jennifer Sharpley and Mary Sutton. This is recorded in the bibliography under Killick et al, forthcoming. Hereafter, this is referred to as 'the ODI study'.

It is thus not surprising that existing arrangements lack cohesion and consistency. For example, on the one hand deficit developing countries are advised to adjust their economies so as to eliminate unviable payments deficits while, on the other hand, the domestic and trading policies of the industrial countries, and the official financing they are willing to make available to support adjustment, are apparently inconsistent with the successful achievement of the very adjustment they advocate. A similar criticism could be made of recent pressures put upon commercial banks to maintain credit exposure in certain developing countries, without matching actions on the part of industrial-country governments to achieve the increase in world economic activity that would be necessary for a restoration of debt-country creditworthiness. A related incoherence lies in the reluctance of G10 governments to provide the IMF with the financial resources it would need if it were to be able to carry out the tasks the G10 insists is ought to undertake.

Related to this is an apparently diminished recognition in surplus countries of the symmetrical nature of payments imbalances - the logical impossibility that the deficit group of countries can reduce its deficits without a corresponding willingness by the rest of the world to see their surpluses scaled down.[1] As is shown later, the necessity for greater symmetry of adjustment was the principal theme of the C-20 report but there are few echoes of this in present-day discussions. This is perhaps partly because the greater flexibility in exchange rates should diminish, even eliminate, the asymmetry problem but in practice it has remained a large difficulty - with some surplus countries being reluctant to allow the necessary appreciation of their currencies. The asymmetrical nature of post-war arrangements is, of course, reflected in a distribution of voting power within the IMF which allows surplus countries (plus those who can run persistent deficits by virtue of being reserve-currency countries) a dominant voice in the councils of the Fund. They can with justification point out that they are dominant too in world trade and that it is their currencies which are on-lent by the Fund (it could hardly be otherwise), but the fact is that such a distribution of power can hardly fail to perpetuate the very asymmetry which remains one of the system's weaknesses.[2]

Another weakness - too widely accepted to need elaboration here - concerns the uncertain and unsatisfactory nature of global arrangements for exchange rate determination since the break-down of the adjustable peg system in the early 1970s. Even with 'dirty' floating, wide fluctuations around trend values in the exchange rates of

key currencies, unrelated to any but the most transient economic circumstances, have added to the costs and uncertainities of world trade and payments, although it must be added that available evidence does not point to large negative effects (see paper by V. Cable)*. That the asset-structure of global reserve assets is similarly unsatisfactory is another long-established and widely recognised criticism. It is now over 20 years since Robert Triffin's (1961) critique of the deficiencies of national currencies and of gold as reserve assets, and over a decade since the first allocation of SDRs as a potentially superior form of reserve asset. Notwithstanding the lip service which continues to be paid to the objective set out in the 1976 Jamaica agreement of "making the SDR the principal reserve asset in the international monetary system" the reality is that the SDR remains of little significance in total world reserves and the idea of the substitution account has apparently been shelved.

The ambivalence of the G10 towards the role of the SDR reflects a deeper ambiguity about the desirable role of the IMF itself. For while governments continue to affirm the importance of its objectives and while large global payments disequilibria certainly point to an important role for the Fund, member governments have been unwilling to prevent a major erosion in the size of Fund resources relative to the value of world international transactions. This is indicated by the following figures (taken from Killick _et al_, forthcoming, p.132) on the value of total IMF quotas relative to world trade:

1945	16.2%	1971	8.2%
1950	14.2%	1981	3.8%
1960	11.5%		

Even the recently-agreed 47½% quota increase in 1983-84 will probably only bring the ratio to around 5%. While it would admittedly be desirable to develop a more sophisticated measure, which would take account of changes in exchange rate practices, the existence of non-Fund forms of balance of payments support, the actual and potential degree of instability in international banking arrangements, the size of payments disequilibria and so forth, further reasons are given below for believing that the Fund's present and prospective resources are inadequate.

There is a strong case, too, for a fresh approach to the policy conditions built into the stabilisation programmes supported by the Fund's stand-by and extended facility credits.[3] For one thing, there is an increasing mis-match between the policy prescriptions and the problems to which

* See this volume pp. 57-84. _Ed._

they are addressed. The time has long since passed when the presence of a balance-of-payments (BoP) problem was prima facie evidence of excessively expansionary demand policies at home. A large part of the deterioration in the BoP of oil-importing LDCS has in recent years been attributable to deteriorating commodity terms of trade and rising real interest rates. These have sometimes been aggravated by weaknesses in the domestic productive structure, eg. poor lagging food production. Of course, demand expansion has continued to play a role too but it no longer characterises the problem. Yet, despite attempts in the late 1970s and early 1980s to adapt its programmes to the changed nature of the problem, since the second half of 1981 the Fund's conditionality has in most respects been very close to its conditionality, say, in the late-1960s, with primary emphasis on demand restraint.

This mis-match between the nature of the problem and the measures employed to deal with it results in a potentially high-cost approach to BoP adjustment, with the risk of large losses of output and employment. It is an approach which appears to conflict strongly with the identification in the Fund's Articles of "the promotion and maintenance of high levels of employment and real income and ... the development of the productive resources of all members as primary objectives of economic policy" (Article I (ii)). It carries with it the danger not only of large economic costs but of political destabilisation too. Indeed, senior officials of the Fund privately admit that it is fully aware of the risk of political destabilisation resulting from its conditionality but does not know how to avoid it given the constraints with which it is faced. One of the well-known adverse consequences of this is that member-governments are often extremely reluctant to seek the Fund's higher-conditionality assistance, fearing that the cure may be more hazardous than the disease. As has recently been observed, "The premier institution for adjustment cannot remain a place to be shunned by those who need it most".[4]

It is ironic to recall that the proposals which led to the creation of the Bretton Woods institutions were presented as ways of avoiding, through international co-operation, a repetition of the recession of the 1930s, since the current thrust of the Fund's conditionality (as well as its praise for the anti-inflationary policies of industrial countries) tends to aggravate a world recession through further reductions in aggregate demand. The timing of the 'tightening up' which occurred in conditionality during the second half of 1981 was singularly inappropriate in this respect.[5]

A further strand in the argument for a re-examination of conditionality relates to the changing nature of the countries which come to the IMF for payments assistance. From 1947 until about 1978 industrial countries accounted for about two-thirds of all drawings upon Fund resources; it is only in the most recent years that developing countries have come to dominate its lending activities, so that, as shown in Table 1, as at end-January 1983 all but three of current stand-by and extended facility credits were to developing countries and the value of these amounted to 84% of the total.[6] The significance of this shift is that the formative period for the design of the Fund's conditionality was a period when most of its lending was to industrial countries. While the Fund has sought to adapt the specifics of its programmes to country circumstances this has been a 'constrained flexibility' and programmes have throughout been designed within a rather narrow framework. Partly as a reflection of this, there are widespread doubts about the suitability of the Fund's approach to the circumstances of many developing countries. Indeed, senior members of the Fund's staff share these doubts and suggest that what many of these countries need is more development assistance rather than short-term payments support geared to programmes of demand restraint.

Perhaps the most persuasive case of all for change, however, is the accumulating evidence that fund programmes are not achieving their objectives. On the basis of the results of internal Fund reviews and of independent analyses the evidence suggests that, in the general case, Fund programmes have limited effectiveness.[7] There is a tendency for them to move payments indicators in desired directions, and to affect other variables in certain ways but these tendencies only occasionally pass standard tests of statistical significance. In terms of results which do pass such tests, the programmes appear to have a limited impact. More specifically, the evidence suggests that:

- programmes are associated with a modest short-term improvement in the current account but this is of low statistical significance;

- there appears to be a stronger tendency for the basic or overall balances to be improved, although the known statistical significance of the results is again low and the achievement often falls short of IMF programme targets, which are apt to be over-ambitious;

- there are indications that Fund programmes result in additional inflows of capital from other sources but the effect is not large and ambitious expectations are likely to be disappointed;

- there is no systematic association at all between Fund programmes and sustained liberalisation;

- programmes have not generally had strong deflationary effects but there are indications that negative growth effects were stronger in the most recent years;

- programmes probably result in a net short-run increase in the inflation rate, rather than the desired reduction, but significances are again low;

- both Stand-bys and EFF programmes are subject to fairly frequent breakdowns.

It is necessary to add that the evidence surveyed is far from uniform, depending upon the period, variables and methodologies chosen. It is also important to bear in mind the intrinsic difficulties of forming an assessment of the results of IMF programmes. On the other hand, the results summarised in no way depend upon some unique set of tests and the Fund's own assessments do not claim great success. To quote the most recent internal staff review (of Stand-bys in 1980 and Extended Facility credits in 1978-80):

> The Fund cannot be complacent about a situation in which almost half the cases have not shown any progress towards balance of payments viability. This may be no worse a record than in earlier years....

In an examination of possible sources of this disappointing outcome, one possibility that comes obviously to mind is that it was due to poor programme implementation. There is a good deal of evidence that implementation leaves much to be desired. The IMF has experienced large difficulties in securing governmental compliance with a number of its key performance criteria, especially since 1973, with fiscal difficulties being a major source of non-compliance. Presumably as a consequence of this, programmes appear to have a meagre effect on the key policy

TABLE 1

Stand-By and Extended Arrangements
In effects as of January 31,1983
(expressed in millions of SDRs)

Stand-By Arrangements	Date of Arrangement	Expiration Date	Total	Undrawn Balance
Argentina	Jan. 24, 1983	Apr. 23, 1984	1,500.00	1,199.26
Barbados	Oct. 1, 1982	May 31, 1984	31.88	19.51
Chile	Jan. 10, 1983	Jan. 9, 1985	500.00	378.00
Costa Rica	Dec. 20, 1982	Dec. 19, 1983	92.25	73.80
El Salvador	Jul. 16, 1982	Jul. 15, 1983	43.00	15.50
Gambia, The	Feb. 22, 1982	Feb. 21, 1983	16.90	-
Guinea	Dec. 1, 1982	Nov. 30, 1983	25.00	13.50
Haiti	Aug. 9, 1982	Sept.30, 1983	34.50	22.50
Honduras	Nov. 5, 1982	Dec. 31, 1983	76.50	61.20
Hungary	Dec. 8, 1982	Jan. 7, 1984	475.00	332.50
Liberia	Sept.29, 1982	Sept.28, 1983	55.00	50.00
Madagascar	Jul. 9, 1982	Jul. 8, 1983	51.00	20.40
Malawi	Aug. 6, 1982	Aug. 5, 1983	22.00	12.00
Mali	May 21, 1982	May 20, 1983	30.38	5.00
Morocco	Apr. 26, 1982	Apr. 25, 1983	281.25	84.37
Panama	Apr. 28, 1982	Apr. 27, 1983	29.70	29.70
Romania	Jun. 15, 1981	Jun. 14, 1984	1,102.50	652.50
Senegal	Nov. 24, 1982	Nov. 23, 1983	47.25	41.34
Somalia	Jul. 15, 1982	Jan. 14, 1984	60.00	35.00
South Africa	Nov. 3, 1982	Dec. 31, 1983	364.00	205.00
Sudan	Feb. 22, 1982	Feb. 21, 1983	198.00	128.00
Thailand	Nov. 17, 1982	Dec. 31, 1983	271.50	224.10
Togo	Feb. 13, 1981	Feb. 12, 1983	47.50	40.25
Turkey	Jun. 18, 1980	Jun. 17, 1983	1,250.00	190.00
Uganda	Aug. 11, 1982	Aug. 10, 1983	112.50	62.50
Yugoslavia	Jan. 30, 1981	Dec. 31, 1983	1,662.00	554.00
			8,379.61	4,449.93
Extended Fund Facility Arrangements				
Dominica	Feb. 6, 1981	Feb. 5, 1984	8.55	2.85
Dominican Rep.	Jan. 21, 1983	Jan. 20, 1986	371.25	326.25
India	Nov. 9, 1981	Nov. 8, 1984	5,000.00	3,200.00
Ivory Coast	Feb. 27, 1981	Feb. 22, 1984	484.50	153.90
Jamaica	Apr. 13, 1981	Apr. 12, 1984	477.70	149.70
Mexico	Jan. 1, 1983	Dec. 31, 1985	3,410.63	3,310.32
Pakistan	Dec. 2, 1981	Nov. 23, 1983	919.00	474.00
Peru	Jun. 7, 1982	Jun. 6, 1985	650.00	550.00
			11,321.63	8,167.02
		Totals	19,701.24	12,616.95

Source: IMF, *Memorandum*, 7 March 1983.

variables to which they are directed. In particular, while they do tend to bring about a deceleration in domestic credit, this has slight claims to statistical significance. If we accept the basically monetarist premise underlying the Fund emphasis on the control of domestic credit, it seems unlikely that they could expect to achieve strong BoP results from the limited deceleration they achieve in the expansion of domestic credit. What is even more damaging, however, is evidence indicating no more than a moderate connection between programme execution and the achievement of desired results. Thus the hypothesis that IMF programmes have little impact because of poor implementation receives only slight support from available evidence.

In the end and accepting the desirability of effective stabilisation programmes, the most persuasive argument for reform of conditionality, and of the global economic system within which it must operate, is simply that existing practices are not working well. There have, of course, been some recent changes, particularly in response to the dangers of commercial bank debt defaults by major Latin American borrowers.[8/] But they have been *ad hoc*, fire-fighting reactions to immediate problems, featuring little basic change and thus providing little assurance that similar crises will not recur. Indeed, as mentioned already, recent shifts in conditionality have been perverse, aborting some of the Fund management's attempts to adapt to changing needs. However, recent events have served to raise governments' awareness of their common interest in strengthened international monetary arrangements and have demonstrated that when the will is there changes can be achieved quite quickly. The present task is thus one of maintaining that momentum and of nudging it in the direction of systemic reform.

II. Systemic Reform

To start with the big questions, does the world need an International Monetary Fund. And, if so, in what directions should it develop?

A positive answer must surely be given to the first of these. Consider Article I of the IMF:

> The purposes of the International Monetary Fund are:
>
> (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

These remain objectives of the highest importance in the present-day circumstances of the world economy and an international institution is needed if they are to be realised. There are, moreover, strong practical reasons for promoting these objectives through reform of existing institutions rather than by starting *de novo*. The prospects for reform are dim enough without setting up the additional resistances that would be aroused by attempts to design a new institutional framework.

A prime need in present conditions is a reduction in the risks and uncertainties resulting from the scale and instability of global payments imbalances. What is needed, it seems, is for the Fund to take a view of a viable world pattern of current deficits and surpluses, given reasonable assessments of probable capital movements, and then to so co-ordinate the policies of both deficit and surplus countries as to achieve that viability. That such an aspiration may today sound unrealistic is a measure of the ossification referred to earlier, for it was precisely in this direction that the Committee of 20 *agreed* that the

system should develop. They advocated greater international surveillance and a system in which all countries would aim to keep their reserves within the limits of agreed 'reserve indicators', and they envisaged the IMF playing a more active role in determining the consistency and appropriateness of member-country policies. No doubt, the precise nature of the various suggestions included in their report would need modification to take account of subsequent changes (for example, reserve norms may not be satisfactory BoP indicators given floating or frequently adjusted exchange rates), but their desire to push the system in the direction of improved international co-ordination is now even more valid than in 1974. So too is the desirability of reduced dependence on national currencies and gold as reserve assets, and of regulating the expansion of global liquidity in contra-cyclical directions. On this, there is perhaps not much more to be done than to return to the thrust of the Jamaica agreement. It would, however, be desirable to regularise decisions about new SDR allocations by establishing an agreed set of guidelines to determine desirable levels and allowing the Fund management greater autonomy in making decisions about this.

Some emphasis is placed above on the asymmetrical nature of BOP adjustment as a deficiency of the present system. On this too the agreed recommendations of the Committee of 20 are illuminating and refreshing. It urged "more effective and symmetrical adjustment procedures"; that surplus countries, as well as those in deficit, needed to justify their policies to the Fund's governing bodies; and that "graduated pressures ... be applied to countries in large and persistent imbalance, whether surplus or deficit".[9/] The noted, though, that special provisions would be required for such cases as the Gulf oil states with very large export earnings and low import absorptive capacity. The Committee did not agree on the forms of "pressures" that might be adopted but for surplus countries the following were among the possibilities considered:

(i) A country could be subjected to a charge on reserve accumulations above a reserve norm or other specified level. The rate of charge could be graduated with respect to the size of the reserve accumulation and the duration of the imbalance.

(ii) Countries could be required to deposit reserves above a specified level with an Excess Reserves Account to be established in the Fund at zero interest. This pressure combined with the preceding one would amount to the payment

of negative interest on excess reserve accumulations.

(iii) All or part of future SDR allocations of a country in surplus could be withheld for a specified or an indefinite period.

(iv) A report could be published on the external position and policies of a country in surplus.

(v) Countries could be authorised to apply discriminatory trade and other current account restrictions against currencies in persistent large surplus, subject to any necessary modification in the rules or practice of the GATT. This would be the most extreme form of pressure on countries in surplus.

Of these, (iii) has the merits of combining a genuine economic incentive to avoid excess surpluses and of not being contingent upon the setting of reserve targets.

It was suggested earlier that the structure of voting power within the IMF's membership was itself a reflection of the asymmetrical nature of the adjustment process (see the paper by V. Cable on the failure of the provisions relating to the 'surveillance' of surplus-country policies as an effective means of bringing pressure to bear upon them*). Were adjustment to fall more evenly upon surplus and deficit countries there would be much to be said for a similarly more even-handed distribution of power. Of course, the interests of the major trading and financing countries must be adequately represented for the Fund to be viable at all. 'One country, one vote' is not an appropriate model - but neither is dominance.

In whatever way the voting is spread, there is also a question about the degree of political control over the day-to-day working of the Fund. At present the Executive Board meets on an almost daily basis and is highly intrusive, leaving a minimum degree of discretion with the management. In exercising such detailed control the member governments are no doubt paying the Fund the tribute of treating it as important but the effect has often been negative. It has, for instance, acted as a brake on the ability of the management to adapt Fund policies to changing conditions. It has also helped to politicise lending decisions in ways which have prevented the management and

*Op cit. Ed.

staff from applying the principle of uniformity of treatment across all member countries. As a result of politicking by Executive Directors some countries have received particularly favourable treatment (eg. Zaire, Pakistan, perhaps most recently Mexico and Brazil); others have been discriminated against (most obviously in the case of Vietnam, denied access to credits because of a de facto veto, notwithstanding its highly prudent fiscal and monetary policies). And while great care must be applied in likening the Fund to a central bank, it is noteworthy that the extremely short-leash political control of the Fund is in marked contrast with traditions in some countries which give their central banks a measure of freedom from political control. In any restructuring of the Fund it would be desirable to lengthen the leash, widen the discretionary powers of the management and de-politicise some of its decisions.

One type of decision that could be altered in such a direction relates to the size of Fund quotas and subscriptions. A simple alternative would be to make these automatically subject to annual adjustments, based on a system of index-linking to trends in world trade prices or to some more elaborate formula.

The last comment to be made under the heading of 'systemic reform' relates to the reference in its Articles that its resources may be made "temporarily" available for BoP support (I (v) on p. 9 above). No doubt "temporarily" is an elastic term but, as it has been interpreted, it has confined most Fund credits to disbursement over a single year, with a maximum of three years in the case of the extended facility. Without doubt, this is a major obstacle in the way of adapting the Fund to meet the BoP needs of many developing country members. If the Fund is forced to largely confine itself to short-term programmes in the context of a liberalised system of trade and payments, it must perforce concentrate on the contraction of demand, for that is the surest way of achieving quick results. Programmes which attend more to structural adjustment involve longer gestation lags and require longer-term support (as was recognised in the extended facility and, even more so, in the World Bank's structural adjustment lending programme). A simple deletion of "temporarily" from the clause in question might meet the point but the principle that needs to be positively affirmed is that the Fund's constitution and policies should be so designed that it can provide equally effective assistance to all members. That condition is not satisfied at present, which has led some to advocate creation of a new agency to fill the gap through which some ldcs currently fall. The preference here, however, is instead for a more versatile Fund.

III. The Reform of Conditionality

The Content of Conditionality

Although this is not a concept which lends itself to precise definition, the chief components of conditionality attached to a Fund stabilisation programme can be broken down into: (a) preconditions; (b) performance criteria; and (c) other measures written into the letter of intent. However, a number of additional components can be identified as aspects of conditionality - and as variables that can be made 'easier' or 'harder' according to how the Fund wishes its conditionality stance to vary over time. These include: (d) the degree of Fund flexibility over performance criteria and other programme components, ie. willingness to grant waivers or modifications (discussed shortly); (e) the proportion of the credit which is made available in the initial instalment, ie. the amount of 'front-end loading'; (f) the frequency with which performance tests must be met before the next instalment becomes available, ie. short-leash versus long-leash programmes; and (g) its willingness to provide medium-term EFF credits rather than one-year stand-bys. Of these components, preconditions are, on past practice, most likely to include exchange rate depreciations and interest rate reforms, perhaps also changes in the pricing policies of government and parastatal agencies and, less likely, to changes in taxation. As regards the performance criteria, these include standard obligations not to introduce or intensify exchange controls and, frequently, ceilings on the acceptance of new external debt obligations of specified maturities. However, ceilings on total domestic credit and on credit to the government (or public sector) are invariably the hard core of the programme.

Reference was made earlier to a tightening in conditionality in the latter half of 1981 and it is interesting to relate this to the various dimensions of conditionality. It appears that this took the forms of (1) greater insistence on preconditions; (2) reduced willingness to grant waivers and modifications; (3) reduced front-end loading, with a substantially larger proportion of credits being retained for the last instalments of the credits so as to maintain maximum leverage over programme implementation; and (4) shorter-leash programmes.[10] It is not known whether there was any move to lower credit ceilings and in other ways make the performance criteria and 'other measures' more onerous, although it would be consistent with the direction of change if such did indeed happen. There was also an associated move away from use of the EFF and back to conventional one-year stand-by programmes (which, however, could be set within the context of a medium-term succession of such credits). The extent of withdrawal from the EFF can be judged from the fact that

while there were five EFF agreements in 1979, six in 1980 and eight in the first half of 1981, there were only two in the second half of that year and one in the whole of 1982.[11]

The Case of the Extended Facility

The history of the EFF in some ways encapsulates the problems with Fund conditionality. The EFF was, in fact, one of the few recommendations of the Committee of 20 to be acted upon. It was set up in 1974 to meet the needs of countries in 'special circumstances of BoP difficulty' requiring support over a longer period than normally covered by stand-bys. The Fund staff presentations in support of the EFF provided a cogent statement of the need for the Fund to move towards medium-term programmes and towards measures that would act upon the structure of production and demand, as well as upon the level of aggregate demand. But while it was presented as a significant shift to more supply-oriented programmes, the conditionality associated with EFF credits in practice continued to centre around the Fund's traditional concern with demand management, with credit ceilings remaining the key performance criteria. Indeed, the evidence is that credit ceilings under EFFs tended to be somewhat *more* restrictive than under stand-bys.[12] Any policy conditions that related to supply-oriented measures were *additional to* the conventional provisions.

It has become the received wisdom that EFF programmes, at least during the period of expansion of 1979 to mid-1981, were particularly problematical, which, of course, is the justification that can be offered for the subsequent, withdrawal from this facility in 1981-82. However, careful review of internal IMF studies reveals a more complex picture. Briefly, it found that EFF programmes were somewhat more likely to break down than stand-bys; that they probably brought smaller benefits to the BoP than stand-bys when comparison was made with the pre-programme situation but that there was little in it when comparison was made with programme targets; and that they appeared to have a better record in maintaining economic growth and restraining inflation. Overall, the evidence did not provide much support for the view that results with the EFF had been markedly weaker than for stand-bys. However, it should be added that the EFF represented an unsatisfactory test of the validity of supply-oriented approaches to adjustment, being a half-way house between the Fund's traditions and a more thorough-going re-design of adjustment.

Suggested Changes in Conditionality

It is the cost of adjustment which turn an unviable BoP into a problem. The task, therefore, is to minimise these costs, relative to the size of the needed adjustment. Implicit in many of the criticisms of past Fund policies is the view that it has paid insufficient attention to the cost-minimisation task. The chief determinant of such costs is the extent to which adjustment is achieved through reductions in demand (and the associated losses of output and employment), as contrasted with an increased production of tradeable goods and services. Linked to this factor is the amount of financing that is available to support the adjustment programme and, therefore, the time available to achieve the necessary changes in output and demand.

Our most general recommendation, therefore, is for Fund-supported stabilisation programmes to be consciously set within a cost-minimising framework.[13/] This would carry a number of important implications. First, it would involve placing greater weight on the 'primary' objectives of growth, employment and development specified in the Articles, and accepting them as constraining the design of stabilisation programmes. The Fund already does this to some extent with respect to economic growth (and also price stability). On the other hand, it has always declined to take explicit account of distributional consequences when designing its programmes. While we accept that this is both a sensitive area and one on which it is often difficult to obtain firm evidence, sensitivity of subject-matter has not deterred the Fund from other policy areas. Moreover, its programmes frequently include measures which directly affect the distribution of income: changes in the pricing policies of parastatals, in the structure of taxation and subsidisation, in incomes policies. No doubt it is often necessary for programmes to be addressed to such measures but surely no rounded view of their desirability can be formed without explicitly assessing their likely distributional consequences? This is particulary true of the poorest members of society who must be protected from the potentially adverse effects on their precarious hold on life of the general need to restrain consumption. Quite apart from this, the distributional factor has a crucial bearing upon the likelihood that an agreed programme will be executed and sustained, as repeated difficulties over the reduction of food subsidies and devaluation have demonstrated.

The greater attention to costs advocated here should be further extended to a more systematic and explicit consideration of the political consequences of stabilisation programmes; indeed, one of the chief reasons for programme

breakdowns is that governments often perceive the political costs of carrying through a programme to be greater than the payments crisis to which it is addressed. While the Fund does form political judgements, it is weak in this area. There are both ethical and efficiency grounds for urging the Fund to strengthen its capacity in this area. At the moral level, and to quote Foxley (1981, p. 225), if one prefers an open, democratic society then policies 'that require a good deal of political repression to have a reasonable chance of success are certainly not a satisfactory solution'. At the efficiency level, programmes designed with sensitivity to the probable political consequences simply stand a better chance of being implemented.

Not the least of the advantages of the changes suggested above is that it would tend to narrow the differences between the objectives of the Fund and member governments. It opens up the possibility that a higher proportion of programmes could be arrived at by consensus, thus increasing the probability of successful implementation. More extensive employment of resident Fund representatives would also facilitate the achievement of consensus, as would a cessation of the practice by which the Fund mission brings with it a draft of the letter of intent (admittedly open to negotiation) setting out what is represented as being the government's programme.

Another general recommendation concerns the degree of variety in programme design. Although the Fund does seek to adapt programmes to specific country situations, it does so within narrow confines and there is a rather well-defined 'conventional' IMF approach, based largely on demand management and exchange rate depreciations. <u>We urge the use of a richer mix of policies</u> and acceptance of the principle that programmes must be designed to address the causes of the problem in question. Demand-control programmes addressed to 'structural' problems are apt to be high-cost solutions; just as 'supply-oriented' programmes are in the face of deficits resulting from excess money creation. In our view, country circumstances vary too much for any standard approach to be appropriate.

Next we urge that the Fund should move away from its emphasis on quantified performance criteria and concentrate instead on achieving a consensus with member governments about the <u>policy measures</u> necessary to achieve the desired stabilisation. A shift towards achieving a consensus on policy changes would carry a number of implications. It would require substantial give and take among <u>both</u> parties, including more flexibility on the part of the Fund than it has sometimes shown in the past. It would also require more

time, or a more continuous interaction between the Fund and the government, than has typified past stand-bys. For this and other reasons, we favour more extensive use of resident Fund representatives.

The case for dispensing with quantified performance criteria in a wide range of circumstances relates to the attention biases they create; the large margins of error to which they are subject; the sometimes rather tenuous connection between them and the economic variables it is desired to influence; the barrier they may set up against a rounded judgement of the overall extent of programme execution. Instead, continuing access to Fund credit should depend upon an overall judgement about the extent of programme execution - what are known in Fund parlance as 'review clauses' - rather than upon observance of conventional performance criteria.

There would, however, remain a role for quantified indicators of programme execution so long as the uncertainties are small enough for them to be meaningful as indicators. Subject to this qualification, there is, however, a case for utilising a wider range of economic indicators than has been in the past. It is not typically the case any more that monetary indicators are the only tolerably reliable statistics which are quickly available. Monitoring these, probably in relation to a targetted range of values, could provide valuable evidence on progress with the programme and an early warning system when things are going wrong. When a red light is flashed, this could serve as a triggering device for a review mission from Washington to determine whether overall execution of the programme is sufficiently poor for the government to be declared ineligible for continued access to the credit until policy performance is improved.

A final general recommendation is to reverse the trend towards a relative reduction in the resources available within the low-conditionality facilities and specifically to increase the size and coverage of the compensatory facility (CFF). It is basic to any cost-minimising approach to BoP management that temporary deficits should be financed; only non-reversing deficits should bring into play corrective policy actions. This is, in fact, a widely accepted principle and one which is incorporated in the CFF.

The relative size of this facility has, however, declined over recent years and there is a good case for making more resources available under it by raising the quota limits on drawings and the percentage of shortfall

that may be covered. Furthermore, the logic of the CFF argues in favour of extending its coverage to include all aspects of externally generated short-term adverse movements in the income terms of trade. This implies compensation for import excesses arising from increases in import prices as well as against export shortfalls. While such modifications would assist countries in dealing with temporary payments problems, they would also ensure that where a deficit is persistent, ineligibility for CFF finance would drive the country towards the stricter conditionality facilities, even if the deficit results from external factors. Expansion of low conditionality lending through a modified CFF rather than through the first credit tranche has the advantage that it avoids the 'moral hazard' associated with the sub-market interest charges on some Fund finance. Without the external causation element contained in the CFF, countries might be encouraged to pursue over-expansionary domestic policies which result in access to relatively cheap, and in effect subsidised, resources from the Fund.

For expositional purposes, it is convenient to identify two polar cases of countries facing a (non-temporary) BoP problem. First, there is what might be called a 'classical IMF' problem, of a persistent deficit attributable largely to excessively expansionary fiscal and monetary policies. At the other extreme we may take the 'structural' case of a country confronted with an enormous increase in the unit cost of imports, a depressed foreign demand for its traditional exports and persistent, serious deterioration in the terms of trade, pursuing responsible fiscal and monetary policies at home. These factors may be aggravated by structural weaknesses of a more domestic origin, or such weaknesses may themselves be the principal source of difficulty - lagging agriculture; high-cost industry; an inefficient marketing system.

As regards the 'structural' problems, the type of programme required is one that places primary emphasis on improved capacity utilisation and on shifting the distribution of productive resources in favour of tradeable goods and services, plus supporting demand management policies. Essentially, what is being urged is a redesign and reactivation of the EFF - something which, therefore, it should be possible to accommodate within the Fund's existing framework of activities. The precise nature of this type of programme is specified in some detail in the concluding chapter of the ODI study (see Killick _et al_, forthcoming). Since it is possible fully to specify such programmes only in a country context, the Annex includes a specific illustration applied to the situation in Kenya as at mid-1982. The chief features of this are:

(a) It is set in a cost-minimising, growth oriented framework and is also designed to be consonant with the government objectives of poverty alleviation.

(b) It is a medium-term programme, designed to be executed over five years.

(c) The emphasis is upon a programme arrived at as a consensus, reflecting a genuine government commitment. We place some importance on the role of an IMF resident representative in this context, as also in monitoring the programme.

(d) A substantial number of measures to stimulate the production of exportable and import-substituting goods and services relative to non-tradeables are included, with at least the same status as other provisions of the programme.

(e) The inclusion, however, of supporting demand-management measures, including fiscal and monetary restraint, in recognition that the absence of such restraint could subvert the success of the measures directed at the productive system by preventing the necessary reduction in absorption (especially consumption) relative to output.

(f) Quantified performance criteria are replaced by a broader set of 'review indicators'. Performance under these indicators would not govern eligibility for continued access to the credit, as in the case of existing performance criteria, but - like these criteria - they would trigger a review mission whose job it would be to form a rounded judgement of overall progress with the programme and to make recommendations about continued access on that basis. A review mission could be despatched at the initiative of either the government or the IMF.

(g) There would be an agreed timetable of execution of all, or a large proportion, of the programme elements and explicit provision for the ways in which progress would be monitored.

(h) In addition to lending its own resources, the Fund would initiate actions to attract additional supporting finance from other multilateral, bilateral and, perhaps, commercial sources.

It is worth repeating that the type of programme just outlined is not presented as a new standard approach. The important principle is that programmes should be designed according to specific country circumstances. In practice these are likely to include some combination of excess-demand and structural weaknesses, and these will call for a blend of the Fund's traditional approach (subject to the various recommendations presented earlier) and of the type of measure just outlined.

Questions Arising

Inevitably, many questions are begged in the foregoing because of the difficulties of doing justice to the complexity within a brief paper. Most of these questions are, however, discussed in the concluding chapter of the ODI study; the procedure is adopted below is to give only brief reference to the discussion in the ODI study. Particular attention is drawn to the following:

(a) Consideration is given to the possibility that the Fund's conditionality should incorporate 'positive discrimination' in favour of the less developed countries. It is argued that the Fund should rather adhere to its present principle of uniformity of treatment but that in applying this it should pay more attention to countries' differing capacities to transform their economies.

(b) For the above recommendations to be feasible the Fund would require large increases in its usable resources (in addition to the pending increase in quotas). There is a variety of possible sources and we favour further quota increases, a new SDR allocation designed to provide extra resources for programmes financed out of the General Account, and further utilisation of the Fund's gold resources. Such increases in resources would be linked with interest-subsidy arrangements for the poorer (or least creditworthy) borrowing ldcs.

(c) The above proposals could be regarded as an attempt to transform the IMF into a long-term aid agency, and as obscuring the traditional division of labour with the World Bank. This is rebutted and it is argued that in order to carry out its primary task of providing BoP support the Fund must perforce move in the direction of longer-term programmes which pay more attention to supply-oriented measures.

(d) It can also be objected that the proposals would give the IMF too much power over borrowing-country policy, extending its influence from macroeconomic demand variables to microeconomic supply variables. The reply is that the macro/ micro distinction is unhelpful; that supply measures would not be additional conditionality, as they are with the present EFF; that they are offered in a context which would be structured so as to arrive at programmes by consensus; and that this type of difficulty does not appear to have been insurmountable in the case of the World Bank's structural adjustment programme.

(e) Put crudely, the suggestions are open to the objection that 'there's nothing in it for the industrial countries' - that it would require an additional transfer of resources to LDCS which would involve real and unacceptable costs to DCS It is replied that there is a common interest in a strengthening of the payments adjustment mechanism (and the international monetary system) and that, when there is much underutilised capacity in industrial countries, it is not apparent that there would be significant real economic costs.

One point not dealt with in the Annex on which some comment should be offered is the suggestion (by Cooper, reported in Williamson,1982) that Fund conditionality should be varied over time so as to have a contra-cyclical effect on the world economy. While sharing his criticism of the 1981-82 tightening at a time of acute world depression, the suggestion carries certain difficulties. It implies that some countries facing payments problems may be refused credits even though they are agreed with the Fund about what

needs to be done, on the grounds that there is a global excess of liquidity (as well as the contrary position in which a country receives a credit even though it has no adequate BoP programme, because of a global shortage of liquidity). A preferable principle would be that credit decisions should be made on the merits of the country case and that like circumstances require like solutions, both across countries and over time. A better way for the Fund to smooth out fluctuations in the world economy would be through the discriminating creation and withdrawal of SDRs according to global liquidity needs, although it is true that were it in a position to give large-scale support to many countries the Fund could not ignore the effect of its decisions on global liquidity.

IV. Conclusion

No attempt will be made here to summarise the foregoing. It must, however, be added that a paper confined to an examination of the reform of the IMF suffers from the disadvantage that what the Fund can and ought to do may only really be decided in a more general context which includes other aspects of payments financing, international trading policies, the roles of other monetary and financial institutions, and the economic policies of the major economies of the world. Just as the ability of deficit countries to achieve BoP adjustment is contingent upon the actions of the surplus countries, so suggestions concerning the policies and resources of the Fund can only finally be settled in the context of an overall view of the total flow of resources to deficit countries and the terms upon which these are made available. These matters are, however, outside the present terms of reference.

Footnotes

1/ This discussion admittedly glosses over the question of what definition of "deficit" is most relevant in this context. In loose terms, the objective must be to eliminate that part of current account deficits (surpluses) that cannot be matched by sustainable inflows (outflows) of capital.

2/ For an authoritative discussion of the dominance of the Group of Ten (G10) countries in the affairs of the IMF see Tew, 1982. Dell and Lawrence, 1980, discuss the asymmetrical nature of present-day arrangements.

3/ There are, of course, other Fund facilities which do not attract the same of conditionality, the most important of which being the Compensatory Financing Facility (although even with this there is apparently a greater tendency to associate access to the CFF with agreement to a higher-conditionality credit). Discussions of conditionality in this paper refers to the higher-conditionality stand-by and external facility credits, plus associated uses of the Enlarged Access Policy.

4/ From the second report of the Brand Commission (1983) p. 65.

5/ That such a 'tightening up' occurred is by now well documented - see chapter 6 of the ODI Study. See also Williamson's (1982) record of criticisms of the Fund for the pro-cyclical effect of this change.

6/ It is evident, however, that the economies of countries such as Mexico, Brazil and Argentina have many of the characteristics of industrial economies and continue to be classified as 'developing' largely as a matter of convention. This qualifies statements about the concentration of Fund lending in 'developing' countries.

7/ For published evidence see Beveridge and Kelly (1980); Connors (1979); Donovan (1982); Johnson and Reichmann (1978); Reichmann (1978); and Reichmann and Stillson (1978). Chapter 7 of the ODI Study also makes extensive use of unpublished Fund staff assessments, as well as drawing attention to the conceptual and practical difficulties of arriving at a definitive judgement.

8/ On this see ODI Briefing Paper No. 2, 1983, 'Developing Country Bank Debt: Crisis Management and Beyond'.

9/ These references are from pages 4-11 of their report.

10/ We suspect that there was also an associated tendency to increase the de facto conditionality for access to the Compensatory Facility by requiring prior agreement on a higher-conditionality programme but have been unable to confirm this.

11/ However, three new EFF credits were announced in the early months of 1983, including large ones for Mexico and Brazil. It is not clear at this stage whether this signals a more general rehabilitation of the EFF.

12/ Unpublished Fund statistics show the targetted deceleration of overall and public sector domestic credit to be both absolutely and relatively greater in 1978-80 EFF programmes than in 1980 stand-by programmes.

13/ The term 'cost minimisation' is admittedly being used loosely here, to describe a conceptual framework rather than any precise quantification. We do not intend to imply that all adjustment costs are capable of being measured in value terms.

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IMF REFORM: THE DEVELOPING WORLD'S PERSPECTIVE

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Introduction

This paper deals with the issues of the reform of the International Monetary Fund (IMF) under five major headings: (1) creation of international liquidity; (2) extension of payments finance and conditions attached thereto; (3) relationship with the commercial banks; (4) relationship with regional monetary groupings; and (5) participation in decision making by member countries. In the process of dealing with each of these issues, we have taken note of changes not only in the exchange rate regimes but also in the evolving balance-of-payments situation in general and of the developing countries in particular.

I. Creation of International Liquidity

The IMF was assigned an apex position under the international monetary system agreed upon at Bretton Woods in 1944. Its principal role was to oversee the arrangement under which each member country maintained the par value or exchange rate of its currency in terms of gold or the US dollar. Changes in exchange rate of up to only one percent on either side were allowed. Beyond that a member could change its exchange rate only in consultation with the Fund when its balances of payments was in fundamental disequilibrium, a situation that was never clearly defined.

The major sanction behind the Fund's supervisory role with respect to the exchange rates of member countries derived from the access each member country had to the resources of the Fund to finance its balance-of-payments deficit. The Bretton Woods system provided explicitly for the creation of a pool of currencies in the hands of the Fund. The pool was made up of the subscriptions - one-fourth in gold and three-fourths in the national currency - member countries made on the basis of their respective quotas fixed on the basis, principally, of economic size. It is out of this pool, it was evidently envisaged, that the Fund would, when necessary, sell the currencies of the

countries in payments surplus against the currencies of the countries in deficit. A deficit country's eligibility, however, to purchase currencies of surplus countries from the Fund was tied to its quota. Also such purchases were subject to conditions which varied directly with the ratio of these purchases to a deficit country's quota.

Whatever else one may say about the Bretton Woods arrangements, particularly now with the benefit of hindsight gained from the experience with these arrangements, one can safely say that in its conception the arrangements provided the Fund, at any one time, with liquid resources consisting not of the whole pool of currencies and gold placed by the member countries at the Fund's disposal but only of the gold plus the currencies of the surplus countries. Since, to begin with, the USA was the only major surplus country the resources at the Fund's disposal did not amount to more than 7 per cent of the aggregate imports of its member countries. As against that, the quotas taken together were 16 per cent of aggregate imports.[1/]

Although the provisions of the Fund's charter allowed it to generate liquidity, both directly as well as indirectly, the latter by borrowing from governments and the market, these provisions were invoked - and that too rather hesitatingly - after a lapse of some twenty-five years when the Bretton Woods system was on its last legs. Thus the access of the Fund to lendable resources was a limited one. Naturally, therefore, it constrained the Fund's ability to become a major source of finance to cover the payments deficits of the member countries.

Immediately after World War II, when the USA enjoyed large payments surpluses, it cycled back the surpluses which were not needed for enlarging its investments abroad to deficit countries. Major recipients of these recycled surpluses were the war crippled economies of Western Europe and Japan. Subsequently, when these economies emerged with payments surpluses, they used these surpluses largely to build up their exchange reserves by accumulating dollars and only marginally to encash them in gold. Thus it was again left largely to the USA both to cover its own payments deficits[2/] and to recycle them to other deficit countries in various forms.

When the US external position weakened somewhat as its reserves declined [3/] collective arrangements were agreed upon between the major industrial countries to extend help to each other in the event of excessive pressures. The General Arrangements to Borrow (GAB) was one such arrangement which was arrived at in 1962 between ten

industrialised member countries of the Fund.[4] Under this arrangement, the Fund was to set up a special facility for which it could borrow the currencies of these countries up to specified amounts for extending low-conditionality, low-cost finance to any of the countries in need of payments support. No non-participant was eligible for drawing out of this facility.

Thus, from the very outset resources placed at the Fund's disposal were so limited that it could not have been expected to extend any large-scale credit to deficit member countries. Was it because of the belief that under a regime of fixed exchange rates there would be little need for providing large-scale cover to member countries? Or was it that, for the generation of liquidity needed to cover the payments imbalances arising between member countries, it was intended to rely on one or two national currencies?

Those who were principally responsible for hammering out the agreement, namely the Americans and the British, who, as the Brandt Commission put it, had "for unique historical reasons" an unusually large influence in establishing the system and subsequently controlling it, should have known better from the experience of the inter-war years.[5] In the absence of satisfactory multilateral arrangements for the generation of liquidity the world was driven to relying on a country to meet the demands in liquidity by the creation of its national IOUs for use internationally. For this purpose, the country providing international liquidity has to either incur deficits on current account or make net investments abroad or, of course, do both in some combination. During the inter-war years this role was performed largely by the pound sterling. After World War II, the new system worked out at Bretton Woods surrendered this role to the dollar by making no arrangements for the Fund to create its own IOUs. When De Gaulle complained in the 1960s of the "exorbitant privilege" the system conferred on the United States of financing its deficits through the creation of more and still more dollars to be held abroad, he was not saying something new, he was only highlighting that an international monetary system relying on one or a few dominant national currencies to meet the requirements of international liquidity conferred enormous benefits on the countries issuing such currencies.

Such a monetary system, as Robert Triffin has been at pains to point out in his writings, is basically wrong because not only does it make the working of international monetary arrangements critically dependent on the decisions

of one or a few individual countries which can be highly erratic and unpredictable but also it entails a severely regressive distribution of resource transfer in favour of a handful of economically dominant countries. [6/] Not only are the developing countries altogether excluded from the benefit of such transfer but they also have to effect transfers in favour of the reserve-creating countries in the process of accumulating foreign exchange reserves. Thus, between 1944 and 1967, of the increase in non-gold reserves of the order of $ 20 billion, the benefit accruing to the developing countries (including the oil-exporting countries) can be placed at only $ 3.3 billion (i.e. 16.5 per cent)representing as it did the internationally created credit in the form of Reserve Positions in the Fund and SDRs allocations in their favour. Between 1967 and 1978, against the non-gold reserve additionality of $250 billion the corresponding benefit to the developing countries works out to $ 6 billion (i.e. 2.4 per cent).[7/] Even the above does not quite tell the whole story, because the developing countries have held an increasingly larger proportion of the world foreign exchange reserves. Between 1953 and 1978, foreign exchange reserves held by the developing countries increased by $ 112 billion. [8/] Thus nearly half of the resource transfer entailed in the generation of these reserves was from the developing countries to the developed countries, predominantely the USA.

Any major reform of the world monetary system must, first and foremost, attend to the question of generating reserves multilaterally. The attempts made so far in this context have been, as we shall note presently, not only half-hearted and peripheral but also extremely conservative and narrowly focussed with an almost pathological reluctance to break new paths. Attempts at multilateralisation of liquidity generation have taken the form of (a) enhancement in the quotas of Fund members and (b) allocation of SDRs. In addition, the Fund has engaged from time to time in (c) borrowing from some countries in order to increase its ability to extend credits; but it has refrained so far from (d) raising funds directly from the capital market although the capital market has engaged increasingly, in recent years, in financing of payments deficits on the strength largely of the funds it could attract from the surplus countries. The Fund also has (e) a stock of gold, a legacy from the old days when part of the quota subscription had to be paid in gold. This stock of gold has remained virtually sterile. In the rest of this section, an attempt has been made to indicate in the above order, the lines on which IMF reform could accelerate the pace of multilateralisation of liquidity generation from the point of view of the developing countries.

(a) Quotas

Fund quotas have not remained unchanged. They added up to only $ 9 billion at the start, at present they add up to $ 66.7 billion and are stated to rise to $ 99 billion by the end of 1983. However, as a proportion of the value of world imports, Fund quotas have been on the decline. To quote the Brandt Commission, "the ratio of IMF quotas to world imports, which averaged about 10 percent in the period 1960-65, is now down to little more than 4 per cent, though the sixth review of quotas has raised the level of quotas to SDR 39 billion and the proposed seventh review will increase them even further to SDR 58.6 billion".9/

The increase in quotas has the effect, no doubt, of raising the size of the pool of national currencies at the disposal of the Fund and thereby of improving its ability to extend payments support to its member countries in deficit. So it certainly can be said to multilateralise extension of international credit. But it cannot be said to multilateralise the generation of international liquidity. The generation of international liquidity remains the responsibility of individual countries. Fritz Machlup has aptly described the role of the Fund in disposing of the national currencies placed at its disposal as one of cloak-room. 10/

Still, quotas remain the principal source of the Fund's access to resources and if the view that this should continue to be the case prevails, expansion of Fund quotas will have to be pursued with vigour. Furthermore, if the choice were only between the generation of international liquidity by individual countries according to their own whims and fancies and its generation through the expansion of Fund quotas, there can be no doubt that the choice would have to be made in favour of the latter because then one can hope for the extension of credit to be (a) based on considerations less weighted down by national factors and bilateral relations and (b) less inequitous.

While it is true that the expansion in Fund quotas has occurred much more frequently in recent years than was the case in the past, the fact remains that in relation not

only to the expansion in world trade but also to the escalation in payments imbalances quotas have expanded rather tardily. According to an UNCTAD study, 11/ from an average of 84 per cent in the period 1966-70, the ratio of the quotas of the Fund members to the sum of their current imbalances fell 39 per cent in the years 1971-75 and to 27 per cent in the five years thereafter. Also, the Fund quotas have not kept pace with the expansion in international reserves and commercial bank lending. From 1970 to the third quarter of 1981, international reserves and commercial bank lending increased some seven times whereas the Fund quotas barely more than doubled. Naturally therefore the Fund's capacity to cope with payments imbalances has suffered a severe decline relative to other sources of payments finance.

As a first step to restore the Fund's role, urgent action will have to be taken to change radically the procedure currently followed for expanding Fund quotas. The present procedures whereby each expansion in quotas has to go through a process of reviews by the Fund management followed by approval at the levels of the Executive Board and the Board of Governors and has ultimately to be ratified by each and every government - the majority required is 85 per cent - make each expansion an independent, major decision subject to considerable non-economic pulls and pressures. As a result, not only is the time taken to complete every quota review long but also its outcome is extremely uncertain. It is necessary to provide, instead,for the regular expansion of quotas on the basis of agreed objective criteria, such as expansion in the value of world imports and the size of payments imbalances.

At the same time, the broader question about the role of quotas in determining the size of Fund resources cannot be overlooked in any discussion of IMF reform. The dominant view so far, that quota subscriptions should be "the primary source of the Fund's financial resources" is open to objection on several grounds. Experience has shown that, by being tied down to quotas, the Fund's resources failed to expand not only in relation to world trade but also sufficiently to cope with the demands arising from the switch over from the fixed to floating exchange rates in the early 70s. What should be a cause of serious rethinking, even though in retrospect, is that, while all fears with respect to the inflationary consequences of an uncontrolled expansion in international liquidity had been concentrated on the Fund, hardly any step was taken to restrain and regulate the expansion of international liquidity through national currencies and commercial bank credit. This way of managing world finance needs radically to be altered; to achieve this it will be absolutely

necessary that the Fund, if it is intended to perform a pivotal role in world finance, should be made the real fountain-head of international liquidity. In this context, quota subscriptions to the Fund will have to be treated more like the equity capital of a commercial bank and the Fund given wide powers both to create its liabilities or IOUs and thereby to generate international liquidity and also to regulate and restrain the generation of such liquidity in other quarters.

b.(i) Issue of SDRs

When the decision for the first issue of Special Drawing Rights (SDRs) was taken in 1968, it was heralded as a major step in the direction of multilateralising international liquidity and reducing the dependence for that purpose on national currencies. The Fund management itself had hoped at the time that when the allocation of the SDRs to the tune of 9.5 billion, then agreed upon, was completed, they would represent some 16 to 17 percent of the world monetary reserves and that as a consequence it would prevent the dependence of the world monetary system on the creation of currency reserves. Actually, by the time the allocation of SDRs was completed in 1972 the world foreign exchange reserves alone had increased to $ 104 billion. As a proportion of world non-gold monetary reserves, the SDRs stood at a mere 6 per cent in 1972. Inclusive of gold reserves, valued at market prices, only 4 per cent of world monetary reserves were accounted for by SDRs.12/

The second issue of SDRs to the tune of 12 billion, over a three-year period, 1979-81, could be agreed upon after a lapse of ten years, while the world financial system was flooded with liquidity generated by the national currency authorities and even more by the commercial banks. At the end of 1981, only 2.5 percent of the aggregate monetary reserves (including gold reserves) comprised SDRs in spite of the second issue. Thus not only were the hopes set initially on the SDRs falsified by the events but also the belief then entertained that the dominant view had at long last conceded the need for a substantial generation of international liquidity multilaterally proved to have a rather weak basis in reality.

It is important to note in our context that agreement on the issue of SDRs by the Fund was part of the package which stipulated at the same time how the SDRs would be allocated among the Fund's member countries. The SDRs were to be allocated to the member countries in the same proportion as their quotas. This meant not only that

almost 70 percent of the SDRs would be allocated to the industrial countries but also that the bulk, close to 60 percent, would go to countries with either payments surpluses or the privilege of financing deficits by issuing their own IOUs. By deciding thus, the Fund was clearly being denied the right to treat the SDRs as a source to be tapped for providing payments cover to member countries in deficit. On the other hand, it was being left to member countries to decide when and where to use the deposits thus created in each country's favour. Naturally, as Machlup has pointed out, it meant that while part of the newly created deposits going to deficit countries would "have a quick first round of spending", the part of these deposits going to the member countries in payments surplus or those who could issue their own IOUs would "never be used in even a first round of spending."[13] Thus, while of the quota subscriptions, subscriptions made in reserve currencies constitute the primary source of finance for the Fund's operations, in the case of SDRs the part allocated to the reserve currency countries is likely to remain altogether unused.

The SDRs can become an effective centre-piece of the international monetary system, if, as the Brandt Commission rightly urged, (a) "it becomes the principal means of increasing global liquidity" and (b) "it is itself used to improve the adjustment mechanism."[14] To achieve the first, it will be necessary to agree on the objective criteria on the basis of which SDRs can be created regularly and in sufficient quantities in accordance with what the Brandt Commission refers to as "non-inflationary demand for world liquidity". At the same time, further creation of national reserve currencies as well as new commercial bank lending will have to be severely curtailed.

b.(ii) Substitution arrangement

As for the problem posed by the massive overhang of national reserve currencies, in particular US dollars which account for close to 80 percent of the world foreign exchange reserves, the solution no doubt lies in pursuing the idea of a possible substitution arrangement. The idea of substituting SDRs for the reserve currency balances of the various monetary authorities is not new. Triffin, who has for long lamented over the system that permitted one national currency, namely the US dollar, to perform the role of reserve currency and forecast the emergence of a situation in which the dollar would continuously be faced with crisis of confidence is on record for having proposed large-scale replacement of dollar balances of the monetary authorities with appropriate internationally

created assets as part of a programme of international monetary reform.[15] Later, during the 1972-74 discussions within the Fund's Committee of Twenty, it was also recognised that suitable arrangements would have to be made for the substitution of excess holdings of dollars in the hands of various monetary authorities by SDRs as part of the reform effort in general and particularly in the context of an asset settlement arrangement, under which imbalances in payments of any country would not in future be settled by using its own currency. Unfortunately, none of the substitution account proposals has made much headway so far because of the inability to agree upon the asset settlement obligations of the countries now providing currency reserves. In particular, the US has shown no inclination to accept a reduction in the future reserve currency role of the dollar. During the 1972-74 reform discussion, the US was prepared to consider only such substitution arrangements as would offer to fund such of the dollar holdings of the other countries as are voluntarily surrendered and that too without accepting any limitation on its future method of payments financing. In more recent discussions when the substitution account idea was revived largely out of concern of countries like Germany and Japan which are reluctant to let their currencies play a major reserve currency role alongside dollars, the proposal had to be dropped once again because of the continued US rejection of any constraint on the privilege it enjoys of creating dollar liabilities abroad.

Whether the reserve currency countries, particularly the US, will be more or less receptive in the future to the demand for asset settlement obligation as part of a substitution arrangement is difficult to say. Going by the experience of the past ten years or so, the US position on the question seems to have hardened over the years. At least, there is no indication that it has softened. The substitution arrangement discussed in 1979-80 was far less demanding of the US than the arrangement which the Europeans mooted during 1972-74 reform discussions even though the overhang of dollars has become far more formidable in recent years than ever before notwithstanding the phenomenally large expansion of Eurodollar credit, by the US-dominated commercial banks no doubt, in the intervening years. It might be therefore quite unrealistic to assume that much progress can be made towards a substitution arrangement that requires the reserve currency countries, in particular the US to agree to any sort of asset settlement obligation.

In the circumstances, would it be worthwhile to pursue the substitution arrangement idea? In this context, it is important to bear in mind that, really and truly,

a substitution arrangement involves the creation of international credit with a view to funding the external obligations of the reserve currency countries. It is basically no different from that of rescheduling the external debt of a country. The difference is that the reserve currency countries have come to realise that the size of their external obligations is of less concern to them than to those who hold these obligations as their reserve. So, why should the reserve currency countries agree to limit the creation of their obligations in the future? It is the reserve accumulating countries which will first have to agree not to accumulate further reserves in the form of national currencies. This they will be more willing to do, the more they are attracted to the alternative offered to them in the form of SDRs or SDR-denominated claims. The Fund can do a lot in this regard by making the holding of SDRs and SDR-denominated claims sufficiently attractive to hold in terms of both yield and usability. It is not in the interests of the developing countries to keep the yield on SDRs low or to restrict the usability of SDRs.[16/]

From the point of view of promoting multilateral generation of international liquidity, it is important that any substitution arrangement must provide for adequate safeguards that the national reserve currencies do not expand at the same time and add to international liquidity. In other words, an effective and comprehensive asset settlement must be agreed upon before a substitution arrangement comes into effect. [17/]

b.(iii) SDR allocation

Not only have the issues of SDRs been small in amounts and far between but, as noted earlier, the allocation of SDRs on the basis of quotas is both inequitable and contrary to what any need-based criteria would suggest. The question of further issues of SDRs cannot therefore be divorced from the allocation formula. If quotas remain the basis for allocation, not only will every SDR issue aggravate the inequality in the distribution of multilaterally created liquidity but also every such issue will have to be far larger to meet a given estimated need for international liquidity than if allocation is need-based.

The case of the developing countries for linking the issue of SDRs to development finance and allocating therefore the SDRs newly issued by the Fund to the developing countries is primarily actuated by the objective of making SDR allocation need-based. The Brandt Commission fully conceded this case when it suggested that new SDRs should

be allocated to "countries which are most likely to experience balance-of-payments deficits and high domestic costs of adjustment and least likely to be able to finance them from alternative sources". Since "many developing countries fit into these categories", the Commission felt that there was "therefore a strong case based on efficiency as well as equity for a larger share of new unconditional reserves to be distributed to the developing countries than is achieved through allocations proportional to the IMF quota system". 18/

Still, it has to be faced that a possible major factor coming in the way of more regular and larger issues of SDRs is the strong, persistent demand for linking the SDR issue to development. To the extent this is valid, the developing countries may have to show some flexibility in this regard. This is a concession they will be making to the reality of world politics. That SDR allocation must be need-based cannot and ought not to be given up. But whether a need-based allocation must necessarily be in favour of countries regardless of their immediate balance of payments need, or in favour of an institution like the Fund itself, which can then dispose of the resources thus placed at its command according to objective criteria,with minimum relationship of member's access to quotas, is something that the developing countries should be prepared to treat as an open question.

(c) Borrowing from member countries

Although the Fund has, as indicated above, relied principally on quota subscriptions for the resources it requires to finance its type of payments support, it has, from time to time, entered into agreements with the member (and even non-member) countries to borrow temporarily both for special purposes as well as for supplementing its general resources. 19/ The earliest such arrangement, entered into in 1962, was, as stated earlier,the GAB specially devised for exclusive use by a small group of industrial countries (G-10) with a view to extending help to each other on soft terms and conditions but under the Fund's auspices. The Fund borrows from the participating countries in certain specified proportions as and when it needs to extend assistance to any of these very countries. Most recently, it has been decided to enlarge the GAB from $ 7.1 billion to $ 19 billion and to make its GAB resources available for conditional assistance even to non-participant countries.

In 1974 and 1975, the Fund entered into borrowing agreements with 17 lender countries, including Switzerland (which,though a non-member, also contributed to GAB) with a view to raising an amount of $ 7.6 billion for the Oil Facility which was set up temporarily to finance special low-conditionality Fund credits to countries with payments difficulties in consequence of the oil price rise.

In 1979, the Supplementary Financing Facility was established, funded by borrowing to the tune of $ 8.6 billion from 14 lenders including Switzerland. This was in response to the second round of oil price increases but the Fund credits to be financed out of this facility had to carry high conditonality.

As the resources raised for the Supplementary Financing Facility came to be committed, the Fund negotiated another set of borrowing agreements. The principal lender this time was Saudi Arabia which undertook to lend the Fund up to $ 5 billion annually for three years starting with 1981. Another set of 18 countries also undertook to lend the Fund a total amount of $1.5 billion over a two-year period. The resources thus raised by the Fund were again supposed to finance high-conditionality assistance to member countries under its policy on enlarged access.

The outstanding borrowing of the Fund on April 30, 1982 added up to $ 7.5 billion - 11 percent of the total value of Fund quotas. However, when the unused credit lines amounting to $16.5 billion are added to outstanding borrowing, the total was equal to 34 per cent of quotas. Since under the present guidelines for Fund borrowing the outstanding borrowing plus unused credit lines must not exceed the range of 50 to 60 per cent of quotas, the maximum amount the Fund might borrow additionally as from May 1, 1982 could not exceed $ 11.6 billion. [20] That, more or less, equals the amount by which the credit line to GAB has been raised. Of course, one has to make note of the provision that under the guidelines referred to above "in respect of the GAB either outstanding borrowing by the Fund under the GAB or one-half of the total credit lines under the GAB, whichever is the greater, has to be taken into account." [21] Therefore, of the enhancement of GAB by about $ 12 billion, only half will count towards determining whether the ceiling has been reached or not, so long as less than half GAB credit line has actually been used by the Fund. Also, with the enhancement in quotas to $ 99 billion likely to come into effect towards the end of 1983, the ceiling on Fund borrowing should rise by $ 18 billion. So the scope for Fund borrowing is not so bad, judging by the level of Fund quotas or even by the level of outstanding

Fund borrowing. However, if one goes by the pace at which the total drawings of the member countries have been rising - from around $ 3.5 billion in 1974 they have gone up to $ 7.7 billion in 1982 [22/] - or by the escalation in the payments deficits of the non-oil developing countries - the group that alone has, in recent years, resorted to the Fund - the increased borrowing that the Fund can rely upon, to augment its resources within the framework of its existing guidelines, will appear to be very modest indeed.

There are, in addition, two basic questions with regard to Fund borrowing. One concerns the linking of Fund borrowing to its quotas. If, as has been argued above, Fund quotas ought to be treated more like the equity of a banking company than as a yardstick to Fund borrowing, as at present, this practice cannot but be considered as extremely restrictive. The less the Fund depends on quotas to provide it with its major resources, and that is how it should be regardless of whether or not the proposition put forth later in this paper with regard to the re-distribution of quotas, the more it will be necessary to relax the limits on Fund borrowing. As a first step, the minimum immediately necessary action called for is to raise the ceiling on Fund borrowing to 150 percent of quotas to come into effect by the end of 1983. However, as a measure of basic reform, it would be advisable to delink Fund borrowing altogether from quotas and instead relate it to factors such as anticipated payments imbalances, the likely demand for Fund support and the Fund's access to other resources.

(d) Borrowings from private market

The second question concerns the sources the Fund should be allowed to tap for the purpose of its borrowing. The Fund has so far been restricted to borrowing from governments/monetary authorities, and, more or less, precluded from resort to the private market. Although lately it has been conceded that the possibility of the Fund resorting to the private market cannot altogether be ruled out, the dominant view has prevented this from coming about. At the same time, phenomenal expansion has been allowed to take place, virtually unchecked, in the size of the private market. The aggregate of bond issues plus net bank credit expanded from some $ 60 billion in 1970 to $ 85 billion in 1972; thereafter it expanded to over 1,000 billion by the end of 1982, with both the national monetary authorities as well as the Fund acting as virtual spectators. While the question of instituting some system of international surveillance over this market and the

Fund's role in exercising such surveillance is dealt with later in this paper, it ought to be said, right at this stage, that by denying the Fund access to the private market not only has the international community foresworn the use of a major, proved instrument of central banking control, namely open market operations, at the international plane but also it has left untapped a major source of finance for the Fund's operations. Indeed, if the Fund had a relatively greater access to the private market it could possibly have responded much more effectively to the situation that emerged after the first and second rounds of oil price increases as a result of immense payments surpluses on the one hand and equally large deficits on the other. Also, the Fund's access to the market would have reduced its dependence on governments, for, direct or indirect, budget support is not always easy to extend because of domestic budgetary consideration for even the most well meaning political leadership at the national level.

(e) Activation of gold stock

The gold holdings of the Fund are now worth about $ 45 billion. Various suggestions are afloat with regard to the disposition of these holdings. They fall into broadly two groups: (1) suggestions for the sale of gold and using the proceeds or profits only for development finance and (2) suggestions for "restitution" to the member countries. While gold has formally been demonetised, in the sense that not even reserve currencies are obliged to maintain a gold value, the fact remains that the monetary authorities still hold on firmly to their monetary gold stocks. Restitution would only mean transfer of gold from the Fund to national monetary authorities. The suggestions for sale seem to be unacceptable, although that seems to be the right course to adopt, regardless of how it is decided to make use of the sale proceeds. If the proceeds cannot be used for development finance, they could go to augment the pool of resources the Fund can use for extending payments support to member countries. In the event that even this is not acceptable, the Fund should then be able to use its gold holdings as collateral to borrow from the market. Of course, the question of using gold as collateral arises only if it is decided not to let the Fund borrow on the basis of its need, as proposed above.

II. Extension of Payments Finance and Conditionality

Right from the start, a major issue to sort out in the negotiations leading to the Bretton Woods arrangements was about the symmetry of adjustment action by the

countries in payments surplus as well as deficit. In the actual working of the old arrangements however, not only did the burden of adjustment fall more and more on the countries in deficit but alsc among the countries in deficit a great divide emerged. This was the divide between the reserve creating deficit countries (principally the US) and the non-reserve creating deficit countries. While the former could finance almost any amount of payments deficit by the creation of its external IOUs, the latter had to look around for necessary finance. Naturally, therefore, the burden of adjustment fell almost wholly on the latter. With the collapse of the Bretton Woods system, the former were released from whatever obligations they had undertaken to maintain the exchange value of their reserve currencies and there has, as a result, been a virtual flooding of the world with reserve currencies. The relative position of the non-reserve creating deficit countries, on the other hand, can be said to have suffered a set back except that those of this large group of countries which, for various reasons, enjoyed access to the emerging, fast expanding private capital market for their payments finance were, temporarily at least, in a position to cope satisfactorily with their payments deficits which started mounting in consequence of the drastic deterioration in terms of trade following the increases in oil prices.

Since a loan by its very nature, once taken, must be serviced, that is, repaid with interest, it goes without saying that a country incurring a loan must take suitable steps to make sure that it can service its debt according to schedule. The borrowing country has therefore to take appropriate measures to make sure that it will not default in the servicing of the debt it is incurring. Of course, it depends considerably on the terms and conditions at which a borrowing country can raise external finance how much latitude it really has in the choice of measures to be taken in order to generate the required debt servicing capability. But there is absolutely no question that a country cannot go on incurring payments deficits, unless, of course, it is a reserve currency country whose IOUs are acceptable as reserve by the reserve accumulating countries.

Also, as the Secretariat document prepared for UNCTAD VI [23] points out, much depends on the causes behind a country's payments deficit. Is it a deficit that is expected to reverse itself in the short-to-medium term? That would be the case when a temporary downturn takes place in commodity prices because of recession in the importing countries or when because of crop variations the import bill goes up or when interest payments go up on

debt contracted at variable interest rates. Or is it a deficit caused by an irreversible drop in a country's terms of trade? Or is it a consequence of the country's own domestic inflation? When a payments deficit is the result of domestic demand expansion, a policy of disinflation, combined where necessary with exchange rate adjustments designed to offset the rise in domestic prices, can generate the necessary correction in the country's payments position. When a deficit is the outcome of temporary, reversible causes, the appropriate response is to finance such a deficit rather than incur the costs associated with changing the level of demand and output which would have to be reversed at a later date. This indeed is the rationale behind the Compensatory Financing Facility (CFF) which the Fund has already had in operation for several years now. However, when a deficit is caused by an irreversible factor, it creates a structural imbalance calling for an adjustment in the structure of supply. Such a structural adjustment can be both costly and time-consuming. In order for a country to apply the right remedies, it is necessary first to have a correct diagnosis made of the nature of its deficit and then to ensure that the diagnosis is backed by finance in adequate quantities and on appropriate terms and conditions.

The recent escalation in the payments deficits of the developing countries has been the consequence of a sharp drop in both their terms of trade and finance. As the IMF Annual Report 1982 notes, more than two-thirds of the deterioration in the payments position of the non-oil developing countries from 1978 to 1981 was due to adverse movements in terms of trade and the rising cost of debt servicing accounted for the major part of the remaining third. The latter was a clearly temporary phenomenon. Also, some part of the deterioration in terms of trade caused by the cyclical downturn could be considered temporary. Both call for adjustment action on the part of the developed countries in the form of reflation of their economies and lowering of interest rates whereas the enduring component represented by permanent changes in terms of trade calls for structural, supply-adjustment measures in the developing countries. Thus the present situation clearly calls for a substantial availability of bringing finance to the developing countries on conditions which do not force them to take measures that may impose unnecessary sacrifices on them in the name of adjustment action. In fact the IMF itself advised countries with payments problems arising in the wake of the first round of oil price rises not to resort to adjustment action such as "deflationary demand policies, import restrictions and general resort to exchange rate depreciations" because

"it would serve only to shift the payments problem from one oil-importing country to another and to damage world trade and economic activity".[24] It is only after the second round of oil price rises that the IMF has made the major change in its stance and has stridently been calling for strong policies of aggregate demand restraint and realistic exchange rate adjustment on the ground that since the payments deficits are structural rather than transitory they are not amenable to correction over a short period of time.[25] But the argument offered altogether overlooks that the structural cause of the recent payments deficits has little to do with demand expansion and that adjustment action, if any, has to concentrate on the supply side.

The Extended Fund Facility(EFF) is meant to enable the Fund to offer support for a multi-year programme to deal with the structural disequilibria requiring extensive changes in the member countries' economies, including changes in the pattern of production. In practice, however, as has been pointed out by Ariel Buria, most of the so-called structural adjustment programmes designed by the Fund for borrowing member countries availing themselves of this facility, "remain essentially a chain of conventional demand management programmes built around the usual ceilings on credit expansion, fiscal deficit etc. to which ad hoc measures of trade liberalisation and production incentives have been added to stimulate a supply response". [26] Though the number of Fund-supported multi-year programmes has increased relative to one-year programmes, it ought also to be noted that the difficulties of member countries in meeting the Fund's performance criteria have led to a large number of the programmes, particularly multi-year programmes, being discontinued. In 1981 alone, the value of cancellations of Fund programmes added up to $ 2.7 billion, which was more than thrice the total value of the cancellations in the preceding three-year period. It would not be unfair therefore to raise doubts even at the practical level about the appropriateness of the conditionality the Fund is currently intent on imposing on the borrowing member countries.

Two aspects of Fund conditionality need urgently to be attended to. First, the content of a Fund conditionality package has to be delinked from the size of a country's payments deficit. Instead, the conditionality package has to be designed on a case-by-case basis depending upon the factors leading to the deterioration in the payments position of a country. To the extent the deterioration is temporary and reversible, it should be financed in the manner in which temporary

shortfalls in commodity export earnings are sought to be offset through the Fund's CFF. In fact, there is an urgent need to liberalise this facility considerably in several respects. If drawings from this facility have to continue to be tied to quotas, then the present ceiling of 125 per cent on cumulative drawings will have to be raised substantially to accomodate much larger use of this facility in line, at least, with the increase in limits on credit tranche drawings from 150 per cent to 450 per cent. As the UNCTAD document refered to above notes, while drawings equal to 125 per cent of quota would have, in the years 1966-1970, financed an overall deficit of a "representative" member country for 21 months, they would have covered that deficit on average for only seven months in the years 1976-1981.[27] Since the quotas themselves are being increased by roughly 50 per cent by the end of 1983, in order to restore the relative position of the facility it will be necessary to raise its quota-related ceiling on drawings by members to 250 per cent. If the facility is also to support deterioration in payments for temporary or reversible causes other than shortfalls in commodity export earnings (and increases in the cost of cereal imports, a purpose that the facility has lately been allowed to accomodate) the ceiling would have to be fixed even higher.

Secondly, when it comes to dealing with the deterioration resulting from more enduring factors, a clear distinction must be drawn between demand and supply adjustment required for restoring the payments position to health. The Fund's bias in favour of demand adjustment action needs severely to be restrained. Also, to the extent adjustment action is required on the supply side, the Fund should be prepared to extend support for programmes designed to meet the situation in sufficient amount and for a period long enough to show results. For this purpose again, the Fund must not be restrained, as at present, by a ceiling on Fund support tied to quotas. In any case, the present ceilings on annual and cumulative drawings of 150 per cent and 450 per cent of even revised quotas, coming into effect at the end of 1983, may be insufficient to accommodate the genuine need for Fund support from member countries when they face irreversible deterioration in their payments position.

The higher ceilings on drawings, as recommended, should not be difficult to accomodate, once it is agreed to allow the Fund to supplement its resources both by the regular issue of SDRs for financing its own operations rather than for allocation to member countries and by resort to the private capital market, in addition to

borrowings from governments or their monetary authorities, on the basis of need-based criteria.

III. Relationship with Commercial Banks

Reference has been made above to the phenomenal role the international capital market has come to play in payments financing in recent years. As the IMF Annual Report 1982 puts it, "the rapid growth of private international lending has reflected not only an increase in flows between industrial countries but also growing use of these markets by developing countries". 28/ This started happening at a particularly rapid pace after the first round of oil price increases in 1973-1974. Indeed, the recycling of payments surpluses of the oil-exporting countries to the oil-importing deficit countries was done primarily through the intermediation of the commercial banks. The role of the IMF and other multilateral arrangements was only marginal in the financing of the payments deficits. Of the total net external borrowing of the non-oil developing countries to the tune of $ 76 billion during the three years 1974-1976, while as much as $ 36 billion (45 per cent) came from private sources, the Fund's contribution (by way of various types of support including that from the Oil Facility) added up to a mere $ 6.1 billion (8 per cent). During the three-year period 1979-1981, following the second round of oil price increases, while the net borrowing by the non-oil developing countries was as high as $ 190 billion and the contribution of the private sources was also higher at 60 per cent, the Fund's relative support was lower at 4 per cent. 29/ Taking the whole decade of 1970-1979, private flows, other than direct foreign investment, rose from less than 20 per cent to more than 40 per cent of the payments finance drawn upon by the non-oil developing countries; in the same period,the proportion of such finance covered by bilateral and multilateral official development assistance fell from 60 per cent to 40 per cent.30/ There can be no doubt,therefore, of the increasing dependence of the developing countries on the private capital market for payments support.

The new pattern of financial flows, as the UNCTAD document referred to above points out, has had important implications for the distribution of available foreign funds among developing countries and for their burden of interest costs. Borrowing from the international capital market has been not only large but also highly concentrated, the main recipients being a limited number of countries with relatively high levels of per capita income. 31/ Thus practically the whole of Euro-currency financing raised by

non-oil developing countries in 1978 and 1979 was accounted for by countries with per capita income above $ 500. Indeed, in early 1980 lower-income developing countries actually had deposits in the Euro-currency market of a value larger than loans they received from the market.

At the same time, the countries which came to depend heavily on borrowing from private capital markets not only accumulated large amounts of debt from this source but also became increasingly vulnerable, as a consequence, to the high and fluctuating costs of debt servicing. The market rate on Euro-currency lending, the principal source of commercial bank finance, has been subject to wild fluctuations since the mid-1970s; it has also manifested a marked upward trend in recent years. 32/

The rapid build-up of the external indebtedness of the developing countries to commercial banks has now reached a stage 33/ where fears have been expressed more and more about the increasing exposure of the banks to developing country borrowers. This has coincided with the particularly difficult liquidity, as well as payments, position which the major borrowing countries (along with all the other developing countries) currently face in consequence of the sharp deterioration in their terms of trade and finance. In the circumstances, it is of great interest to the developing countries in general, and particularly those indebted heavily to the private banks, what role the IMF plays in not only sorting out the payments problems immediately arising on account of the debt servicing liabilities falling due, but also establishing a long-term, stable relationship between the commercial banks and the developing country borrowers which is at the same time less volatile and fluctuating than it has proved to be so far, particularly in recent months.

In recent months, as the liquidity position of some of the major borrowers among the developing countries deteriorated sharply, the IMF has been called upon to intercede between the commercial banks on the one hand and the concerned borrowing countries on the other with a view primarily to rescheduling debts and debt servicing. Though the Fund's own access to resources is limited, it has succeeded in hammering out case-by-case arrangements whereby crises have been successfully overcome and the much feared collapse of the private capital market averted. But it has thrown doubt on the future role of the commercial banks in the financing of the payments of even those of the developing countries which enjoyed access to them so far.

As the Fund Managing Director observed recently,[34] the degree of exposures of the commercial banks coupled with the emergence of debt servicing difficulties in several of the largest debtor countries almost simultaneously in the latter part of 1982 have sharpened bankers' perception of the risk in lending to the non-oil developing countries. They may therefore be much more restrained in their future lending to these countries. The Fund Managing Director felt that while over time this general reassessment by the commercial banks should strengthen the system, it will be important to see that in the immediate future an indiscriminate or abrupt retrenchment of bank lending is avoided. If that were to occur, it would, he felt, force adjustment on deficit countries on a scale and in a time frame that would be disruptive and harmful to creditors and debtors alike. His message therefore for the immediate future to the commercial banks was clear; it was in their own interests not to push the borrowing countries to the wall. Going by the Fund's experience in hammering out recent rescue arrangements for the countries in trouble, it is evident that the banks got the message right and have agreed not only to reschedule debts but also to lend afresh, although much of the new lending covers only the interest payments falling due. The banks committed these new amounts in parallel with the Fund.

The Fund's success in working out the rescue arrangements has encouraged it to claim that the present international financial system has shown both its resilience and its adaptability. The Fund Managing Director remarked that the Fund, the BIS, the central banks and the commercial banks, "have shown a capacity to handle crisis in full cooperation and in a quick, pragmatic, and effective way". [35]

Three sets of questions arise in the above context. First, even assuming that the Fund Managing Director has not spoken too soon, what is important from the point of view of the developing countries is not whether future crises faced by individual countries can effectively be met on the basis of the new ground broken in the relations between the various institutions mentioned above, but whether in future conditions can be created under which such crisis situations have little chance of recurring. Will the banks be as amenable to pressure and advice in non-crisis

situations as in crisis situations? Must these banks continue to be allowed to engage in international financing operations on the scale and in the manner of the recent past without effective, multilateral control? And if controls are necessary, what role will the IMF play in the exercise of such control? Additionally, if the objective is to expand international credit in line with the non-inflationary requirements of world trade, the role of the commercial banks will have to be kept within strict limits which are effectively enforced. This is as important as curbing the creation of national IOUs for use as international reserves. Finally, it is important that access to market finance is much less unevenly provided to the various countries in need of payments support than has been the case so far. To achieve these objectives, the Fund will need to be given an effective say, something that it now is completely denied, in the overseeing of the international operations of the commercial banks. Fund surveillance will therefore need to be made more comprehensive so as to cover not only the reserve creation by national governments but also the international operations of the commercial banks in so far as they result in the generation of international liquidity.

IV. Regional Monetary Unions

Any scheme of IMF reform will have to take note of the possibility that at regional and sub-regional levels member countries of the Fund may follow the lead of the European Monetary System (EMS) and establish institutions with a view not only to stabilising their mutual exchange rates but also to reducing the variability of their exchange rates with countries outside the regional or sub-regional arrangements. While this is no place to go into the pros and cons of regional and sub-regional arrangements between countries, particularly of countries the bulk of whose trade may be with countries outside the region or sub-region, the possibility of such arrangements emerging within the foreseable future cannot be ruled out, especially if effective steps are not taken at the global level to move towards a system of exchange rates whose variability can be kept within certain acceptable limits.

It will have to be recognised that whether or not the European Monetary System has, in the four years of its existence, fulfilled all the high hopes and expectations set on it when it was established, the system has, as a recent Fund study brings out, not only worked quite smoothly in an operational sense, which in itself is said

to be quite an achievement, but also avoided major exchange rate disruptions. At the beginning, it was feared that, under the system,the required exchange rate changes might not be undertaken in time or to the extent required. Actually, the system proved to be much less rigid than initially feared. It was still possible to bring down exchange rate variability. In fact, as the Fund study referred to above observes, "this stabilising influence has spread to the exchange rates of those European countries outside the EMS which have close economic and financial ties to EMS participants". 36/

Among the developing countries, the experiments with earlier payments unions have not been as rewarding as originally believed. So it can certainly be argued that these countries may not be attracted to the suggestions for monetary unions. While this argument cannot easily be brushed aside, it has, at the same time, to be recognised that since the payments strains on the developing countries are significantly greater than ever before they may be much more receptive to ideas on effective payments union arrangements than in the past. And if the idea of a payments union takes firmer root in the changed circumstances of today, there is every chance that the new payments union schemes will incorporate ideas on monetary cooperation as well, if for no other reason than to strengthen the ability of the arrangement to settle the payments between its member countries.

Of course, there is no question of the Fund not allowing member countries to form regional/group payments-cum-monetary unions. But can it not be much more positive in this regard? Should it not actually promote the formation of such unions so that the concerned countries are enabled thereby not only to make much better use of their national gold as well as foreign exchange reserves to finance their collective payments deficits,but also to expand mutual trade and economic cooperation?

V. Participation in Decision Making

The much expanded role for the IMF envisaged in the proposals made above is predicated on a radical re-thinking in regard to the sharing of decision making among the Fund member countries. The present arrangement is extremely one-sided: it gives to the industrial countries close to 70 per cent of the voting power and to one country, viz., the US - with over 20 per cent of the voting power - a virtual veto over practically all the major Fund policy decisions since they must be carried by 85 per cent majority. It is an arrangement that the non-industrial participants

cannot be happy about, even if the industrial countries had been less mindful of their own individual and group interests while participating in the Fund's decision making. Actually, the non-industrial countries have reason to complain that the decision making in the Fund has been directed principally to promoting the interests and meeting the concerns of the industrial countries. Benefits, if any, for the non-industrial countries have followed mainly as by-products.

As the Brandt Commission perceived it, "the new international monetary system should have a pluralistic basis, in which no single political entity or small group of entities plays a predominant role". The Commission called for a broad-based leadership to manage the international monetary system and suggested, for that purpose, "clear, fair and explicit rules for managing the system, rules which will protect the interests of all members of the system, including the weaker ones". Such rules, the Commission felt, "must ensure that the Fund is not wholly administered on the basis of shareholding". The Commission specifically asked that "the participation of the developing countries in the staffing, management and decision making of the IMF should be enlarged". [37] It is worth noting in this context that under the EMS, while each country was obliged to contribute to the European Monetary Cooperative Fund (ECMF) 20 per cent of its gold and dollar reserves, so that their contributions varied considerably, exchange rate changes were to be a matter of common decision making requiring unanimity among EMS participants. No country, however large its contribution to ECMF, enjoyed a dominant position by virtue of its reserve contribution. As has been noted already in this paper, the smooth operation of EMS during the past four years of its existence has not suffered on this score.

In order to broaden the base of Fund decision making, it is necessary as a first step to re-allocate quotas among member countries so as to enhance the voting power of the developing countries. In this context, it is appropriate to refer to the latest communique issued after the February 1983 meeting of the Intergovernmental Group of 24 on International Monetary Affairs (G-24). The group emphasised "the urgency of a comprehensive re-examination of the economic criteria and the weights to be attached to them in quota formula so as to reflect the financing needs of members". More specifically, the group asked that "the quota share of the developing countries should go up to 45 per cent". The group asked also for "a special adjustment in quotas of small countries, including small island economies, having regard to their size,

openness and limited access to capital markets and their narrow productive and export base". 38/

Reallocation of quotas and therefore voting rights should, it is felt, be less difficult to agree upon, the less the Fund is dependent on quotas as the principal source of its resources. In this context, the reforms suggested earlier in the paper in regard to the regular creation of SDRs for the Fund's own use and the Fund's access to capital markets assume importance.

VI. Concluding Observations

Since the collapse of the Bretton Woods System in the early 1970s, it has not been possible to agree upon a comprehensive substitute system. What has been in place ever since is an *ad hoc* arrangement combining decisions taken on various issues as and when their consideration could not be deferred any longer. There is a widespread recognition now that this "adhocism" must give way to a properly thought out financial system for the sake of a smooth working of the world trading system. This recognition is not confined to the developing countries only, though they insist that any new arrangement must not overlook their interests.

Whatever new system is thought up, it may well be in everyone's interest if the system makes use of the existing institutional arrangement to the maximum extent possible instead of dismantling altogether the existing institutions and building everything from scratch. It is in this spirit that this paper has sought to offer ideas on IMF reform.

Notes and References

1. Author's own calculation. The figure for the period 1960-65 works out at 10 per cent, as per Brandt Commission's calculation; see North-South: A Programme for Survival, The Report of the Independent Commission on International Development Issues under the Chairmanship of Willy Brandt, Pan Books, 1980 (elsewhere referred to as Brandt Report), p. 213.

2. In four years, 1946 to 1949, the US surplus on current account excluding transfers was $32.8 billion; in the subsequent five years, 1950 to 1954, it was only $13.1 billion. Transfers in the former period added up to $17.1 billion as against $14.8 billion in the latter period, when the balance on current account including transfers had been converted from an earlier sizeable surplus into a deficit. See The Economic Report of the President 1982, Washington D.C.

3. Between 1952 and 1962, the decline was of the order of 30 per cent, from $24.7 billion to $17.2 billion. See The Economic Report of the President 1982, Washington D.C.

4. These ten industrialised countries comprise the Group of Ten.

5. See Brandt Report, p. 202.

6. See Robert Triffin, International Monetary System, Yesterday, Today and Tomorrow, Random House, 1968, p.87.

7. Author's own calculation based on the data published in the International Financial Statistics, a regular publication of the IMF. It is to be noted also that only a handful of the developing countries, mostly oil-exporting, have been able to have a Reserve Position in the Fund.

8. Author's own calculation.

9. See Brandt Report, p. 213.

10. See "The Cloakroom Rule of International Reserve Creation and Resource Transfer" in R.N. Cooper (Editor), International Finance, Penguin Modern Classics, 1969.

11. See UNCTAD VI Policy Paper on *International Financial and Monetary Issues* (Document No. TD/275 of 26 January 1983) p. 30.

12. Author's own calculations.

13. See "Cloakroom Rule.......", op cit.

14. See Brandt Report, p. 210.

15. See his *Gold and the Dollar Crisis*, Yale University Press, 1960.

16. See Robert Triffin, "'Europe and Money Muddle' Revisited", Banca Nazionale del Lavoro, *Quarterly Review,* Vol. 31, 1978.

17. See Brandt Report, p. 210.

18. Ibid, pp. 211-2.

19. See IMF, *Annual Report, 1982,* p. 84.

20. Ibid, p. 85.

21. Ibid, p. 162.

22. These exclude interest subsidy receipts of the member countries of $36 million in 1982, out of the special accounts administered by the Fund.

23. See UNCTAD, op cit, pp. 25-6.

24. See IMF, *Annual Report, 1974,* p. 26.

25. See IMF, *Annual Report, 1980,* p. 18.

26. See his "IMF Financial Programmes and Conditionality" cited in UNCTAD, op cit, p. 33. See also I.S. Gulati, *IMF Conditionality and Low Income Countries,* Kale Memorial Lecture, Pune, 1982.

27. See UNCTAD, op cit, p. 30.

28. See p. 70.

29. See IMF, *World Economic Outlook,* Occasional Paper 9, 1982, p. 167.

30. See UNCTAD, op cit, pp. 15-24.

31. See UNCTAD, op cit, p. 16.

32. The quarterly average for 6 months' LIBOR varied between 5 per cent and 15 per cent during 1974-79. At times, during 1980-81, it reached 17-18 per cent Lately, however, it has come down to just below 10 per cent. See UNCTAD, op cit, p. 49.

33. By the end of 1981, almost 60 per cent of the total outstanding long-term debt of the non-oil developing countries was owed to private creditors. See IMF, Annual Report,1982, p. 36.

34. See J. de Larosiere, The IMF and the Developing Countries, Address at the University of Neuchatel, Switzerland, on March 3 1983.

35. Ibid.

36. See IMF, The European Monetary System. The Experience, 1979-82, Occasional Paper 19, 1983, p. 9.

37. See Brandt Report, p. 220.

38. See IMF Survey, February 21, 1983.

MULTILATERAL AID TO DEVELOPING COUNTRIES

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"What is Multilateral?"

Our subject is multilateral ODA (henceforth MODA for short) and its related institutions. There is a general convention of how to define "multilateral" as distinct from "bilateral" ODA and we will follow the generally accepted dividing line. However, in putting forward thoughts about developing and improving MODA it would be counter-productive not to realise the narrow basis and somewhat arbitrary nature of the prevailing definition - otherwise we may bar ourselves from progress in important directions, particularly in the "grey areas" between bilateral and multilateral ODA, as well as that between development finance and balance of payments finance.

The narrow conventional definition is that to be multilateral ODA must be channelled through and distributed by a multilateral organisation or institution or fund. The clearest case is where such institutions are in the UN system - the World Bank, UNDP, World Food Programme, UNICEF, etc. The second ring of multilateral institutions not in the UN system yet generally recognised as multilateral would include the Regional Development Banks - such as the Asian, Inter-American and African Development Banks, the Caribbean Development Bank, etc and funds like IFAD. Thirdly, regional activities such as EEC funds (the EDF, EEC food aid) often are included as multilateral; however, in the case of food aid, some of the definitions are limited to the World Food Programme while others include EEC food aid. This third or outer ring of multilateral institutions would also include various Arab or OPEC funds (e.g. OPEC Fund for International Development, Kuwait Fund and several others).

The danger of restricted definitions is that they limit our perceptions and reform proposals. For example, in this case, all action outside the multilateral institutional system would be labelled as "bilateral", with the implication that it is uncoordinated, guided by national interests only, politically motivated, etc. The implication often is that bilateral action should be left alone, or even that it should be reduced in favour of multilateral action.

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* With assistance from Mrs. Stephany Griffith-Jones.

But nothing could be further from the truth in the real world. Much bilateral action is in fact coordinated action and there are many links between the multilateral and the bilateral systems. A good example in the case of ODA would be the aid consortia or consultative groups. Where there is an effective aid consortium, the bulk of the aid committed would be classified as bilateral, but it is committed in a coordinated or multilateral framework, usually with the World Bank in the chair, with decisions based on policy papers and assessments also largely prepared by the World Bank. This means two things :

> (1) the bilateral ODA has considerable multilateral elements - in some cases it may become almost a formality whether aid is channelled through the World Bank for distribution by the World Bank, or whether on a country basis the World Bank to a significant degree helps to determine the volume and specifications of aid by way of a consortium/consultative group.
>
> (2) The truly multilateral aid element is larger than the statistics show because the quantitative aid figures neglect the crucial catalytic functions of multilateral institutions in coordinating policy advice and clearing the way for other sources of finance by giving "seals of approval" and raising credit ratings. Since the mid and late seventies this refers particularly to private bank lending, flowing largely to developing countries with relatively higher incomes.

The importance of these catalytic functions cannot easily be quantified but it is possible that for certain categories of countries the multiplier involved is of a high order of magnitude. For example, the Fund's Managing Director has argued recently:

> "It is true, of course, that the Fund's financial resources are limited in scale. But Fund financing has an important effect in restoring confidence on the part of other lenders and thereby unlocking access by the country concerned to additional external finance. It has been estimated that every dollar of Fund financing in support of adjustment programs has in the recent past generated an additional four dollars of new

commercial lending."[1]

This estimate by the Fund's Managing Director seems even in general terms somewhat optimistic; furthermore, it refers mainly to a particular category of developing country (the middle-income ones) which are considered "creditworthy" enough by the private banks to attract significant loans from them. Most of the low-income countries (i.e. the majority of countries in Sub-Saharan Africa) do not attract such credits to any significant extent.

In the case of such low-income countries, however, the IMF's "seal of approval" may nevertheless generate additional aid flows, from bilateral donors, who -like the commercial banks - are often lacking the assessment capacity, the access or the influence to come to informed judgements or to offer policy advice in individual developing countries. In fact, the continuation or expansion of bilateral official development assistance may be increasingly dependent, as World Bank/IDA already is, upon countries' working out agreements with the IMF as to the conduct of macroeconomic policy.

The World Bank has also claimed a multiplier effect (at 5:1, even higher than the Fund) in connection with its co-financing activities. When announcing a recent expansion and diversification of its co-financing activities (45 per cent of which are with commercial banks), it claimed that the additional activities proposed would cost $500 million in direct Bank finance, but would generate additional funds of $2.5 billion from commercial sources alone.

To some extent - but only a minor extent - the point could also be reversed. Just as some, even much, of bilateral ODA could be called multilateral because it is strongly multilaterally influenced and coordinated, some of the multilateral aid could be defined as in some sense bilateral. This would be the case, for example, where a single country has a veto power over the transactions, either because it controls the resources and contributions of the multilateral fund or because there is a consensus or unanimity rule. Such unanimity rules in multilateral organisations in fact give individual countries bilateral power, if not to initiate transactions, at least to prevent them.

II. Grey Areas

(a) The distinction between multilateral and bilateral aid

As it happens, the "grey area" between bilateral and multilateral assistance probably has some of the best future potentialities. Better coordination of bilateral aid can go a long way towards achieving the advantages of multilateralism. For example, one of the main drawbacks of bilateral assistance compared with MODA is the frequent tying of aid to the products of the donor country; this makes multilateral aid more valuable to the recipients because they have a wider choice of sources of supply. Yet the same benefit to the recipient could also be achieved by a coordinated and mutually agreed untying of aid. This would leave the donor countries as a whole no worse off (although some individual donor countries may marginally gain or lose), while the recipient countries would be better off. In fact, insofar as the increased value of the aid to the recipients results in accelerated development (which is a mutual interest) the donors will also gain. It is thus a positive sum game and the agreed mutual untying of aid should certainly be high on the agenda for future progress.2/

Similarly, in the area falling within the common definition of MODA possibly the most likely future developments will be to widen the scope and effectiveness of MODA by intensifying co-financing on the part of the IBRD and regional banks, or of increasing their multilateral influence in the area of policy advice, signalling to other sources of finance, chairmanship of consortia and consultative groups, etc.

Given the trend of a more intimate relationship between different lenders and donors, the role of policy advice (often referred to as conditionality) applied by the IMF and the World Bank acquires a key significance. The increased coordination between donors and lenders and the rapidly growing importance of the IMF's "seal of approval" to allow access to other flows of funds, would only be a welcome development if Fund (and Bank) conditionality are perceived by developing countries to be appropriate to their situation, to stimulate - rather than inhibit - growth and development and to "pay due regard to the domestic, social and political objectives of member countries" (the latter point was stipulated in the Fund's revised guidelines on conditionality issued in 1979). If Fund and Bank conditionality is not made more appropriate for developing countries' prospects for growth and development (and if its overall impact on the global economy is deflationary, as some observers fear) then its increasing influence in the

Third World would be a negative phenomencn. Therefore, the debates about appropriate Fund and Bank conditionality acquire a much more crucial significance than they ever had. We will return to this subject in later sections.

(b) Food aid as an example of grey area

The case of food aid is a good example for some of the dilemmas and for the wide spread of "grey areas" between multilateralism and bilateralism. Most food aid is given bilaterally, with the US the largest contributor, but the bulk of bilateral food aid is given within the framework of a plurilateral donor arrangement known as the Food Aid Convention (FAC). This covers some 75 per cent of the official UN target for cereal food aid (7.6 million tons of a target of 10 million tons) and over 80 per cent of the actual volume of cereal food aid (around 9 million tons). Thus the FAC covers the great bulk of food aid and is specifically "intended to secure the achievement of the UN target of 10 million tons through a joint effort of the international community".[3] Its importance lies in the fact that this represents a binding commitment for several years ahead (up to 1986) with an agreed burden-sharing among the main donor countries. This is particularly important because the commitment is in real (physical) terms, i.e. tonnages, not in financial terms. This not only eliminates difficult questions of valuation and pricing when discussing national quotas of such ODA, but it also puts a secure volume floor under aid flows to prevent a situation, such as occurred in 1972-74, when the real volume of food aid dropped sharply just when food prices were rising sharply and food aid was most urgently needed.

Such a multi-annual commitment in real volume terms providing a fairly high floor for aid flows has never been achieved in the case of financial aid. Perhaps it should be an objective to achieve such a Convention analogous to the FAC also for financial aid, guaranteeing a minimum figure somewhat higher than the present 0.35 per cent of GNP but lower than the 0.7 per cent target which has been proclaimed for so long but in vain. The 0.7 per cent target (like the 10 million ton target for food aid) could still remain as a desirable actual figure to achieve, beyond the minimum commitment of perhaps 0.5 per cent.[4]

For our present purposes the main point is that although the 7.6 million tons of cereals under the FAC are classified as essentially bilateral, yet they are part of a plurilateral or semimultilateral arrangement, in the framework of a UN target. To complicate matters further, the member countries of the EEC make their contributions under

the Food Aid Convention partly through their participation in the EEC food aid programme, and partly bilaterally. Is the EEC food aid programme multilateral, a part of MODA, or not? In the statistics of the FAO when monitoring the target for flows of external financial aid to agriculture set by the World Food Conference in 1974, aid from the EEC is classified as bilateral rather than multilateral, while in other tabulations the EEC is treated as multilateral. In view of the importance of EEC food aid, particularly in the case of dairy products, this obviously makes a tremendous difference in calculating multilateral versus bilateral shares, or in analysing different commodity composition or country allocation in multilateral versus bilateral programmes.

The membership of the FAC includes "the EEC and its member countries" which are listed with a single collective pledge, indicating the mixed bilateral/plurilateral character of their contributions and avoiding the tricky job of distinguishing bilateral from multilateral transactions (if indeed the EEC is considered as multilateral). So an EEC member country can make its contribution in five different ways (and some of them do so in all five ways): (a) bilaterally; (b) as part of the EEC programme; (c) as part of their regular pledge to the WFP; (d) as additional (extra-budgetary) transactions channelled through the WFP; (e) as bilateral aid which is handled or distributed by the WFP. While (c) and (d) are clearly multilateral (amounting to about 15 per cent of all FAC contributions), 5/ (b) and (e) are doubtfully multilateral and (a) is bilateral but part of a multilateral (or at least plurilateral) arrangement, the membership of which includes Argentina (normally reckoned among the developing countries) and is in pursuance of a multilaterally (UN/FAO) agreed target. Moreover, the FAC is part of a wider international arrangement (the International Wheat Agreement) and is administered by an international secretariat (the International Wheat Council). What remains of any clear borderline between "bilateral" and "multilateral"? (And who cares?)

The Convention is administered by the Food Aid Committee on which all parties to the Convention are represented. This is not to be confused with the Committee for Food Aid (CFA) which administers the World Food Programme, but has also been given coordinating functions, e.g. the establishment of guidelines, for food aid as a whole. 6/ Paradoxically, while the Food Aid Committee administering the Convention is considered in the bilateral area, it "continues to be a focus for international co-operation in food aid matters", while the CFA, which is clearly in the multilateral area, is often criticised for

limiting itself to WFP operations and not carrying out its assigned functions of broader international coordination and discussion of food aid.

Similar complications arise in the case of the IEFR (International Emergency Food Reserve). Here again there is a multilaterally recommended target (500,000 tons set by the FAO), and some of the bilateral contributions to this multilaterally agreed reserve are again channelled to or through the WFP/FAO. However, as distinct from the case of cereals under the FAC, the contributions to the IEFR take the form of voluntary *ad hoc* or annual pledges rather than binding commitments to fixed agreed minimum amounts.

Yet another complication is that some of the contributions under the FAC are used by the donors to buy up surplus food from developing countries such as Zimbabwe (maize), or Thailand, Burma and Pakistan (rice) for use in other developing countries , e.g. Zimbabwe maize in Zambia, Thai rice in Bangladesh. These "triangular" transactions add a further multilateral element for what are technically considered to be bilateral transactions (unless such triangular transactions are undertaken by, or channelled through, the WFP). Such triangular transactions by FAC members are encouraged, and the Convention states that "when cash contributions are used to purchase grain, preference should be accorded to developing countries". This is "now widely recognised as one of the most valuable forms of food aid".

Finally, food aid also illustrates the fluid borderline between government ODA and the voluntary agency section. Although the contributions under the Convention are all made by governments, a considerable proportion is in fact channelled through, and handled and distributed by, voluntary agencies such as, in the case of the UK, Oxfam, Save the Children Fund, etc.7/

The case of bilateral funds placed at the disposal of multilateral UN technical agencies is also widespread in the case of technical assistance funds where the practice worries the UNDP as it threatens to undermine the intended coordinating function of the UNDP. Its share of total multilateral grant technical cooperation funding has fallen from three-quarters to about one-half. One feature in this situation is that the funds thus placed with UN agencies such as FAO, WHO, etc ("trust funds") can be tied while the UNDP cannot accept tied funds. Thus the initial intention of establishing the UNDP as a controlling channel for untied technical cooperation has been by-passed and eroded. The

development of "grey areas" is thus not without problems of its own.

All this goes to show that semantic and statistical exercises to define and classify food aid as either multilateral or bilateral are not particularly useful and fly in the face of reality. The more useful approach would be to describe and then improve and intensify the interplay of bilateral and multilateral elements in such a way as to bring out the best in both - in the quantitative sense of achieving the greatest volume of aid and in the qualitative sense of obtaining it in the best commodity composition, getting it in the best possible way to the right recipients and ensuring its most effective use.

(c) The grey area between development and balance-of-payments finance

Up to now we have discussed the existence of "grey areas" between multilateral and bilateral ODA. Of equal significance are the "grey areas" between development finance and balance of payments finance. 8/ Conceptually, the financing of developing countries has been clearly separated into two distinct categories: (a) development finance, whose purpose is to mobilise capital for longer-term investment in projects and for overall progress. External sources of development finance include official development assistance (both MODA and BODA), foreign bonds, investment by transnational corporations and long-term lending by commercial banks; (b) balance-of-payments finance is, in contrast, a matter related to the provision of liquidity; temporary finance is made available to "tide countries over" their temporary shortfalls in earnings and allow them to maintain the flow of imports which would have to be temporarily interrupted. Liquidity of this kind may be externally provided by the IMF, short-term to medium-term lending from foreign monetary authorities and commercial banks.

However, in the seventies and eighties, it has become increasingly difficult to distinguish development from balance-of-payments finance. If a country is hit by very large increases in prices for key imports (e.g. oil) and by world recession, the shocks to its balance of payments are much greater than had occurred in previous decades. It is unclear in what proportion the financing required to cover their increased deficits should be regarded as development finance or as short-term. The longer the time horizon defined, the greater the room for adjustment via supply changes and therefore the greater role should be given to "development finance". As a consequence, the definition of

the needs for "development finance" are linked to the accepted perception of an optimum path of adjustment (shock adjustment relying mainly on demand measures would require less "development finance" than a gradual adjustment relying mainly on supply measures).

Furthermore, as so much finance is currently used to sustain imports at required levels (without which not only development itself would be interrupted, but also incomes and consumption levels may actually decline), the distinction between development finance and shorter-term balance-of-payments assistance becomes somewhat academic to Ministries of Finance in low-income countries struggling to finance urgently required imports.

III. Multilateralism and the Recession

As a reaction to the recession in their own countries and in the world economy, the main industrial countries recently reacted by reducing ODA, and within ODA they have tended to reduce the multilateral element more than the bilateral element. This impact is already clearly visible in the financing difficulties of the IDA, IFAD, the UNDP and other multilateral funds. The rationale - or *apparent* rationale - of cutting down on the multilateral element more than the bilateral element is the same as that for cutting down on ODA as a whole. In a period of stagnating GNP and rising domestic unemployment, there are political pressures to "put our own people first", and within ODA to preserve those parts of the programme which are in the direct political interest of the individual donor country. The pressures making for reduced ODA, and for letting cuts fall with doubled intensity on the multilateral part, are essentially the same as those for the protectionist pressures apparent today. 9/ Yet, from another perspective, (as clearly pointed out by the Brandt Commission and also by the Commonwealth Group of Experts on the North/South dialogue) the *real* rationale should lead in exactly the opposite direction: when there is unutilised capacity and unemployment, aid (which directly or indirectly promotes exports) is relatively costless since it will lead to an increase in demand, which can be supplied from the unutilised capacities and underemployed labour with little inflationary impact; within the total aid process the multilateral element should become *more* important because joint and collective action is cheaper and more feasible than individual action. Thus, according to this line of argument, the worse the recession, the clearer the mutual benefits which can be derived from an expansion of MODA and strengthening of the multilateral system.

There is thus a conflict between apparent national rationality and real global rationality. The resolution of this conflict is a task for enlightened statesmanship; and it also calls for development education among parliamentarians and the general public, particularly in industrial countries.

It is interesting to note that according to this perception when developing countries press (through the Group of 77, Group of 24, or other fora) for an increase in aid or an increase in world liquidity (i.e. through an issue of SDRs) they are not only furthering their own national interests, but are also arguing for measures which would improve the global economy.

The 0.7 per cent target for total aid would in any case reduce required aid in a prolonged recession with stagnating or even declining GNPs. This raises questions concerning the nature of the target, which links aid requirements uniquely and exclusively to one single element in the capacity to give aid, i.e. GNP. The capacity of a country to give aid is as much determined by its rate of inflation, its balance of payments, its rate of unemployment and other factors as by GNP. The time may have come to give some thought to linking aid more directly with such other factors, and this could perhaps apply more specifically to the multilateral part of ODA. If we take the balance-of-payments factor: the present IMF - contrary to Keynes' original ideas - is based on the assumption that it is up to the balance-of-payments deficit countries to "put their house in order" by financial and economic discipline, and restructuring and policy changes so as to cope with the balance-of-payments deficits. Yet in a recession it is the balance-of-payments surplus countries (if they refuse to reflate or channel finance to other countries) which create problems for the rest of the world and cause deflationary pressures making the recession worse. Thus the recession has brought to light questions about the present multilateral system - questions which had lain dormant in the "golden years" of full employment and steady growth of the 1950s and 60s. The calls for changes within the IMF - some of them already implemented to a very partial extent - for expansion of quotas, creation of SDRs, creation of medium-term balance-of-payments support facilities, lengthening of loan periods, changes in the nature and method of imposition of conditionality, broadening of low conditionality facilities in the IMF (such as compensatory financing), are all expressions of this change in perception required by the different context of global recession in which the multilateral system has to work today.

The wider issues are also beginning to be raised: are there methods by which pressure can be put on balance-of-payments surplus countries to expand - including increased expenditures on aid - to balance the pressure now put on deficit countries? How can the multilateral system play its proper role in recycling such balance-of-payments surpluses to maintain world stability and world development? Is the present division between ODA on the one hand ("a matter for the World Bank"), and financial stability on the other hand ("a matter for the IMF") still tenable? There are already clear signs that the World Bank is moving towards balance-of-payments support, while the IMF is moving towards development assistance. Does the situation not call for major redefinitions and institutional reforms? The demands for a "new Bretton Woods" are increasingly growing, as the existing multilateral institutions are finding it increasingly difficult to cope with the growing financial and economic strains in the world economy. The need for major reforms could partly be postponed in the seventies by the growth of private banks as major "recycling" agents between surplus and deficit countries; however, the problems resulting from private bank lending not only inhibit their role in this aspect for the future, but also add new reasons (i.e. what to do with the debt overhang?) for a major review of the multilateral financial system.

IV. Multilateral Aid as a Residual Factor: a Heavy Burden

Multilateral aid in relation to the investment needs of developing countries is a small proportion particularly for certain developing countries. It is a fraction of a fraction of a fraction of a fraction. To explain: total foreign exchange resources are only a fraction of total resources needed; total financial flows are only a fraction of total foreign exchange resources; total ODA is only a fraction of total financial flows; and total MODA is only a fraction of total ODA. As a very small residual factor MODA cannot by itself change the situation fundamentally. It also follows that in difficult times changes in other, much larger factors, such as foreign exchange earnings from trade, commercial finance and bilateral ODA, may put tremendous - perhaps unsupportable - strains on the MODA system. It also follows that the most important impact of MODA may lie in any effect which it can have, by direction, encouragement, coordination, signalling, advising etc., on these much larger flows. Once again, this emphasises the influence of functions such as providing frameworks and fora for global negotiations, chances (such as in the technique used by the GATT multilateral trade negotiations, MTNs) to generalise bilateral agreements into

a multilateral impact, policy coordination(such as Chairmanship of aid consortia), signalling functions (such as the function of an IMF agreement to give the green light to commercial lending, export credits), encouraging bilateral action by providing reciprocity and mutuality, and also professional analysis and pioneering in new directions of development policy. Examples of the latter are the roles of the ILO and the World Bank in certain of its prescriptions, which suggested more employment-oriented and poverty-oriented policies, the role of the FAO in pointing out the need for repairing neglect of agricultural and rural development, of UNEP in bringing to the fore environmental factors and parts of the "common heritage of mankind", the role of UNICEF in pointing out the tragic waste of child malnutrition. There is no doubt that such guiding, coordinating and pioneering functions vastly transcend the 0.1 per cent [10] of total resources provided by the multilateral system.

Negative examples are the excessively dogmatic orientation to the "monetarist approach to the balance of payments",excessive emphasis on deficit countries and insufficient concern for growth and income distribution, which according to many analysts still characterise the IMF's policy influence. For MODA to have a significant effect on the growth rate of recipients or the reduction of poverty it becomes necessary to show that it has certain catalytic effects far beyond its direct quantitative contribution to the recipients' national incomes or its own direct capital contribution.[11] The instititions providing MODA have instinctively or perceptively accepted this point and they all in their reports and pleas for resources have demonstrated or argued the existence of such catalytic effects. Reliance on such catalytic effects is clearest in the case of multilateral technical assistance, where indeed the catalytic effect is the whole point of the operation, and there is (e.g. UNDP) no significant physical capital contribution, and of all inputs into "human capital" - health, education, nutrition, etc. For those institutions providing financial or physical capital, it is no accident that they rely strongly for an assessment of their impact on the technique of "social returns" which includes the indirect and catalytic as well as the direct effects. But this technique, while suitable for project analysis, is more difficult to use convincingly for programme lending and hardly at all for balance-of-payments support. Even in the case of projects, it fails to deal with the "fungibility" argument, i.e. that the support for Project A will "really" be a resource transfer resulting in the addition of a quite different - and usually unidentifiable - Project B. Fortunately, for the case of MODA, catalytic effects can

often be demonstrated or reasonably assumed. Some such effects have already been mentioned in this paper.

Similarly, from the LDCs' point of view, it is immensely more important for the donors to resume economic growth, combined with liberalised market access, to provide markets for LDC exports, to stabilise and maintain commodity prices, to utilise the potential of the multilateral system for collective decision and collective action, to direct the financial and technological power of their TNCs into collectively agreed channels supporting multilaterally agreed patterns of development, to keep their own bilateral aid in tune with each other and within the framework of multilaterally agreed rules etc., rather than marginally increase the volume of resources directly distributed through multilateral channels say from 0.12 per cent to 0.15 per cent of GNP. But it is also important that they should permit and encourage the multilateral system to move in the required new directions.

V. MODA Residual to Commodity Prices

To realise that many of the problems of MODA are not internal but arise from its attempt to cope with global forces, we need only look at the implications of the extremely low commodity prices which are a result of the current recession. In terms of low prices for their exports, reduced export earnings and poor terms of trade, more resources are drained from the LDCs than are put back by ODA. Low commodity prices help to dampen inflation in the industrial countries - but at the cost of the LDC producers of these commodities (and also of DC exporters to the LDCs). The gap was in the seventies and early eighties largely filled by non-concessional finance - but at the price of growing indebtedness which is a mortgage on the future growth of LDCs; the growing debt service reduced their available export earnings; this is equivalent to a further deterioration of their terms of trade, thus perpetuating the vicious circle started by the initial fall in their export earnings.

Action to stabilise commodity prices and export earnings, whether through UNCTAD (Common Fund) or through the IMF (CFF), clearly acquires much higher priority in the present circumstances. So does action on debt settlements, debt relief and possible "debt rediscounting", as proposed by the second Brandt Report; a proper multilateral institutional framework does not not yet exist in this field. Should not the multilateral system be encouraged to provide a lead in providing loans tied or "indexed" to the world prices of the chief exports of the borrowing

countries or more appropriately to their terms of trade? Should not facilities to stabilise developing countries' exports be broadened so they cover the full extent of their shortfalls particularly in periods of recession? Should not the repayment of loans under the CFF be subject to the condition that countries' export earnings have recovered? (The latter proposal would make the facility symmetrical, as currently repayments are accelerated when countries' export earnings recover very rapidly; a comparable set of provisions should be made for deferred repayments, mutually within a maximum time limit, in case of continued real export shortfalls.)

Proposals to broaden the CFF, so it covers to a far greater extent (ideally to a total extent) shortfalls in countries' real export earnings, and to make its repayments schedule flexible are being currently put forward and given increased priority by many different sources.[12/] In fact, if adopted, such proposals would not only greatly reduce the cost of adjustment to developing countries in prolonged periods of recession and low growth in the world economy; they would also have an important and highly desirable counter-cyclical impact on the world economy as a whole. For this reason a broadened CFF should ideally remain within the IMF, thus moving this institution towards a more important role, somewhat more akin to that of a world central bank.

Moving to an even wider context, we could look at the disastrous fall in commodity prices and deterioration in the terms of trade as a symptom of our failure to implement the original and full Bretton Woods system. The system was conceived to rest on three pillars, not two. A development support institution (now the IBRD), a world central bank and financial institution (now in attenuated form the IMF), and thirdly an international trade organisation (ITO). Yet the last institution never came into existence, and only partial functions were taken over by GATT, the UN "Interim" Committee on Commodity Arrangements (ICCA), later UNCTAD with its recently developed Integrated Commodities Programme (ICP), the limited IMF compensatory financing and buffer stock facilities and - still unratified and much reduced - the Common Fund. Apart from such "bits and pieces", there is still a big gap where this "third pillar" of Bretton Woods should have been. What is perhaps even more serious is that the IMF system was based on a world currency based on a fixed price of gold - whereas the original ideas leading up to Bretton Woods had included a world currency based on the prices of a bundle of primary commodities, including major export products of developing countries. Thus stabilisation of commodity prices would have been directly

built into the financial system, and even more importantly the multilateral system would have included a world central bank capable of direct counter-cyclical financial action. The only direct remnant of this function are the SDRs (with many inhibitions and minimal effects, as SDRs represent a very low proportion of total world foreign exchange reserves) and the disposal of the revalued gold (also minimal and erratic).

At any rate, the system has shown itself incapable of preventing, by multilateral action, disastrous declines in export prices and export earnings in real terms for many developing countries, and much of the recent debate on institutional changes and increased resources for the multilateral system has in effect been an attempt to compensate for falls in real export earnings and the enormous expansion of debt connected with them. It is clear that a return to the original Bretton Woods conception (or pre-Bretton Woods conception of Keynes) would require a major institutional re-shuffle, or rather rebuilding.13/ More realistically, the opening of "new windows" in the existing institutions to deal with pressing current problems seems a more immediate approach - but the failure to create a new energy affiliate in the World Bank is not a good omen. Simply to increase the resources (capital, quotas, gearing ratios, contributions, borrowing rights, etc.) of existing institutions will help, but cannot be the only response to the current needs. And the "commodity gap" in the system would be among the first to receive attention.

The failure to deal with the commodity gap by effective multilateral action may also be directly connected with the unilateral producer action in the case of oil in 1973/74 and again in 1979/80. The disastrous effects of this - and of the failure even to guard after the event multilaterally against such consequences - on world prosperity and world stability do not need spelling out here. Neither multilateral prevention nor multilateral cure was in place, and much of the subsequent North-South and NIEO debate with its confrontations and deadlocks was distorted by the need - and inability - to cope with the OPEC problem. Perhaps the recent - temporary? - subsidence of OPEC pressures will offer the opportunity of a new multilateral approach and a chance to look at the commodities problems as a whole once again.

The primary commodities problem is also closely interwoven with the problem of the Fourth World (the least developed countries). It is the low-income countries, largely concentrated in Africa and South Asia, which depend on exports of primary commodities and which for lack of

creditworthiness also depend to a much larger extent on ODA. Further, the capacity of these countries to form effective projects and make effective domestic adjustments in the face of external difficulties is much more limited. Hence, the nexus of commodities/least developed countries/ODA dependence/balance-of-payments support and programme lending/new forms of conditionality forms a seamless web in the case of the countries of the Fourth World. The conditionality they need is one that helps them to open up new sources of supply (specially but not only of home-grown food) and of increasing or economising their skilled manpower rather than one of "adjustment", as conceived by the IMF and the private banks. Their financial "indiscipline" is a symptom rather than a cause of their helplessness in coping with external stresses in the face of extreme underdevelopment. This is not to deny that there is an element of poor management and political instability which adds to financial imbalances, further reduces creditworthiness and unnecessarily increases dependence on ODA, in a number of these countries; but it is usually more a case of vicious circles and cumulative causation rather than a simple cause-effect relation. Thus, the commodity gap in the multilateral system has encouraged the emergence of a low-income stagnating Fourth World and thus placed a heavy burden on the ODA system (multilateral and bilateral) as it has to concentrate on ex-post action in the Fourth World.

VI. Institutional Fragmentation and Need for New Institutional Coordination

In the case of commodities, we have seen how the gap created by the non-existence of the ITO (plus the limited role played by the IMF and the failure to introduce a commodity-based world currency) has been filled by various activities centred in different multilateral organisations, principally GATT, UNCTAD and the IMF. This has raised two problems: (i) the problem of institutional fragmentation and the difficulties (not peculiar to the multilateral system only) of bringing different institutions with their own vested interests and their own philosophy/ideology/mythology to collaborate properly with each other; and (ii) the problem of different groups of countries being "sponsors" of different institutions with whose philosphy/ideology/mythology they happen to agree.

To take this second problem first, this is a particularly dangerous development since it destroys one of the main potential advantages of multilateral action, i.e. that it is less subject to national political pressures. In a world dominated by nation states, this can never be 100 per cent true, specially where the multilateral organisation

has to depend on voluntary, non-automatic contributions of the member countries. For a time, the rise of OPEC held out the prospect that greater pluralism in contributions could spread support and control more evenly over the North-South divide, on the pattern of the first IFAD contributions and spread of voting power, but this prospect has faded. As it is, each group has its favourites among the multilateral institutions and this is where it wants the discussions to take place and the action to be shifted. In the case of commodity action, GATT and the IMF are clearly the favourites of the industrial group. From their perspective, GATT and the IMF are "reliable", "pragmatic", "operational", "sensible", while UNCTAD and the UN General Assembly are "wild","utopian", "rhetorical", "talking shops", "irresponsible". The "autonomy", "independence", "competence", of the first group must be safeguarded from any encroachment by the other. From the perspective of the Group of 77, the first group represents "vested interest", "donor control", "reactionary", clinging to an outdated international economic order with minimum reforms grudgingly conceded under strong pressure, while the second group represents the fighters for a NIEO, the source of new ideas, the repository of hope for real reform and greater equity in the global system. In this way, North-South conflicts are exported into the multilateral system which is torn in two, with attendant difficulties of coordination within the system and difficulties of locating and focusing negotiations. The struggle over the relative roles of the UN General Assembly and the Bretton Woods institutions in the Global Negotiations, which has so long delayed their very start, is the outstanding illustration of such difficulties. As the Commonwealth Group of Experts on the North-South Dialogue rightly observed: "Many important issues of substance lie behind the procedural difficulties".14/ The Expert Group continues that "it should certainly not be beyond the ingenuity of the parties concerned to find a satisfactory formula that would at least permit the substantive negotiations to commence".15/ The very fact that it does prove so difficult even to "commence" suggests that more than procedure and also more than "substance" is involved. Thus, in the specific case of commodities, the problem is made more difficult by the absence of a universally recognised single organisation like the ITO. Such an institution would have covered the diverse lines being pursued between UNCTAD, GATT and the IMF, avoiding to some extent the coordination problems between them, as well as softening some of the ideological battles. Naturally, some organisational tensions would remain (i.e. between departments) as well as different ideological and material perceptions, but these could be resolved in a more organic way, if concentrated in one institution.

To return to the first problem of fragmentation, this is difficult enough even without the added dimension of political sponsorship. The functions of the intended ITO were split up between the GATT, UNCTAD and IMF. The difficulties resulting from the original split between GATT and (since 1964) UNCTAD have been of concern to the Brandt Commission.[16] The creation of UNCTAD is linked to the dissatisfaction of the developing countries with the non-ratification of the ITO in Havana sixteen years earlier. The Brandt Commission felt it necessary to "bring UNCTAD and GATT closer together". The immediate recommendation is for a "small coordinating body", following up on the much more limited cooperation incorporated in the joint control of the International Trade Centre by UNCTAD and GATT. This should have as an immediate result the linking of commodity negotiations (with their financial ODA elements of the Common Fund and buffer stock financing) with the question of access to markets; at present, the former lies with UNCTAD, the latter with GATT. But "in the longer term" the Brandt Commission feels it necessary to recreate the ITO as "an organisation which can represent all interests". Accordingly, it recommends that "an international trade organisation incorporating both GATT and UNCTAD is the objective towards which the international community should work".[17]

But even if the UNCTAD/GATT problem were resolved by better cooperation, or a coordinating Committee or by the re-establishmentof the ITO, there would still be the problem of coordination on commodity financing between the new ITO and the IMF. This has a balance-of-payments context which points to the IMF, particularly in the context of its Compensatory Financing Facility, which - though unsatisfactory - has operated since 1963; the question also has a commodity context and therefore IMF quotas and IMF terms and conditionality do not seem directly relevant.[18] So the respective sponsors of the claims of the two institutions would battle on with arguments arising from their different perspectives, the different composition of their Boards, etc. Yet both institutions would be part of the multilateral system. This system does have its own machinery to avoid conflict, duplication and competition, and promote positive collaboration, centring upon the ACC, the Administrative Committee on Coordination of the United Nations. This has also been pointed out by the Commonwealth Group of Experts, which has urged the ACC "to intensify its efforts to coordinate the activities of such institutions" - in fact mentioning specifically the relations between UNCTAD and the Bretton Woods institutions.[19] However, nobody could claim that the ACC machinery is effective at the level indicated, and in fact there are recent signs that it is being weakened even at the much lower level of coordination at which it is used to

operate. To give it the status and power envisaged by the Commonwealth Group of Experts would certainly amount to a major institutional shake-up.

VII. Structural Adjustment and Balance-of-Payments Loans: Changing Roles of the IMF and World Bank

The Bretton Woods system was based on the assumption that there is a neat, or at any rate a clear, line of division between "development finance" on the one hand, and "balance-of-payments support" and other monetary issues on the other. The former was for the World Bank, the latter for the IMF.

This line of division was maintained for a long time and even made sharper by the fact that the World Bank provided development finance - both through its regular semi-concessional window and also through its concessional IDA window - largely on the basis of project financing (although this was not a necessary requirement under its original constitution). This had the advantage of enabling the World Bank to combine its assistance catalytically with improvement of project identification, project design, implementation, monitoring etc, including the training of local personnel in these crucial areas. It also enabled the World Bank to calculate rates of return on its lending; this is impossible with programme lending or balance-of-payments support. On the basis of respectable rates of return on Bank-financed projects the Bank could establish a reputation for effectiveness and create an image of success which impressed potential contributors and gave the Bank top credit rating for its borrowings. Also economic advice to countries could be based on the World Bank's involvement with concrete projects and activities. The Bank was also able to establish itself as the leader in the coordination of all ODA, e.g. through the aid consortia and consultative groups. Some institutions consider the role of the Bank in this respect as indispensable. For example, OECD (DAC) states: "Everyone speaks favourably of coordination by the recipient government, and the principle is correct. But without help by a strong and respected multilateral agency, host government co-ordination is likely to be pro forma".[20] This "project approach" was compatible with a limited volume of sector lending and even programme lending based on grouping or combining projects - but such lending for a long time remained very small in relation to project lending.

As already indicated, the project approach had till recently enabled the Bank to keep its operations relatively separate from those of the IMF, (even though it has been common practice to have representatives of the Fund on Bank

missions and vice versa). It is a moot question to what extent the desire for institutional tidiness and avoidance of institutional conflict had played a role in pushing the World Bank towards project financing. Under the presidency of Mr. MacNamara, it had not prevented the World Bank from also playing a catalytic role in developing - or helping to spread - new approaches, particularly in recent years a poverty-oriented or basic human needs approach to development. It is not, however, quite clear that within the World Bank these two roles merged in a satisfactory manner; some critics maintain that the World Bank is not always practising what is preaches. In other words there seem to be problems of coordination even within this impressive institution as between the Office of the President or the Economic Policy Department of the Bank on the one hand, and its operational departments on the other hand.

Turning now to the IMF, its role was confined to short-term economic management, and to financing short-term balance-of-payments disequilibria - functions which were supposed to be separable and distinct from development problems. As discussed above, such a distinction might be plausible in the case of industrial countries but in the case of the developing countries it was doubtful from the very beginning. Nevertheless for the 25 years up to 1973 the distinction could be maintained, because "development" was largely sustained by the general growth of the global economy, by financial flows both from commercial sources and ODA, while balance of payments disequilibria were manageable by means of "short-term adjustment" and balance of payments finance. Short-term economic management was somewhat facilitated by being in the context of fixed and only infrequently changing foreign exchange rates of the major countries as well as low world inflation.

In fact, an important part of IMF lending in recent years has been to the poorest of the developing countries (which cannot count on and cannot afford commercial bank lending). When foreign exchange shortages and deteriorating terms of trade, superimposed upon a stagnating global economy, impose strains of an entirely new order on poor countries whose desperate need is to sustain imports and levels of activity, the idea that the realm of the IMF could be separted from the development activities of the World Bank becomes increasingly unreal. In fact at these low levels of development the capacity to adjust is itself a function of development. As the Brandt Report puts it: "The adjustment process in developing countries should be placed in the context of maintaining long-term economic and social development. The IMF should avoid inappropriate or excessive regulation of their economies, and should not

impose highly deflationary measures as standard adjustment policy."[21/] Short-term "adjustment" and long-term development are inevitably inter-linked; if IMF conditionality is not adapted to the specific conditions of the poorest countries and if its deflationary bias is not removed, its policy advice will not only contribute to lower levels of consumption and production, but will also inhibit the possibility of future growth and development.

There is thus an increasing risk that the overall policy advice of the IMF in the direction of "restraint" will become increasingly incompatible with the policy endeavours of the World Bank - less in its capacity of project lender but certainly in its capacity as policy adviser and chairman of consortia and consultative groups - to promote development in the poorest countries. In these circumstances, the Bretton Woods fiction that the IMF gives macro advice related to broad policies, while the World Bank gives micro advice related to specific projects, sectors and development programmes becomes unreal in a situation where foreign exchange shortages and balance of payments pressures become the governing factor in development programming and even in the implementation, continuation and maintenance of specific projects.

As already discussed, the line of vision has been further blurred by two developments:

(1) The IMF has moved from its originally assigned field of short-term financing more and more into the field of medium-term financing, while the World Bank has moved from long-term financing towards medium-term structural adjustment lending. This again has created a new situation in which coordination between these two largest multilateral institutions requires new consideration. Essentially both the IMF and the IBRD now serve the purpose of providing time or breathing space for hard-pressed low-income countries, without direct concord of what the breathing space bought with their resources should be used for. As the Brandt Commission papers point out, there are still gaps in the facilities provided by both institutions: "A range of financial needs falling between those catered for by the IMF and those met by the World Bank and similar institutions call for attention."[22/]

(2) The World Bank is clearly moving in a direction away from its almost exclusive concentration on project lending to increasing emphasis on programme lending, structural adjustment lending, concern with debt settlements, local currency lending, lending for continuation and maintenance of projects etc. thus blurring yet another distinction from the field reserved for the IMF. This is

directly related to the need for much greater and more fungible resource transfers to the developing countries than originally envisaged at Bretton Woods, or than it was possible to assume before 1973. This has made the Bank keenly aware of the limitation of absorptive capacity for aid handled on a project basis, especially if its customarily high standards of project preparation, and of monitoring the implementation and impact of projects are to be maintained. This lack of capacity due to the multiple lags between commitment and expenditures exposes the Bank to the risk of new institutions being proposed (such as the World Development Fund proposed by the Brandt Commission). The need for more flexible, i.e. non project-restricted, external resources will become even more pressing, as the commercial banks which have previously supplied the bulk of such financing will reduce their lending in view of their increased perception of the risks involved in lending to LDCs and as in any case the bulk of their lending will simply amount to the roll-over of existing debts (thus implying very little net new lending). The limitations of lags involved in project-financing also make such financing very difficult to use for anti-cyclical purposes and to deal with current balance-of-payments pressures. It can also be observed in low-income countries that project financing pre-empts the limited project-formulating capacity for low-income countries, at the expense of often more basic administration of existing projects. It remains true, of course, that even balance-of-payments support still requires the resources thus made available on a non-project basis to be translated into concrete projects. But these will often consist in maintaining projects and services otherwise threatened with breakdown, at a cost and to the disadvantage of any projects financed by project-tied transfers. The paper on 'The International Financial System and Institutions' prepared for the Brandt Commission argues that "the problem of absorptive capacity /if there is a shift to programme lending/ should not be exaggerated; there are few countries which could not manage higher levels of effective investment given additional resources"23/ and goes on to argue that "in many cases programme finance would increase absorptive capacity for project finance, indeed is often indispensable as a complement to project lending."24/

The World Bank itself had already keenly felt the limitations of project lending in a context of balance-of-payments pressures as early as 1978, as indicated by the following statement in its Annual Report for that year:

> "A review by the /World/ Bank of the causes of the slow growth rate in disbursements indicates that implementation of many Bank-

assisted projects has been adversely affected as borrowing governments have tried to adjust to inflation, to balance-of-payments difficulties, and to rising budgetary deficits. In adjusting to inflation by reducing expenditures, and in adjusting to balance-of-payments difficulties by cutting back on domestic credit expansion, governments have found that counterpart funds needed for the full financing of Bank-and IDA-assisted projects are in short supply; this shortage, of course, affects project implementation."25/

The World Bank and IMF activities were also kept apart because the IMF stabilisation programmes concentrated on "demand side" measures, such as monetary and fiscal measures to reduce aggregate demand, additional measures to encourage exports, most frequently through devaluation, as well as simplification and/or liberalisation of trade restrictions. On the other hand the World Bank's structural adjustment loans were, and still are, considered to concentrate more on "supply-side" measures to increase the efficiency of production and of international competitiveness through shifts in investment priorities and rationalisation of price structures. However, more recently the IMF has claimed to pay much more attention to supply-side measures, particularly under longer-term programmes such as those undertaken with an IMF extended facility standby. The World Bank on the other hand has been moving towards giving more weight than in the past to demand side measures, particularly in its policy advisory functions and its co-ordianting functions in aid consortia and consultative groups, as well as in its signalling function to sources of finance. In any case, supply-side and demand-side aspects cannot always be reasonably kept apart; for example an improvement in the efficiency of a parastatal organisation such as a Maize Marketing Board or a Cocoa Marketing Board in Africa can be equally considered as a supply side measure in improving the efficiency of the economy, and mobilising agricultural surpluses, and also as a demand side measure since the deficits of such marketing boards are major elements in government deficits and hence in inflationary pressures. It seems clear that some kind of synthesis of demand side and supply side measures is needed and thus the division between World Bank and IMF roles becomes questionable.

The second Brandt Report draws the same distinction between the supply-oriented Bank approach and the demand-oriented Fund approach to terms of conditionality, and in

an interesting passage comments on the fact that the prior precondition on Fund approval under its Extended Fund Facility (EFF) arrangement before a Structural Adjustment Loan by the World Bank is approved swings the balance unduly towards the demand approach:

> "In fact, a country is usually expected by the Bank to reach agreement with the Fund first on a standby or EFF credit when it initially applies for a SAL. This is an unfortunate sequence, effectively relegating supply-side adjustment issues to a secondary place in policy formulation, given the Fund's current approach to conditionality."[26/]

The natural suggestion arising would be either that the indicated sequence should be reversed (or at least that the two actions should be simultaneous and mutually co-ordinated); or else the nature of Fund conditionality should be fundamentally modified.

The qualification in the passage just quoted should also be noted, (i.e. "... given the Fund's current approach"). In fact, the Fund's purposes, as defined at Bretton Woods in its Articles of Agreement, include "the development of the productive resources of all members" and "promotion and maintenance of high levels of employment and real income" as "primary objectives". In this as in other respects touched upon in this paper proposals for "change" or "reform" in fact surprisingly often really amount to a restoration of original concepts subsequently forgotten or abandoned in actual practice.

The Fund's defence of its concentration on "sound demand management" is to deny that such policies are "inimical to growth", but that on the contrary "lax demand management policies" have been "at the root of severe inflationary pressures" and that "studies in the Fund have demonstrated clearly that, over the long run, those countries that have been more successful in controlling inflation have also achieved a better growth performance"[27/] To this there are two replies. One is to note the qualification "over the long run" and to question whether the developing countries, and especially the poorer developing countries, can afford such a long-run view, or whether perhaps in relation to them Keynes' dictum is more relevant that "in the long run we are all dead". The other reply is to state that the debate is not whether "lax demand management" is good or bad for growth - most would agree that it is bad - but about the nature of "sound

demand management" where the excess demand is as much, or more, due to lack of resources to meet it than to "lax management". Both the proportion of resources lent under high conditionality facilities and the conditionality itself therefore need to be questioned.

It has been argued that the shift towards more high-conditionality lending by the IMF has been the by-product of the way in which IMF resources have been increased in recent years to cope with increasing difficulties and balance-of-payments deficits of developing countries. This was mainly by increasing access to Fund resources by allowing borrowings as a higher proportion of countries' quotas, rather than by increasing quotas themselves. While the increase in quotas would have created additional low-conditionality resources, the expansion of the proportion of quotas which can be drawn created high-conditionality resources. As a result, while in the seventies the bulk of IMF support (two-thirds) was low-conditional, now the situation is reversed and the great bulk of IMF support (an 80 per cent estimate has been made for 1980-81) is now on strict high-conditional terms. It has therefore been argued that this is largely a result of the form in which Fund resources were generated recently (by borrowing from capital surplus countries rather than by quota expansion). However, this argument is not necessarily valid as in the mid-seventies borrowed resources were used by the Fund to create low-conditionality facilities, such as the 1974 and 1975 Oil Facility; this Facility was not renewed after the second (1978-79) large rise in the price of oil. Therefore, there seems also to have been an explicit decision at the Fund to increase lending via high-conditionality facilities.

Where the external imbalance is the result of deterioration in the terms of trade (or decline in capital inflows) the perceived excess of aggregate demand over aggregate supply corresponding to the external deficit is best viewed as being the consequence of a shift in the supply curve rather than of the demand curve. This distinction is useful not only as a diagnostic device but also to the prescription of policies, since it points to the need to increase the capital stock and change its composition. Adjustment in the foreign balance is more difficult and complex when the imblance is in the pattern of supply.

The critiques of Fund conditionality can be perhaps divided into two aspects: (a) the time frame of adjustment. As we have argued above (following an increasing consensus), the deterioration in the international environment and the greater need for structural adjustment, as well as the specific problems which characterise poorer countries, imply

the need for a slower pace of adjustment than advocated by the Fund, so that greater emphasis can be placed on supply expansion rather than on demand contraction. Slower adjustment would be less costly for the individual country (in terms of consumption, production and employment sacrifices) and tend to remove deflationary bias on the world economy of Fund programmes. It would however require additional and more long-term flows of finance. One mechanism which could easily be used to achieve this purpose - as it would be based on facilities already in operation at the Fund - would be a substantial enlargement and an improvement of the Compensatory Financing Facility and the Extended Fund Facility, possibly accompanied by special windows for low-income countries facing severe adjustment problems and with inadequate access to financial markets;
(b) there is a second - related, but clearly distinct - critique of Fund conditionality. It is linked to the relatively uniform method of adjustment applied to countries with different levels of development and different types of economic and political systems. Furthermore, the type of adjustment recommended by the Fund - based on a monetary approach to the balance of payments - is very far from being universally recognised as being the optimum method for adjustment in a given period, such that it minimises the "cost" in terms of output and employment and leads to a more favourable income distribution. Once the external financial constraints have been defined (hopefully having been broadened as discussed above in point (a)), the Fund is correct in stressing the need for adjustment so that the country's level of economic activity is consistent with the real and financial constraints within which it has to operate.[28] However, the optimum form of adjustment should be much more open to discussion within the negotiations between the Fund and the country. Developing countries' governments and scholars (as well as those advising them in the North) should devote much more time and effort to the development of concrete and financially viable alternative approaches of adjustment to those put forward by the Fund. Potentially this should become an increasingly important area of technical assistance and intra-developing country cooperation in the coming years. Perhaps some of this research could be carried out in the Fund itself; more importantly, the Fund should be open to discuss and accept such alternative approaches in negotiations with individual countries, and possibly be willing to apply such alternatives in other countries. Given the problems of bureaucratic inertia and the weight of ideology as well as of an easy and clearly established - even if clearly inappropriate - modus operandi of the Fund staff, the most likely source of change will be the pressure which countries' governments can - individually and collectively - exercise

at different levels of the Fund. For example, the work of the Group of 24 in this field - which is already very valuable - should be strengthened.

Changes in the IMF's *modus operandi* would be valuable so as to make the adjustment process more appropriate to the needs of developing countries. In particular, it has been suggested[29/] that greater weight should be given by the IMF to output, employment and income distribution, relative to its past almost exclusive emphasis on inflation and balance of payments. Operationally, this could be achieved by including amongst the conditions attached to drawings, the achievement of certain growth targets, as well as maintenance (or perferably increase) of real household incomes of the poorest strata, as well as of public services directly linked to the welfare of the poorest. At the same time somewhat greater flexibility could be attached to macro-economic targets; thus, for example, if the underlying assumptions about the future course of important economic variables differs substantially from that assumed in the programme, macro-economic performance criteria could be revised within suitable margins of deviation, without interrupting drawings on the loan agreement with the Fund, and without need for protracted renegotiations leading to new loan agreements (as occurs now).

Technical work on those issues - both within and outside the IMF - needs to be combined with political persuasion, to ensure that such changes are accepted by the Fund's authorities.

Returning to the subject of better coordination between the Bank and the IMF, suggestions which have been made include the use of staff rotation between the two organisations - it is in fact remarkable that this has not happened more, considering that the two organisations are next door to each other in Washington - and also the merging of certain departments,[30/] as well as joint rather than separate country missions and country assessments. Such joint action and joint policy advice would also make the catalytic or signal functions of both institutions more effective.

Apart from natural institutional compartmentalism (or in more polite terms institutional "autonomy") the greater intellectual movement would be required from the IMF rather than from the World Bank; as has been pointed out before, the real fundamental problem of low-income countries is one of the supply shortages and bottle-necks characteristic of their situation, and even their foreign exchange shortage in the context of a stagnating world

economy and weak commodity prices is, to an important extent, a question of external factors rather than domestic management. Yet the IMF advice is not addressed to these external factors (mainly the industrial and capital surplus countries causing them) but rather to those suffering from it. This takes us back to the asymmetry built into the Bretton Woods system by not developing IMF conditionality in the direction of balance of payments surplus countries.

VIII Catalytic Functions of World Bank/IDA and IMF: Implications for Staffing and Decentralisation

The emphasis on the crucial policy-making, co-ordinating and signalling functions of the two big multi-lateral institutions - which have developed strongly since the early days of Bretton Woods - also have direct implications for staffing and for decentralisation.

On staffing, there is broad general agreement that it would be desirable to have more representation from developing countries, especially at the senior and policy-making levels. While the general desirability of this is recognised, to be effective such shifts in staffing would have to be combined with three other considerations.

(1) The staff members from developing countries would have to be genuinely rooted in their own countries and with experience in their own countries, shown for example by a high proportion of their professional life spent working there, rather than fresh graduates from American or European universities (this is of course directly related to the level of staffing).

(2) As long as the operations of the Bank and Fund remain so strongly centralised in Washington, additional staffing from developing countries could result in a further brain-drain and the new appointees would soon be part of the general Washington environment.

(3) The changes in shifts of staffing would have to be related to similar shifts in the distribution of voting-power and control. This last issue is of course under considerable debate and it is clearly related to the overall issue of a New International Economic Order and Global Negotiations (NIEO), and to the issue already discussed of politicisation of multilateral agencies. Presumably the shifts in voting power and control in the IBRD/IMF would have to be matched, on the part of the developing countries, by some dilution of their own control of the UN General Assembly as a policy-making body. This issue has been discussed by the Commonwealth Group of Experts on

North-South Negotiations who have suggested a strengthened ECOSOC or similar sub-group of the UN General Assembly with more balanced voting power as an effective organ of control. Similarly there are related suggestions to entrust effective negotiations and policy-making to sub-groups dealing with particular issues with balanced and flexible distribution of voting-power depending on the particular issue concerned; in the vision of the Commonwealth experts and of the Brandt Report such ad hoc groups would be co-ordinated on top by some kind of summit arrangement a la Cancun. However this arrangement still leaves open the precise roles of the UN General Assembly on the one hand, and of the Bank/Fund on the other hand.

The issue of developing countries' influence on the Bretton Woods institutions is not only related to voting power and staff representation, even though these are important pre-requisites. Also of great importance is that the representatives of LDCs in these institutions (and particularly in their management, such as the LDC Executive Directors at the Fund and the Bank) are extremely well prepared (both in the technical and political aspects) to defend the interests of their countries and get sufficient back-up from their governments,either through direct communication with their countries or through high level technical assistance in Washington. Industrial countries' influence in the Bank and the Fund not only relies on voting power, but also on the priority attached to high levels of technical experise of many Executive Directors and their back-up teams (the British representatives clearly being amongst the leaders in high quality technical contributions). As the Executive Directors of developing countries have the more difficult task of challenging the existing modus operandi and proposing alternatives - their need for expertise is even greater than that of industrial countries.

Similarly, the LDC teams in charge of designing national programmes of short-and long-term adjustment - as well as negotiating them with the Fund and the Bank - need to be strengthened. Of particular value will be national as well as intra-LDC efforts in this direction, with contributions from academics or technical advisory teams from industrial countries. The contribution of the Fund and the Bank (as well as of commercial banks increasingly "in the business" of advising LDCs on policy-making) is of much more doubtful value, as the aim should be to strengthen alternative - though viable - approaches to adjustment to those advocated by the Fund and the Bank. This would allow a real high level "policy dialogue" and not a monologue!

More balanced staffing and control is directly linked to the question of decentralisation or regionalisation. As often pointed out, the degree of centralisation of both the Bank and the Fund in Washington is extraordinarily high, with 90 to 95 per cent of the staff there. A regionalisation of the Bank and the Fund would possibly put them in closer touch with the views of governments and other groups in developing countries; it would facilitate recruitment of staff members from developing countries; and above all it might result in closer collaboration with the Regional and Sub-Regional Development Banks. The Regional Banks (Inter-American, Asian and African Development Banks) are already a significant channel of multilateral finance although they are presently over-shadowed by the World Bank. The Regional Development Banks have also developed a method of balanced control and voting-power which in the case of the Inter-American and Asian Banks does not seem to be a major source of trouble. In the case of the African Development Bank, however, there was no participation of non-African contributors in its basic capital[31] initially, and thus for a long time the African Development Bank was relegated to a very minor role in development financing. Very recently, however, an agreement has been reached and the African Development Bank has been opened up to non-African contributors who have been allocated one-third of the voting-power, ensuring that control remains in African hands. It would, however, take a very major expansion of the resources and activities of the African Development Bank to fill the African gap. For example, the Asian Development Bank, although it is three years younger than the African Bank, at the end of 1981 had private loans more than 20 times larger than the African Bank. Even the present plans for an expansion of activities by the African Development Bank would still leave it well below the two other Regional Banks.

What has been said about the Regional Development Banks broadly also applies to the Sub-Regional Banks in the Caribbean, Central America and elsewhere.

Some decentralisation of World Bank structures, combined with closer links with the Regional Development Banks and certainly a larger role for the African Development Bank (the natural multilateral agency for poverty-oriented investment in the African poverty belt), would have the further advantage of avoiding an awkward dilemma. This dilemma lies in that increased multilateral resources for economic development in the directions in which clear gaps now exist (such as energy, some mineral development, financing of local expenditures, maintenance and repair requirements of ongoing projects, poverty-oriented human

development, such as action for children, etc.) must mean one of two things: either a proliferation, probably wasteful, of multilateral institutions or else a strengthening of the already quasi-monopolistic and highly centralised World Bank as the dominant multilateral channel. A decentralised World Bank structure with a strengthened role for the regional institutions seems the natural way of resolving this dilemma. "New Windows" in the World Bank, without some devolution of this kind, would not seem to achieve this.

The Brandt Report tries to avoid this dilemma in a different way: by merging all the new gap-filling functions in one single new institution - the Brandt Report's proposed World Development Fund 32/ - as well as by decentralisation and regional devolution which the Brandt Report strongly advocates 33/. The Report also recommends the establishment of Regional Advisory Councils with "autonomy and genuine decentralisation" 34/, and draws attention to the fact that both the general principle of decentralisation as well as the specific proposal for Regional Advisory Councils are in fact explicitly provided for in the Bank's articles. One obvious extension of this proposal would be to have the Regional Advisory Councils actually established within the Regional (and perhaps also the sub-regional) Development Banks to ensure closer coordination and perhaps also to serve as a channel for lines of credit from the World Bank to the Regional Banks 35/. The link with the financial institutions would naturally strengthen the role of such Regional Advisory Councils.

There is a promising potential in a link between the expanded structural adjustment lending by the World Bank and possible decentralisation and regionalisation of Bank activities. The Bank in announcing its "New Special Action Program" (which includes the provisions for expanded structural adjustment lending) stated that it "plans to intensify its use of various consultative mechanisms to urge other international lending institutions and bilateral aid donors to consider measures similar to those in the program" 36/.

IX. Multilateral Technical Assistance: Current Problems of Coordination

There is one area of multilateral assistance where in fact decentralisation has continued apace - although it is by no means clear whether this development should be described as decentralisation or rather fragmentation and loss of coordination. The reference is to multilateral technical assistance within the UN system where the intended central funding role and coordinating function of the UNDP have sharply declined. The principle of a central funding role for the UNDP

has never been openly changed or abandoned since it was formally established in the "Consensus" in 1971. But in fact it has been steadily eroded and is now more of a vision than a reality. This has been due to the increasing tendency of the various specialised agencies to attract technical assistance funds of their own, either through their regular budgets or through special funds or through the establishment of trust funds. This shift has also increased the tying of technical assistance and reduced to that extent the impact of "country programming" which was supposed to be the basis of UN technical assistance work. In a way the shift away from central funding through the UNDP and from a country focus back to the individual agencies and hence back to a sector basis is a return to the earlier days of the UN Expanded Programme for Technical Assistance (ETAP), one of the forerunners of the UNDP. In the initial period of ETAP there were fixed shares for the different agencies, and there was no attempt at country programming. It is not clear to what extent the partial return to this earlier situation is intentional, or simply the result of institutional rivalry or institutional empire building. To some extent this is clearly due to inconsistent positions taken by government representatives on the governing councils of the various agencies.37/

The decline in the role of the UNDP - both absolutely and even more so relatively - has also led to pressures on the multilateral financing institutions, eg. Bank/IDA and Regional Development Banks, to fill the gap by increasingly undertaking technical assistance work of their own in relation to their own projects and also in general project formulation and planning advice. This latter development can either be treated as a negative factor because it erodes the funds available for direct financing, or else it can be treated as a positive factor because it leads to better coordination between technical and financial assistance. But however it is considered, the development is more incidental than planned and there seems an urgent need to achieve a consistent policy and situation in the field of multilateral technical assistance.

From the point of view of the UNDP, much of the erosion is due to the difficulties of obtaining the necessary increases in the voluntary annual contributions (determined in monetary rather than real terms) on which the UNDP depends. Hence any reform or reconstruction of the multilateral technical assistance programme may have to include the development of less volatile and more secure sources of financing for the UNDP. This question is presently being looked at by a special UN review. But above all it calls for a consistent policy regarding the relative roles and magnitudes of the UNDP, the various

specialised and operational agencies within the UN system, the multilateral financing institutions, and also the bilateral technical assistance programmes and their co-ordination which cannot be disregarded in any rational scheme for multilateral technical assistance. But above all it would then require a consistent adherence to the line followed by member governments in all the different institutions and agencies concerned.

As a first step towards more secure contributions, the "indexing" of contributions might be considered. This has two aspects: (1) protection against the erosion of contributions by inflation which now reduces the activities of the UNDP (and other multilateral operations); and (2) protection against fluctuations in exchange rates which can impose unforeseen burdens in contributing countries. Contributions to the UNDP are in terms of US dollars which have recently been very strong in relation to other currencies - but contributing governments should also consider that the expenses of the UNDP in turn are at present also largely in terms of dollars. Hence, any switch might also extend to the greatest possible extent to UNDP expenditures as well as contributions. With a significant proportion of the contributions and the bulk of UN exports and supplies - not to mention their customers - not being "on the dollar", it is not immediately obvious that contributions as well as expenditures could not be switched to a SDR or "bundle of currency" basis, as well as "indexed" against rising prices. Given the present lower rate of inflation in the main contributor countries combined with a higher dollar, now might be a good time to make indexing and switching acceptable to the major contributors. This proposal might well apply beyond the UNDP to contributions to multilateral institutions more generally. It would seem particularly appropriate for the IMF, which already uses the SDR as a Unit of Account in all its operations, to extend this criterion to an "indexed" SDR.

X. Co-financing

One of the proposals increasingly on the international agenda is to increase the catalytic effect particularly of World Bank lending through increased co-financing with private banks. This proposal has been made by different institutions, including OECD/DAC[38] but is still awaiting more widespread implementation. This involves a Bank guarantee in the sense that through a "cross-default" provision a default on the private debts within the package would also be deemed a default on the World Bank component; the idea of course is that this would enhance the security and hence the flow of private financing because developing

countries would be very reluctant to be deemed in default to the World Bank, which would have most serious consequences for their credit rating and future financing prospects.

There are a number of other similar proposals of the same general nature, all sharing the idea of co-financing. The problem of this family of proposals is that it does not adequately cater to the poorest countries who have no access to private capital markets although presumably the Bank participation and Bank guarantee would extend the "reach" of private lending a little further downwards towards the low-income countries by including some of the "in-between" countries. This in turn would set free World Bank and other sources of ODA for low-income countries which would thus benefit indirectly.

Co-financing with the commercial banking sector is of course a familiar Bank practice and has played a useful role, particularly in encouraging commercial banks previously unfamiliar with lending opportunities in developing countries. One of the suggestions is that the practice of co-financing could well be extended further to include specifically commercial banks in LDCs, so as to encourage them to make loans to other LDCs[39/]. However, unless such co-financing is specifically and purposefully directed towards low-income countries, there is a risk that commercial banks in low-income countries (e.g. India) could participate in financing the needs of relatively high-income countries (e.g. Mexico or Brazil). But the suggestion could be very useful when applied to private banks and funds in high-income OPEC countries and directing them into low-income countries. This would help with the generally desirable attempt to provide for more direct re-cyclying of OPEC surpluses into low-income countries[40/]. However, any proposals of this kind are still subject to the basic limitation that for commercial lenders operating on strictly commercial principles low-income countries are not an attractive field for operations and a very important element of public funds or public guarantees in co-financing - a blend of contributions, guarantees or interest subsidies - would be required.

XI. Low-income developing countries (LILDCs)

One of the problems with multilateral ODA - which applied both to the World Bank and to the Regional Banks - is the fact that, with most of the available resources having been obtained by operating in private capital markets or by non-renewable capital subscriptions, the investments concerned must earn semi-commercial rates of interest, with a relatively modest grant element. This is

then supplemented with a separate "window" through which low-income countries can obtain loans at virtually zero interest, with a very high grant element. This arrangement does not seem quite in tune with the great variety of income levels among developing countries and their needs. Obviously one can achieve any intermediate terms of financing by different "blends" of semi-commercial and highly concessional sources for any given country - but this in turn is not easily reconciled with the essentially project basis of the World Bank and Regional Banks.

There are many proposals suggesting ways of filling this gap between the semi-commercial and near-grant ends of the MODA spectrum. The second Brandt Report rejects a proposal by the US Treasury[41] that some countries could be "graduated" out of IDA. The randt Report objects to the proposal because in practice it is directed towards moving China and India out of IDA financing.[42] The new Brandt Report maintains that what is needed is a larger IDA in view of the heavy demands on aid, and an attempt to cut down demand by removing current major borrowers would end by having its terms hardened. The Brandt Report declares: "'Balance', yes; 'graduation', no."[43]

The question of introducing "graduated" or differential interest rates - in effect amounting to a hardening of the terms of IDA - has already come up in the negotiations for the next renewal of IDA (IDA 7), but is resisted by the potential recipients. It would, of course, cease to be an effective hardening of terms and thus reduction of the grant element in concessional aid if it were to be accompanied by a proportionate-or more than proportionate - increase in the total size of IDA. However, such an increase is unfortunately not within realistic expectations. As it is, graduation may in fact be accompanied by a further thinning out of aid for the LILDCs, due to the inclusion of China among recipient claimants and factors such as the need for energy investments (due to the failure to establish an energy affiliate). This strengthens the case for establishing a separate target or sub-target (0.15 per cent) for the LILDCs and for looking at the whole ODA system, bilateral and multilateral, with a view to concentrating the system more on the needs of the LILDCs.

The close link between multilateral aid and flows into LILDCs represents an important element in the present situation and has special importance for future aid policy. About 60 per cent of net MODA disbursements of $14 billion in 1981 was on concessional terms ($8 billion).

In fact, the LILDCs receive around 40 per cent of their ODA from multilateral sources, including among the latter EEC and the multilateral part of OPEC assistance. The action of MODA sources is particularly strongly concentrated on agriculture as well as on the LILDCs. Hence, any shift in total aid towards the multilateral sector - both in overall aid and in concessional aid - is likely to increase the flows into LILDCs and into agriculture (both recognised priority objectives), and vice versa.

It would be good to think that the increase in the multilateral share of ODA which occurred in the mid-seventies was causally connected with the priorities for agriculture and the LILDCs (and, of course, with particular priority for LILDC agriculture). But in fact, this does not seem to be the case, for the multilateral share has subsequently receded again, in spite of sustained or strengthened priorities for LILDC/agriculture. This suggests that, while in the seventies the individual multilateral agencies were able to make a good case for a slice of expanding ODA, the subsequent stagnation and real reduction of ODA has fallen with particular intensity on the multilateral agencies, multilateral cuts being the line of least resistance for a number of donor countries. It further suggests that a restoration of the multilateral share to the 30 per cent plus level achieved in the mid-seventies, to be lasting, should be based on a collective review of the LILDC/agriculture priorities and the special role and experience of multilateral agencies in these priority areas.

Apart from actual financial flows, the co-ordinating ("umbrella") and policy advisory role of the multilateral institutions has greater impact on the LILDCs whose autonomous policy-making capacities may be more limited, and for which whatever limited access there is to commercial funds is even more dependent on the "green light" of multilateral institutions. Deflationary "adjustment" can cause much more harm to these low-income countries, as the poorer a country the less the margin for expenditure cuts without massive damage to essential consumption, basic services, new investment to restore balance, and replacement investment to maintain productive capacity. Furthermore, the lower the elasticities of substitution between tradeable and non-tradeable goods,the costlier it is to correct a payments deficit in the short term (that is without a prior increase in productive capacity). Factors such as the lower share of manufacturing in the LILDCs imply such relatively lower elasticities of substitution. Thus, conditionality falls with particular harshness on the LILDCs, partly because they have less access to unconditional commercial

and other sources of finance and partly because economic, administrative and personnel bottlenecks make it particularly difficult for them to adjust rapidly. To compensate for this unfavourable bias, the IMF should be persuaded to accept that differentiated treatment - i.e. more favourable and flexible conditionality for LILDC's - recognises the differential burden of conditionality and is a more equitable way of dealing with the poorest countries. Technical assistance - for example from other developing countries - to help negotiate with the Fund, and to prepare alternative adjustment programmes, could be of particular value to these countries.

In the case of the UNDP, as the central multilateral funding agency for technical assistance, there has been some concentration on the LILDCs but this is limited by the political requirement that all participating LDCs must have a country programme and "fairly" share in the available resources. Similar considerations apply to food aid in the case of the WFP, although emergency and refugee situations here provide additional opportunities to concentrate on the LILDCs. In the case of the UNDP, the current "erosion" in the form of a shift of multilateral resources towards the specialised agencies may in fact increase the opportunities to concentrate on LILDCs, at least in so far as the additional funds of the specialised agencies take the form of special funds, trust funds, etc. where there is no obligation of "fair shares" for all member countries. The case of technical assistance, in fact, provides an exceptional case where concentration on LILDCs may be easier bilaterally than multilaterally. Some of the bilateral aid programmes of smaller donors in particular, which limit their activities to a few selected countries, may have a superior record of concentration on LILDCs.

The cross-link between priority for agriculture and for LILDCs is strongly indicated by the fact that in 1979 no less than 59 per cent of the official commitments to food and agriculture by DAC members and multilateral organisations went to low-income countries. At the same time, multilateral organisations accounted for about 50 per cent of total commitments to food and agriculture, which in turn represented one quarter of official commitments for all purposes by all donors. The share of multilateral commitments going to agriculture (at around 34 per cent), was almost double that of bilateral commitments going to agriculture from DAC members (at around 18 per cent). However, commitments are not always clearly sectionally allocated, and there is room for divergencies between the "broad" and the "wide" definition of agriculture. Within the UNDP system also, FAO is the largest recipient although its share is less than 38 per cent of capital commitments;

but in addition FAO has been the largest beneficiary of the movement towards decentralisation or UNDP "erosion" and the largest recipient of special funds and trust funds. Thus, the multilateral system has displayed a comparative advantage of concentrating on agriculture and acquiring experience in agricultural aid which also gives it a cross-link to LILDCs, basic needs and poverty-orientation. This is an important institutional advantage worth preserving and developing.

Among the multilateral organisations, in 1978/79 the African Development Bank devoted 94 per cent of its disbursements to low-income countries, and 82 per cent to the least-developed countries (a specially poor sub-group among the low-income countries defined by UNCTAD), this reflecting the nature of its membership. In fact, as the 1981 OECD/DAC report points out, in the case of the African Development Bank all three priority considerations coincide: concentration on low-income countries, on least-developed countries within low-income, and on Africa South of the Sahara[44]. Hence, the prospective expansion of the African Development Bank and the agreement of non-African countries to contribute to its capital structure are particularly significant in strengthening the poverty and agriculture orientation of the multilateral system. The weakening of IFAD (in real terms) will, of course, work in the opposite direction and weaken the multilateral system in its concentration on agriculture.

Aid to the poorest countries has increased in the recent past, both absolutely and as a share of total ODA. Multilateral ODA to these countries has increased particularly fast (by 19.4 per cent per annum over 1974-80 in real terms compared with 8.4 per cent annum for bilateral aid from DAC countries).[45] This indicates that the multilateral agencies seem to have a comparative advantage in directing aid to the poorest countries suggesting that MODA may play a leading role in aid to the poorest countries (it also has comparative advantages in aspects such as its strong grant element). Nevertheless, it needs to be stressed that the performance of aid - and within aid that of MODA - though positive was clearly insufficient, given the magnitude of the impact of the world recession on the poorest countries[46].

The technical assistance element in MODA is also particularly important in LILDCs, pointing to a special role for the UNDP system, giving also special point to the problems created by the "erosion" of the UNDP. Another problem is the universal membership which means that the better-off LDC members would have to take an understanding,

and to some extent self-sacrificing, attitude to the claims of the LILDCs, in effect accepting the principle of "graduation" in the field of technical assistance. In the UNDP, this has already happened with the consensus that 80 per cent of the resources should go to the LILDCs, although this might need further sharpening to focus on the poorest countries.

Levels of administrative and policy management may also be more fragile in the LILDCs - probably true as a generalisation, although with qualifications and exceptions. This increases the influence of conditionality while at the same time making traditional forms of conditionality particularly questionable and dangerous. As a recent World Bank report emphasises, while aid must depend on reform, reform also must depend on aid. "Policy reform without substantially increased aid does not provide a satisfactory solution ..... Many African countries could not undertake reform without additional assistance."47/ The evolution of the right mixture of aid and reform for the LILDCs is an international task of high priority.

In assessing its future role in Africa (where so many LILDCs are concentrated) the World Bank, for the IDA, emphasises strengthening national capacities: "IDA has now taken a new approach toward Africa, which puts greater emphasis on improving human-resource development, on building a sound institutional infrastructure, and improving domestic economic management".48/ In the case of IDA, it is also stated that a policy dialogue, while linked with its expanding programme lending and structural adjustment credits, dominates all its relations with recipient countries even in the prevailing case of project lending. "Considerable time is spent on general economic and sector work before any actual project lending takes place. It is difficult to sustain a good project in an unfavourable environment. Furthermore, fruitful policy dialogue can do more to influence a country's development than even a series of good projects"49/. The weight of such policy advice must be coupled with a certain volume of resources to offer - hence the importance of such policy functions should not be considered an argument for cutting contributions. Furthermore, the international community needs to keep the nature of such policy advice under constant review; for example, fears have arisen that the World Bank's document on Sub-Saharan Africa, known as the Berg Report50/ does not take proper account of the characteristics of the poorest countries and shows excessive faith in the use of market mechanisms and signals to overcome structural problems51/.

XII. Proposals from the Brandt Report

The original Brandt Report[52] made a number of suggestions on changes in multilateral ODA. Some of these changes are closely related to other discussions in this paper and have been implicity or explicitly dealt with. There remain, however, a number of suggestions not so dealt with and it may be convenient to list them and point out their relationship to the rest of this paper.

(1) Brandt suggests the use of the guarantee power of the World Bank and of the Regional Development Banks in order to provide easier access for developing countries to bond markets in the North[53]. This would be a useful addition to the "catalytic powers" of the World Bank discussed in the paper. The Eurobond market would potentially provide funds with longer maturities and at lower cost to developing countries, with more fixed and predictable debt burdens than the Eurodollar loans mainly used to finance LDCs' deficit. While this would be a desirable development it never was of direct importance for the LILDCs whose credit rating was not normally sufficient for access to Eurobonds, (perhaps with the exception of India); given the current trends in private capital markets it is unlikely that any developing countries can raise significant funds in the Eurobond markets. (Since last year LDCs' share in this market has been rapidly declining.)

(2) Brandt suggests that the World Bank should provide lines of credit to the Regional Development Banks[54]. This is in line with the proposals towards a greater decentralisation of World Bank activities discussed in the paper - partly on the basis of the Second Brandt Report - and would be in line with the policy of creating an international network of development institutions. The general policy line in the Brandt Report of strengthening the Regional Development Banks is further underlined by including the Regional Development Banks in the proposal that borrowing-capital ratios could be relaxed and increased. Within the regional network, a further decentralisation is proposed in that the Regional Development Banks are expected by Brandt to lend to sub-regional institutions.

(3) Brandt also is concerned about the "erosion" of the UNDP discussed in this paper. The Brandt Report suggests stronger co-ordination within the UN system of technical assistance - presumably involving the UNDP - and also a strengthening of the UNDP by a longer cycle of budgetary provision instead of the present annual voluntary contribution system[55]. Brandt also declares that "technical assistance should be more closely related to capital aid".

This presumably would involve some kind of closer liaison between the World Bank system and the UNDP system, or the World Bank system and the UN. The present separation and lack of liaison has specific historical reasons[56] but the time has now come to bury the past. Another implication of the Brandt proposal would be a stronger role for the UNDP, and for discussions of technical assistance generally, in aid consortia and consultative groups.

(4) As a first step towards better monitoring and co-ordinating the whole multilateral ODA system and to fill gaps and to institute proper institutional reforms, Brandt supports the recommendation by the UN Group of Experts on the Structure of the UN System in 1975 to pool all UN special funds in a UN Development Authority[57]. Presumably this proposal would be an alternative to restoring the authority and co-ordinating function of the UNDP.

(5) As is well known, Brandt suggests the creation of a new multilateral facility for additional multilateral finance to support mineral and energy exploration and development in developing countries[58]. The favoured form of this "new facility" was an affiliate to the World Bank although this is not spelt out directly. Presumably this suggestion is due to the wish that the requirements of mineral and energy development results in additional finance rather than adding to the pressures on World Bank, IDA and other multilateral sources already overburdened by new claims (i.e. China). Some of these proposals (i.e. for new mineral investment) may need to be reviewed as a result of the impact of prolonged world recession which has depressed demand more in particular sectors, such as metal minerals.

(6) Brandt fully supports the continuation and extension of co-financing as a means of increasing the reach and catalytic power of the World Bank and Regional Development Banks. The provision of guarantees (see item 1 above) can also be considered as a form of co-financing. The Brandt Report adds the deliberate use of concessional funds to improve lending terms and to subsidise interest rates as a form of co-financing[59].

(7) Brandt suggests the need for the performance of the various multilateral organisations to be regularly monitored by a high-level advisory body[60]. Brandt is emphatic that there is a serious gap in monitoring multilateral ODA, and it may be implied in the Report that this lack of proper monitoring is causally related to lack of public and political support for the multilateral system. What monitoring there is, is suspect by being mainly inside monitoring whereas what is needed is a greater amount of strongly independent outside monitoring as well as auditing.

(8) Finally the Brandt Report contains the particularly important proposal for the creation of a World Development Fund (WDF). This Fund would serve as a bridge between the World Bank and the IMF, carrying out functions not satisfactorily covered by either of them at the present time. The need for such a bridge and the existence of such a gap has been discussed elsewhere in this paper. The proposal for a WDF represents the main institutional innovation proposed in the Brandt Report and has been repeated and further underlined in the Second Brandt Report[61/]. In the context of this paper there are five aspects of this proposal worth emphasising:

(a) the WDF would serve as a bridge between the Fund and the Bank in the sense that it would take over from the Fund the principle of programme lending while it would take over from the Bank the principle of long-term lending. But Brandt believes that in this way the WDF would release both the Bank and the Fund from fundamental difficulties pointed out in this Report. In the case of the Bank the difficulty would be the slow rate of disbursements of project loans when projects are held up by a shortage of domestic resources; in the case of the Fund it would be the difficulty of having to impose strict conditionality because countries are in a crisis situation by the time they deal with the IMF. This is a particularly important proposal and crucial to the concept or vision of a new multilateral institutional system of the Brand Report.

(b) the WDF is "not an alternative to the reform and restructuring of existing institutions. On the contrary, it could be a catalyst for change in the entire system of development finance"[62/]. One may add that in the view of Brandt the WDF is also not an alternative to the increase in resources suggested for the World Bank and IMF systems. The discussions relating to the World Bank and IMF and to the rest of the multilateral ODA system therefore remain valid whether or not the proposal for a WDF is pursued. However, it seems clear that if a WDF of any size is created, this could not be without repercussions on the size and nature of existing institutions. For one thing, most contributions to the WDF would be within the 0.7 per cent target (although the allocation of "automatic revenues" for the WDF - also suggested by Brandt - in relation to the 0.7 per cent target for individual countries is not clear).

(c) the WDF should have universal memebership - apart from other reasons why universal memebership is desirable, this is also within the logic of the proposed new system of universal and automatic revenues[63/]. This would be an opportunity to give the developing countries the stronger representation which they are lacking in the Bank

and Fund at present, and thus perhaps reduce the struggle for control within the Bank and Fund itself. Presumably it would also presuppose the active and full participation by Russia and the Eastern bloc countries; in the past it has proved extremely difficult to obtain such full participation.

(d) the WDF operations should mainly go through regional and sub-regional institutions. In that way the WDF would contribute to the decentralisation and regionalisation of the multilateral ODA system, particularly the World Bank part of it, which is advocated by Brandt and may other observers.

(e) the Brandt Report visualises that many of the WDF operations would take the form of co-financing with the World Bank and the Regional Development Banks. This suggestion is put forward with specific reference to the need to avoid a new institution with a large staff and the proliferation of international bureaucracy.[64/] However, this proposal suggests the possible question of why the additional funds could not be directly allocated to the World Bank and Regional Development Banks. The proposal also seems to divert the WDF away from specific global priority purposes, such as might be natural for an institution financed by automatic global revenues and income derived from the "global commons". Such specific global priorities should for example be action of an environmental character - rolling back deserts or promotion of renewable sources of energy - action concentrated on the poverty belts of Sub-Saharan Africa and/or South Asia, or action concentrated on improving the condition and prospects for the world's children, etc.

XIII. A look into the future: MODA resources and institutions

A case can be made out for increasing the resources and activities of the multilateral ODA system. China has to be accommodated; energy calls for new investments; the poverty problems-of-the poorest countries continue to increase; food deficits and food import needs are increasing; the balance-of-payments deficits of non-oil LDCs generally and of LILDCs specifically are increasingly difficult to finance. Primary commodity prices in real terms (other than oil) are at an all-time minimum. The need for helping with maintenance and recurrent expenditures is clear. The weakening of oil prices has brought partial and temporary relief to some LDCs but does not alter the basic case. On the contrary, it can be said to bring some of the oil producers sharply within the group of MODA clients: (Nigeria, Indonesia, Mexico are examples); it can also be said to have

increased the capacity of oil-importing DCs to contribute to the MODA system.

But no conceivable increase in MODA resources alone can make much difference per se. The whole MODA system directly accounts for only 2 per cent of the total development expenditure of LDCs, so even a doubling of MODA would make only a marginal difference[65]. The conlcusion is that the real impact of a more effective MODA system would lie in a further development of what we have discussed in this paper as the "catalytic functions" of the MODA system. One of its most important functions must be to keep the colours of multilateralism and joint action and collaboration flying in a world of recession which may well lead us towards more protectionism, isolationism, unilateralism with its inevitable consequences of retailiation. The concentration on the poverty problems and aid to the LILDCs is one of the areas where the multilateral system could be pathbreaking - for this concessional resources are needed. Another is its role in the gradual evolution of a system of global revenue collection and global taxation in the service of solving global problems (environment, adequate welfare for all children) which is the natural and logical source of financing for MODA. Such action would start with specific graduated taxes on seabed resources, international travel, international trade, armament expenditure or savings from reduced armaments expenditures etc - there are many such proposals - towards an international income tax which would be "the most rational way towards automaticity in contributions and for sharing"[66].

Another conclusion to be drawn from the relatively small size of MODA's actual resources is that some of the burden must be taken away from the system. At present the system is called upon to deal with the consequences of low commodity prices, falling real export proceeds, lack of market access, unfavourable terms of trade and rising trade deficits.When it is realised that the export earnings, even at their present depressed level, of the non-oil exporting LDCs are some forty times higher than multilateral ODA to them, it is clear that this is a burden which MODA simply cannot carry, at least not within the present framework of resources and institutions. The compensatory powers of the MODA system would have to be strengthened and multiplied many times over to cope - but the real answer must be the restoration of a vigorous world trading system with an expanding role for the LDCs. In the multilateral and institutional sense, this means filling the glaring gaps in the Bretton Woods system created by the failure of the ITO and the truncated and distorted functions of the IMF - truncated by not

including world central banking, commodity currency and SDRs strongly "linked" with aid; distorted by having no powers to put pressure on balance-of-payments surplus countries. Really effective reform of MODA cannot be limited to MODA alone.

Furthermore, many of the problems affecting developing countries have been greatly accentuated by world and industrial countries' recession. The necessary reforms of the Bretton Woods system would not only need to make it more appropriate for the needs of the developing countries but also would have to provide a suitable framework for sustained world economic growth. Measures which would allow the international system to put effective pressures on surplus countries, though difficult to implement, would certainly imply a major contribution towards reducing the deflationary bias in the existing system. Other measures - like significantly expanded compensatory financing facility schemes - would not only help protect (through a low conditionality facility) developing countries from a deterioration in the world economic environment, but would, due to their significant counter-cyclical impact, diminish the possibility of such a pronounced world deterioration.

All this is not to say that expansion and institutional development of the MODA system could not have important benefits, many of them mutual benefits for donors and recipients. The gaps already mentioned in balance-of-payments support, programme lending, support for LILDCs, energy development, development of food production, as well as financing of regional projects and enlarged trade among LDCs, are all areas where the multilateral system, including the Regional Development Banks, have an obviously important part to play. Changes in policy of existing institutions are urgently required, e.g. new concepts of IMF conditionality designed to stimulate supply and not only discipline demand. This could be implemented by including amongst the conditions attached to drawings on the Fund's resources, the achievement of certain growth targets, as well as maintenance or (where possible) increase of real household income of the poorest strata as well as of public services directly linked to their welfare. At the same time, greater flexibility could be attached to macro-economic targets; macro-economic targets could be automatically revised in a previously agreed formula if the actual levels of world economic variables (e.g. interest rates) diverge widely from those assumed at the time of the programme agreement. The need for the latter has been recognized by all shades of opinion.

Not only should conditionality be made more appropriate to developing countries in the context of today's international environment, but also a more adequate balance should be attained between low-conditionality and high-conditionality Fund lending. Currently, excessive emphasis on the latter (about two-thirds) is both inadequate and inequitable (as it puts a greater burden of "adjustment" on those who rely on the Fund as lender of first, as well as last, resort).

Similarly, new techniques of guarantees, co-financing and possibly "re-discounting" debt need to be explored, which are more appropriate to existing circumstances. Better cooperation among existing institutions, specifically Bretton Woods/UN, Bank/Fund, Bank/Regional Development Banks, financial aid/food aid, is generally recognised as desirable/necessary, but seems a lot easier to preach than to practice. In addition, "new windows" are needed in existing institutions and some assurance that the new windows result in additional support rather than a reshuffling of a stationary volume under new labels. Finally, new institutions will be needed, partly to satisfy legitimate demands for different distributions of policy and management control. The precise mixture of reform, new institutions, new windows and expansion of existing windows should be the subject of genuine discussion without preconceived ideas, with negotiations focused on specific, concrete and agreed gaps and weaknesses in the present system. Purely ideological blueprints of any kind are not helpful and do not take us any further, as the history of the last ten years or so has amply documented.

Furthermore, existing facilities (e.g. compensatory financing and Extended Fund Facility) need to be expanded and made more functional to overcome the problems posed by the current conditions in the world economy.

FOOTNOTES:

1/ Speech by J. de Larosière, Managing Director of the Fund, on "The IMF and the Developing Countries", made at the University of Neuchâtel, Switzerland, on 3 March. Quoted in IMF Survey, 7 March, 1983. p.74.

2/ The counter-argument in favour of tying is that it strengthens political support for ODA and hence results in greater ODA flows. However, it should be possible to educate the public (and governments) of donor countries that they have nothing to lose (and both they and the recipients have something to gain) by agreed and coordinated untying.

3/ All quotations are from the latest annual report 1981/82 and the Press Release of the Food Aid Committee administering the Food Aid Convention.

4/ Realistically such an actual commitment analogous to the Food Aid Convention could perhaps be best achieved by limiting it first to the poorest countries and/or Africa, and then extending it to other categories. Such a commitment was given by "some" donors at the UN Conference on Least Developed Countries in September 1981 to reach a target of 0.15 per cent of GNP for the poorest countries. The commitment was however vague, as some countries were not willing to commit themselves to precise targets.

5/ Including also smaller amounts routed through other multilateral channels such as UNICEF, the UN High Commissioner for Refugees (UNHCR) etc.

6/ For this purpose the original IGC(Inter-Governmental Committee) administering the multilateral WFP was specifically renamed and reconstituted as the CFA.

7/ Equally in the case of financial MODA, there is also increasing over-lapping with non-official(non-govermental) organisations (NGO). For example, the World Bank established, in 1981, a Bank-NGO Committee with the function, among others, of considering ways to expand cooperation. NGOs both those based in DCs and in LDCs can receive a loan or grant from the receipient country's government out of the Bank loan to implement part of a Bank-financed project; or they can be independent partners implementing complementary activities to the Bank project; or they can act as consultants, trainers or advisers paid out of Bank loan money; or be partners in direct co-financing (e.g. in an education project

in Liberia; a site-and-service (urban housing) project in Zambia; and rural development projects in Togo and Haiti).

8/ This problem is very clearly brought out in G.K. Helleiner's paper, "The IMF and Africa in the 1980s", Canadian Journal of African Studies, March 1983.

9/ Also from this perspective dominant today in the industrial countries' governments, inflation and balance of payments pressures (greatly accentuated in the 1970s by rises in the price of oil) should directly be overcome by greater fiscal and monetary restraints; again in this context ODA is a prime target for cuts, as it is perceived to damage less the national interest than cuts in other sections.

10/ This figures is reached in R.F. Mikesell, "The Economics of Foreign Aid and Self-Sustaining Development", prepared for the US Treasury/State Department/AID, February 1982, p.18.

11/ The distinction between "direct" and "catalytic" effects is also made by Mikesell, op cit.

12/ See, for example, Group of 24, Low Income Countries and International Monetary Sources, Report of a Group of Experts, January 1983; J. Williamson, The Lending Policies of the International Monetary Fund, Institute for International Economies, Washington DC, August 1982, Carlos Diaz-Alejandro, "International Financial and Foods Markets in 1982-83 and Beyond", International Economic Association Proceedings, March 1983. Such proposals are also highlighted in the new Brandt Report (Common Crisis) and in the forthcoming background paper for UNCTAD VI. For a detailed proposal for broadening the CFF, see S.Griffith-Jones, Compensatory Financing Facility: a Review of its Operations and Proposals for Improvement, Report to the Group of 24, January 1983, UNCTAD/MFD/TA/22.

13/ It is interesting that the developing countries are emerging as the principal defenders of the original principles, and more recently agreed adaptations of the Bretton Woods institutions (i.e. by calls to expand the IMF, to centre international liquidity on SDRs). This point is clearly made in G.K. Helleiner, "South-South Cooperation in the 1980s", forthcoming, Third World Foundation.

14/ The North-South Dialogue - Making it Work, p. 28, para. 2.26.

15/ Ibid.

16/ North-South: A Programme for Survival, Pan Books, pp 184-185.

17/ Ibid., P.186.

18/ Commonwealth Group of Experts, op cit, p. 38, para 3.20. As discussed above, the Brandt Report has in fact recommended that in administering the CCF the IMF should relax quotas, measure shortfalls in real terms and make repayment terms more flexible (op cit, p. 219).

19/ Ibid, p.14, para. 1.13 (III)

20/ Development Cooperation, 1982, p.33.

21/ Op cit, p.219

22/ Brandt Commission Papers, IBIDI, Geneva - The Hague, p.609. The paper from which this quotation is taken was prepared by Dragoslav Avramovic and Gerhard Thiebach.

23/ Ibid, p. 645

24/ Ibid, p.646.

25/ World Bank, Annual Report 1978, p.9.

26/ Common Crisis, The Brandt Commission 1983, Pan World Affairs, p.63.

27/ The quotations are all from a recent speech by the Fund's Managing Director in Switzerland, as reported in IMF Survey, 7 March 1983, p.71.

28/ This point is clearly brought out in Dudley Seers' "Preface" in S.Griffith-Jones, The Role of Finance in the Transition to Socialism, Frances Pinter, 1982.

29/ See, for example, Common Crisis, p.66.

30/ For example, see The Brandt Commission Papers, IBIDI, Geneva and The Hague, 1981, p.641.

31/ As distinct from the African Development Fund.

32/ The proposal for a World Development Fund is maintained in the second(1983) Brandt Report, "Common Crisis", which suggests the proposal "should have a secure place on the agenda of the Global Negotiations" (p.97).

33/ "North-South: A Programme for Survival", op cit, pp. 248-250.

34/ Ibid, p. 248.

35/ This latter possibility is in fact suggested in the Brandt Report, p.250.

36/ Quoted from IMF Survey, March 7, 1983, p.78.

37/ This latter possibility is suggested in Development Cooperation 1982 Review, OECD, Paris, 1982, p.82.

38/ A Proposal for Stepped-Up Co-Financing for Investment in Developing Countries, OECD, Paris, May 1979.

39/ International Financial Cooperation. A Framework for Change, Frances Stewart and Arjun Sengupta, ed.by Salah Al-Shaikhly, Frances Pinter (Publishers), London, 1982, p.103.

40/ At the time of writing, the problem of OPEC surpluses seems temporarily less acute, but there still remains the big volume of accumulated past surpluses.

41/ US Treasury, 1982.

42/ Common Crisis. North-South: Cooperation for World Recovery? The Brandt Commission , Pan Books Ltd., London, 1983, pp. 69-70.

43/ Ibid, p.70.

44/ Development Cooperation 1981 Review, OECD, Paris,1981, p.135. A number of data quoted in this section on LILDCs and agricultural ODA are taken from this source.

45/ Brandt Commission, 1983, op cit, p. 75.

46/ The magnitude of the impact of world recession on the LILDCs and proposals which would contribute to compensating them have been recently discussed in the Group of 24 document quoted above, Low-Income Countries and the International Monetary System, January 1983, UNDP/UNCTAD Project Int. 181/046.

47/ Accelerated Development in Sub-Saharan Africa, World Bank, Washington D.C., 1981; also quoted in Common Crisis, op cit, p. 76.

48/ IDA in Retrospect, published for the World Bank by Oxford University Press, 1982, p. 78.

49/ Ibid, pp. 57-58.

50/ Accelerated Development in Sub-Saharan Africa, op cit.

51/ Such criticisms for example are expressed in Common Crisis; for a more detailed critique, see for example IDS Bulletin, Vol. 14, No. 1.

52/ North-South: A Programme for Survival. The Report of the Independent Commission on International Development Issues under the Chairmanship of Willy Brandt, Pan Books Ltd., London, 1980.

53/ Ibid, p. 247.

54/ Ibid, p. 250.

55/ Ibid, p. 251.

56/ H.W. Singer, Terms of Trade Controversy and the Evolution of Soft Financing; early years in the UN: 1947-51, IDS Discussion Paper 181, November 1982.

57/ Brandt Commission, 1980, op cit, pp. 251 and 255.

58/ Ibid, p. 256.

59/ Ibid, p. 256.

60/ Ibid, p. 266.

61/ Brandt Commission, 1983, op cit.

62/ Brandt Commission, 1980, op cit, p. 253.

63/ Ibid.

64/ Ibid.

65/ However, in the poorest LILDCs the impact is larger. IDA alone in 1980 represented 4.5 per cent of the total investment. (Source: IDA in Retrospect, World Bank/Oxford University Press, 1982, Table 4,p.92.) This refers to the "Pure IDA countries" - the very poorest group.

66/ Paul Streeten, What new international economic order?, in Pakistan Journal of Applied Economics, Vol.1, No. 2, Winter 1982.

COMMERCIAL BANKS AND BALANCE-OF-PAYMENTS FINANCING

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This paper summarises the role of the private commercial banks in the international financial system, with respect to their intermediary role in financing world balance-of-payments deficits. Six key aspects of this role are examined:

1. The relative responsibilities of private banks and official institutions.
2. Country credit risk appraisal.
3. Information gathering.
4. The quality of rescheduling techniques.
5. Regulatory issues.
6. Future developments.

The paper concentrates upon the experiences of the recent 2-3 years of growing debt crisis, and draws conclusions as to how future balance-of-payments financing needs might be met.

1. The Relative Responsibilities of Private Banks and Official Institutions

The crisis atmosphere of the last twelve months has resulted in a considerable blurring of responsibilities, both for private banks and official institutions. Most striking has been the degree to which the private banks and the IMF have been working side by side in arranging rescheduling agreements.

To a degree the role played by the IMF has been a necessary one: in order to marshall all the numerous lenders involved in the reschedulings,the Fund has made very pointed requests to banks to increase their exposures in particular countries alongside an IMF support/rescue package. At times,individual central banks, such as the Bank of England, have also made such requests.

Clearly, in a financial market system where private institutions have a particular responsibility to stand on their own feet, such a close relationship (with banks being instructed to increase exposures to countries they deem now to be uncreditworthy) cannot continue indefinitely. This dilemma is recognised on both sides, and for the time being official institutions, private banks, and borrowers probably are looking to a general economic recovery to ensure that this untenable situation need not last longer than is absolutely necessary.

It is important to make clear why the position is untenable. For many years the IMF, and outside observers, have bemoaned the fact that the IMF's influence on its members has been increasingly limited. Most striking was the period in the run up to the Mexican crisis, when many officials felt that the IMF was either unable to influence the banks (i.e. urge them to desist from increasing short-term lending) or to curb Mexico's enthusiasm for borrowing,especially in an election year. Furthermore,the willingness of private banks to lend to countries with large balance-of-payments difficulties has undoubtedly helped countries avoid going to the IMF when perhaps they should (or would) have undertaken a formal IMF-style programme.

Of course,the IMF's declining influence cannot be blamed entirely upon the banks' willingness to lend. The IMF's relatively small financial resources have always made the attraction of borrowing from banks much greater than borrowing (on conditional terms) from the IMF. Indeed it is the theme running through this paper that a key problem in the last ten years has been the absence of sufficiently large official financing facilities, given the size of world balance-of-payments dislocations.

But there is a more fundamental reason why the present situation is untenable. Private banks have a specific responsibility to their shareholders and to their depositors. Bankers take it upon themselves as their profession to offer a safe haven for depositors' funds and a profitable investment opportunity for shareholders, principally as a result of their own skill and expertise in on-lending such funds to borrowers with various risk profiles. Depositors and shareholders have to be confident that the bank can perform this central task of credit risk appraisal adequately. Therefore it follows that any interference (the word is not used pejoratively) to direct bank lending in any

particular direction impacts directly upon the central aspect of a banker's profession, i.e. on credit risk appraisal. The greater the direction given to banks as to whom they should lend to, the less can be banks' true responsibility for such loans and the greater the responsibility taken on by those issuing such directives.

Of course this dilemma is not confined to international lending. During domestic banking and credit crises, official action is often called for to stabilise the market. The degree of official intervention and support is always a key aspect and consideration (see for example the role of the Bank of England's so-called "lifeboat" in the 1974 UK secondary banking crisis). The debate has now shifted into the international arena, and is undoubtedly more complicated given the plurality of regulating institutions, and the plurality of sovereign entities involved.

There is a further aspect to this blurring of responsibilities, an aspect which requires us to make a clear distinction between the role of the IMF and that of the central banks during the rescheduling of the last twelve months.

When central banks issue directives to individual banks these directives pass along established lines. In the UK, for example, the Bank of England is responsible for both the specific regulation of banks and for the control, as the central monetary authority, of the financial markets. The Bank is thus long used to issuing instructions with varying degrees of force to those banks for which it is responsible. In the United States the position is somewhat less straightforward, given the existence of three official bodies (the Federal Reserve, the Comptroller of the Currency and the Federal Deposit Insurance Corporation). Nonetheless, all banks have a direct relationship with their regulators and central banks. There are therefore established channels for coping with any blurring of responsibilities which take place when official monetary institutions issue instructions to the private sector.

In contrast, private banks have no formal relationship with the International Monetary Fund. If private banks continue to lend new money in conjunction with an IMF programme, it is very unclear what private banks can do should the IMF withdraw its 'seal of approval' or end its programme. There is of course nothing to prevent the IMF from trying to cajole other lenders, or from refusing to lend its monies if other

lenders do not contribute. But the Fund/bank relationship must remain an arm's length relationship, albeit in a cooperative way.

As mentioned above, the dangers inherent in the IMF/central banks/private banks cooperation of 1982/3 are fully recognised by all participants. But if the hoped-for world economic recovery proves to be weak and/or delayed, then further blurring of responsibilities may take place. In which case it will become increasingly important that the central banks and regulators, if anyone, take the prime role in "instructing" private banks during any reschuduling as to how much additional funds they should lend. The central banks/regulators in their turn can clearly seek guidance from the International Monetary Fund through their own official channels. This does not solve the problem as to relative responsibilities of official and private institutions but at least it ensures that the signals, messages, nods and winks are passed along the correct channels. Recent practices have developed along this route.

2. Country Credit Risk Appraisal

During the crisis there has been a great deal of discussion of the quality of banks' country risk assessment. Implicit in such debate has been the assumption that banks' country risk assessments have been lacking and/or that bank lending decisions have not paid due attention to country risk factors. Undoubtedly, the enthusiasm for lending of the later years of the 1970s diluted the influence which bank economists have had on individual lending decisions. In contrast, many, lending officers now probably feel the economists' present warnings are given undue weight in comparison to their own market assessments.

A most serious problem for the credit risk analyst has been the lack of sufficient, up-to-date, information. Borrowers, in both developed and developing countries, are often reluctant to publish data on their external debt, often for domestic political reasons. Many countries have not had adequate debt reporting systems, so that with the best will in the world they have not been able to provide up-to-date information. Some countries have not had sufficient control over foreign borrowing by their own institutions.

The credit risk analyst has had to tackle this problem in several ways. First, there has never been anything to prevent country analysts from visiting

countries and gaining a good inside feel for the economic and political future of each country. Though credit risk appraisal will pay a great deal of attention to statistics, it must also pay a great deal of attention to an overall judgemental assessment of the future of the country. In the same way, while corporate credit risk analysis relies heavily upon the analysis of a borrowers' balance sheet, the art of credit risk assessment has always been in looking beyond the bald statistics into the viability of the enterprise itself and into its operating environment.

Where there has often been a glaring absence of statistics the correct action for the country risk analyst has been to point such absences out and assess the reasons for their absence. In some instances it may be justifiable to accept the reluctance of the country to publish data. For many countries, however, it has been appropriate to "mark down" the country if it proves unable to provide adequate data. It is perfectly valid to turn down a credit request on the grounds of insufficient information about the borrower: the doubt, of course, is that banks have not been sufficiently strict on this point.

A second problem which country risk analysts have faced is that, for many major borrowers, the standard yardsticks of credit appraisal have been broken. Many countries have long exceeded the classic 20 per cent debt service ratio "ceiling" suggested in the past by the World Bank. For some time many borrowers have been able to cope with a high debt service ratio, but as 1982 has revealed (with a vengeance) a high ratio is only acceptable and tenable if banks continue to lend new monies. This has placed the country risk analyst in a dilemma: he can point out that according to his appraisal a country is no longer creditworthy, yet has often had the riposte from the lending officer that the market continues to believe the borrower is creditworthy and therefore by definition the debt service burden is supportable (as it can be refinanced). At that point the correct response, on strict creditworthiness grounds, should be that the borrower is only creditworthy while the market has confidence in it, and that under any normal criteria the borrower should be treated with extreme caution.

The present contraction of credit reverses this position (again with a vengeance). With banks seeking to reduce short-term exposures, borrowers are finding it difficult even to raise trade financing requirements, which under normal market circumstances they might be expected to obtain easily. There is thus the risk that

even borrowers who are creditworthy according to economists' standard indicators will prove to be uncreditworthy if the market so judges.

In the context of our concern with the relative role of the private banks and official institutions, a comment also must be made on the importance of the IMF's seal of approval in credit risk decisions. In a private banking market where, as pointed out above, the key professional task of a banker is credit risk appraisal, it is surely totally unacceptable that this central role of a bank should be passed on to an outside institution. Thus reliance upon the IMF's "seal of approval" must be done cautiously. The bank must still judge the degree to which the IMF's programme will improve the credit risk, stabilise the market, and lead to satisfactory improvements in the country's long-term ability to honour its financial obligations. At present it can be justifiably said that banks have no option but to rely upon the IMF's seal of approval, and despite protests, banks have had to increase their exposures to difficult countries, to protect their own current exposure. There is a great deal of "can and mouse" in the present rescheduling arrangements. Banks undoubtedly want to put on record that they are relying heavily upon official institutions, such as the IMF, to police the economies of problem countries, even if the powers of that policeman are strictly limited.

Ultimately the fundamental limitations of country credit risk assessment must be recognised. However skillful the analyst, the task of forecasting the future economic and political developments of sovereign states, in themselves and within a global context, is a major one. There is no such thing as 20/20 foresight.

3. Information Gathering

A propos the discussion of credit risk, a number of proposals have been made recently to improve the information flow in international credit markets. The new Institute for International Finance (formerly known as "Ditchley II") embodies the private sector's attempt to improve the flow of information. There is no denying that better information can help towards achieving better credit risk appraisals, even though information is not the whole of the story.

In practice better information can come from two sources: either from the lenders or from the borrowers. At present limited information is provided by both. Borrowers publish their own debt statistics, sometimes

relatively quickly in their own publications or rather more slowly via the World Bank Debtor Reporting System. Lenders provide information to their own central banks on their exposures. This information is published separately by some central banks (the Federal Reserve, the Bank of England and now the Bundesbank) and is coordinated by the bank for International Settlements in its semi-annual and quarterly statistics on international banking.

So far,when considering the full range of countries, the private banks and central banks have come up with more timely information than the borrowers. Current data provide details on the major industrial countries' banks' exposures to LDCs as of June 1983, and as of December 1982 on a more detailed maturity basis. The 1982/83 World Bank World Debt Tables, in contrast, give external debts up to the end of 1981 only, although they do provide forecasts of debt servicing requirements over the next ten years (on term debts established as of the end of 1981).

The nub of the problem has been the monitoring of short-term debts. Not only have these been always absent from the World Bank's data system but also short-term debts can build up very rapidly and thus timely information on these debts is crucial. When a country's borrowing programme is sound the absence of short-term and up-to-date figures is a limited problem. It is precisely when a country is relying excessively on short-term debt that by definition a problem will arise and the crisis builds up almost undetected.

If a country is going to build excessive short-term debts, no amount of reporting will prevent such an occurrence. However more timely information might at least bring forward the "inevitable" crisis so that the amount of short-term debt built up would not grow too large. Thus the rescheduling and recovery programme could be of smaller magnitude. Appraisal of the BIS statistics has proved useful in giving a degree of early warning but the time lags are still too long. And perhaps more importantly for the credit risk appraiser the statistics could be more detailed. At present an analyst is unable to determine the quality of the assets which banks are reported to have and the degree to which they may relate to standard trade financing requirements can only be estimated.

In principle the effort to improve the information flow would be most efficiently performed by improving the present systems: speeding up the process of reporting to the World Bank Debtor Reporting System, and extending and accelerating the reporting of data through the BIS.

The World Bank, IMF and BIS are all working towards this objective. However the "Ditchley II" idea is that the banks themselves could provide more information to their own institution, on both their lending levels and planned leading activities.

As a means of coordinating current bank strategies such a system might be helpful, but it must he questioned how far a competitive banking industry can in practice be relied upon to share such critical information. Traditionally the private sector has always been loathe to provide official institutions with too much information, and is always loathe to add to the data reporting burden. In an ideal world the fastest way of obtaining good debt information would be from the borrowers themselves, on a country-by-country basis. This would involve fewer institutions in making reports and the process itself should encourage better debt management and control. If the IMF and the World Bank could encourage faster and standardised debt reporting by individual countries then this could improve the overall quality of the market's credit risk assessment.

4. The Quality of Rescheduling Techniques

The debt rescheduling process has been difficult, to say the least. Before mentioning the problems,however, it should be stated that debt rescheduling is not an operation which the market should regard as commonplace. Thus the setting up of automatic rescheduling arrangements is not something which can in the long run encourage good lending or good borrowing practices. Nonetheless, with a large number of countries rescheduling their external debts, it would be foolish to think that the absence of any formal debt rescheduling arrangement can help very much in dissuading countries from rescheduling. Further, with a large number of countries now rescheduling it is in the interests of both lenders and borrowers to at least perform this task as efficiently as possible, however much lenders and borrowers regret the task has to be done at all.

Lenders will tend to operate on the short leash principle. A lender's power is greatest at the period prior to lending new or relending old money. Once any new loan agreement has been signed then the power quickly shifts across to the borrower: possession is 90 per cent of the law. Borrowers, on the other hand, will seek as long an extension as possible knowing full well that even reschedulings arranged in 1982/3 might have to be re-arranged again if the underlying economic positions do not change adequately.

Thus the parties will seek a compromise, giving both sides some room for maneouvre while trying to balance out the level of future negotiability over the credit. This will undoubtedly mean that banks will lend for shorter periods than would really be advisable given the time taken for a country to adjust. Borrowers will always seek to obtain as long a rescheduling as possible and at times even to overstate the extent of their financial problems. Just like the initial borrowing negotiations, reschedulings are a question of wheeling and dealing.

The most serious criticism that can be levelled at the rescheduling arrangements is that the delays in rearranging the credits, and the disruptions caused during the period of rescheduling, cause real economic hardship for the country concerned. If all banks are rapidly cutting short-term lines prior to a successful rescheduling then the country has difficulty in trading, its industries have to slow down even further and its prospects for early economic recovery are further reduced (thus making it even more difficult for it to repay future loans on time). In addition with a large number of banks involved (and particularly a large number of regional banks in the case of Mexico) negotiations have been tortuous and from time to time could have easily broken down if one or more of the participants had broken rank. The large lenders have been as active as the borrowers in seeking to coordinate reschedulings and to keep all players in the game. Hence the Ditchley II ideas might be regarded as very much part of the effort by the major money centre banks to encourage other lenders to maintain and even increase their exposures.

In practice various techniques and procedures have emerged as reschedulings have become more numerous. Each new rescheduling has raised the number of new negotiating ploys. One major problem is just keeping track of the status of negotiations and of the resulting debt obligations of the individual countries, a problem which is going to present country analysts with more and more difficulties as debts are rescheduled and data become rapidly out of date. However, a side benefit of the number of reschedulings has been that the major LDCs have had to publish more detailed payments estimates and forecasts, as reschedulings have required extensive economic analyses to be published.

An additional criticism has been made with respect to the terms of reschedulings, an issue which directly affects the countries' finances. Rescheduled loans have been usually priced at a higher spread than the original

loans and substantial fees often accompany the reschedulings. To some this seems illogical. The country, by the mere fact that it is rescheduling, clearly has a problem repaying its debts and to make the burden even greater by increasing the fees and spreads only adds to that problem. However, from the lender's point of view, given the higher risks now apparent, the rewards need to increase.

On balance, an increase in spreads is justifiable and if any real criticism was to be made with respect to risk and reward it would be that the spreads over the last few years have been too low. Thus reschedulings at least give the opportunity to correct this position. Bankers themselves can point to the 1978/79 period when countries took it upon themselves to renegotiate credits at the lower spreads obtainable when market conditions improved, to many bankers' chagrin.

Once again, reschedulings, no less than other loan negotiations, are a matter for bargaining. Price is set by the market and by the relative competitive positions of both lenders and borrowers. Furthermore, if banks are to make greater provisions against sovereign loans then such provisioning should also be reflected in the price charged for such loans. In practice, in a period of falling interest rates, spreads have themselves tended to rise (being a function of both the business cycle and banks willingness to lend.) Thus even for non-rescheduled loans the current climate should see rising margins for new business. If, through rescheduling, borrowers are seeking to refinance existing credits, then current market conditions must clearly prevail.

Nevertheless, these considerations are obviously not the whole story: insofar as the rescheduling process represents a loan "workout", so it is clear that "normal market conditions" are hardly operative (especially as lenders are largely obliged to relend). The eventual spread will need to be fixed in the light of both the desired return to the lender and the borrower's financial status. Naturally for lenders the spread is all-important, whereas for borrowers the same effect on servicing costs could come from either a fall in spreads (potentially small under any circumstances) or a fall in LIBOR itself (which potentially could be brought down considerably if inflation rates stay low). The latter condition would assist the borrower without reducing the lender's return.

5. Regulatory Issues

On Capitol Hill there are strong calls for the banks to pay the price for the support now being given by official institutions in the rescheduling process. This is not the place to discuss the relative responsibilities of governments and of private banks for causing and/or for resolving the present crisis. Clearly there are strong responsibilities on both sides. The extent to which there was no official route by which the large second oil shock could be recycled through official channels is now being reflected in the demands for governments to make amends for the absence of previcus action. Meanwhile, in the reschedulings,the banks, in total, are often putting in more new money than the official institutions, and thus are bearing a significant share of the burden.

Apportioning blame will always occur during crises but is not in the long run the most important issue: what is at issue is whether or not international banking should now be subject to greater scrutiny and control in order to prevent further crises occurring. If such regulation is imposed this does not mean that further financing flows will be done adequately through official institutions,but at least governments may feel that the ball is firmly in their court.

Ever since 1975 the BIS and central banks have sought to improve their monitoring of the international banking system as the first step towards possibly providing more controls on the system. One major practical hurdle has been that every central bank and every country has its own way of regulating its own financial institutions. The authorities in Japan,for example,have often given very explicit instructions to their own banks as to what proportion of syndicated credits Japanese banks may take (such restrictions are now being lifted). Regulations often relate as much to the general balance-of-payments objectives of the lending country concerned as to concern over the quality of bank's portfolios.

The regulatory issue is important in three main areas: first, should official institutions in some way seek to improve the credit appraisal techniques of banks; secondly, should more prudential controls be imposed upon banks' lending policies (e.g. greater and stricter limits on exposures as a percentage of capital); and thirdly, should different reserve requirements etc. be imposed on banks for their international lending, particularly to developing countries?

As mentioned in the second section there would seem to be little point in central monetary institutions' seeking to impose their own credit judgements on those of the private sector, without a major change in the way in which our international and domestic banking systems operate. Central monetary authorities may have somewhat better information on individual countries but in most cases private banks' credit risk assessment teams are better qualified than those of central banks. Furthermore, as mentioned above, using other official institutions' judgements (e.g. those of the IMF) would equally be of limited value.

Changes in prudential controls ought to offer greater scope for satisfactory progress, although again central banks have always had to rely upon the discretion of private banks to achieve appropriate mixes of risk in their portfolios. A classic example of the limitations of such controls was the so-called "means and purpose" test in the United States. Regulations can only seek to influence banks' decisions, not to replace them with official judgements.

Nevertheless, stricter adherence to risk exposures to capital may be necessary, as long as such single exposures can be adequately defined and policed. Imposing such limits at this point is like closing the stable door after the horse has bolted. Doubtless banks themselves are carefully re-appraising what potential limits they should impose upon individual country exposures. The market is probably performing this task adequately now, and may be being over-enthusiastic in imposing new prudential limits for future use.

The third aspect, of banks' reserve policy, etc., relates very much to government tax policies and accounting principles. It is traditional in banking that doubtful loans are written off even though over time perhaps as much as one third of such loans are finally written back. Where banks are allowed to write off loans against tax in the short term the taxpayer bears part of the burden of the loss. Where a debt has been rescheduled successfully, ostensibly restoring creditworthiness, it is not clear whether that loan should now be treated as doubtful, given that a rescheduling has been done successfully. A major difficulty would be in deciding what amount of earnings should be set aside against potentially doubtful loans. If a major developing country defaulted in total then the banks' real protection (whether reserves or capital) may not in all cases be adequate. It is extremely difficult

to access exactly what the potential losses are in sovereign loans. This has always been the problem in pricing the loans adequately in the first instance, and even now it is not clear exactly how much banks should be providing (except that provisions may be too low).

In practice it would seem advisable to give banks as much leeway as possible to adjust earnings targets and possibly raise new capital as they see fit, and to re-assess any further change once the situation has improved. No amount of regulatory changes at this point would alleviate the present crisis and any change would probably only complicate banks' current decisions.

6. Future Developments

A number of proposals have been made to improve the international financial system with respect to private bank lending to developing countries. Some relate to the restructuring of existing debts. Others relate to improvements required to prevent the need for restructuring in future. There is always a temptation during a major crisis to seek global solutions to solve the crisis. In practice the only solutions lie in a series of individual fire fighting exercises which leave their own mark, adjusting participants' expectations.

A common theme running through the various proposals is the idea that official institutions should provide some new underpinning to private bank lending, either by guaranteeing new loans or by taking off the banks' books existing loans in the form of discounted bonds, etc. Yet all these ideas fall into the trap which we originally identified, that of blurring the distinct responsiblities of the private and the official sectors. If the loans prove to be bad then the banks will undoubtedly suffer. If the loans prove to be good then the banks would be unwise to sell down such loans. Choosing the price at which to discount such loans would be an extremely arbitrary process carried out under very abnormal market conditions.

Of course, changing the system solely to account for past activities would be hardly progressive even though there might be some satisfaction that past errors may have been accounted for. All players (governments/taxpayers, lenders, borrowers) will feel the effect of the inadequacies of past practices, and compensating for any inadequacies is a separate task from altering future structures. Naturally the mistakes of the past should highlight how future arrangements might be structured, but

it would seem most fruitful to return to the key development finance issue: how do LDCs obtain the financial capital for development, and indeed what proportion of LDCs' investment capital needs to come from international savings?

The only logical way to change the system significantly is to increase the direct role played by official institutions or governments in funding LDCs' current account balance-of-payments deficits or providing development capital. The International Monetary Fund and the World Bank are designed to help correct balance-of-payments deficits and to finance developing countries respectively. Neither institution has had sufficient financing support to perform these roles adequately.

The amount of resources allocated to these institutions naturally must be related to the financing need. And it is this latter concept which now warrants very close attention. Balance-of-payments deficits (on current account) do not just represent poor budgeting by LDCs. Their counterpart is the need for capital inflows, or foreign savings, to complement the domestic savings needed for investment in LDCs. If there is a long-term need for a large injection of foreign savings into the LDCs, it follows that there must therefore be a transfer of resources into LDCs.

In the 1970s this transfer escalated rapidly, on the financial side. But much of the required financial transfer was obviously directly offsetting the outward transfer of resources resulting from the deteriorating terms of trade (both higher oil prices and worsening non-oil terms of trade).

In the 1980s however, barring a third oil shock and barring a further serious terms-of-trade deterioration, the balance-of-payments deficits on current account (excluding debt interest payments) need not be particularly large. Hence the required transfer of financial resources to LDCs need not be extraordinarily high. Once the existing debt of the 1970s is adequately treated on its own merits, then there need not be any great need to establish a new system for future resource transfers. Equally, the need for such new transfers has to be identified before designing new transfer mechanisms.

Moreover, if a transfer is required, the experience of the past ten years suggests that private banks are not the best conduit for this transfer to LDCs to take place. The debate then, as suggested above, returns to the issue

of how LDCs obtain capital for development. Just because new mechanisms have not yet been devised other than letting the private banks take the strain (or finance the residual) we should surely not conclude that therefore banks can, and will, finance any significant transfer in the future.

INTERNATIONAL LENDERS OF LAST RESORT: ARE CHANGES REQUIRED?

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I. Introduction

"The widespread belief that, whatever the Bank [of England about 1860] might say, it would support the market in time of crisis, had no legislative foundation". (Fetter, 1965, p. 269)

"The rapid recovery after 1857 temporarily stilled controversy over money and banking among men of affairs". (ibid., p. 268)

"Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities,quickly, freely and readily. By that policy they allay a panic; by every other policy they intensify it". (Bagehot, 1873)

"... the most mischievous doctrine ever broached in the monetary or banking history of this country, viz. that it is the proper function of the Bank of England to keep money available at all times to satisfy the demands of bankers who have rendered their own assets unavailable". (Hankey, 1866, against the Bagehot doctrine)

"From the middle 1870s, the principle was no longer in doubt ... The Bank of England as a lender of last resort was ... accepted as the foundation of monetary and banking orthodoxy". (Fetter, 1965, p.275)

As the national LLR needed clear exposition in 1866-73, so international lender of last resort (ILLR) needs it now. Bank activities are much more complex, internationalised and interlocked. Not merely the welfare of depositors, but the capacity of sound firms at home and abroad to borrow - as well as the capacity of many developing countries to grow - depend on the maintenance of a liquid base for the banking system. We concur with Kindleberger (1978), IMF (1983) and others, that formalised, known international lender-of-last-resort arrangements are increasingly necessary not mainly to "allay a panic", but to prevent one.

However, to construct a proper ILLR requires an improved understanding of LLR functions, in two respects. First, while most observers appreciate that LLR's purpose is not "to bale out banks" - indeed, a major problem is to prevent banks from relying on this perception - neither does LLR exist mainly to protect depositors; its main purpose is to ensure a stable, and if possible steadily growing, flow of credit to sound borrowers. Second, in this task, reliable LLR and really adequate supervision are two sides of one coin, the latter acceptable to banks only with the former; as supervision should smoothen unswings, so LLR should buffer downswings of bank credit.

This paper tries to suggest ways in which ILLR arrangements can be achieved, without unacceptable increases in moral hazard, 1/ by changes in supervisory arrangements and other matters. First, however, we would stress the importance of confidence in ILLR for maintaining, despite recent shocks, the flow of capital to developing countries. This applies even to low-income countries, although they seldom borrow much from commercial banks. The present operations of the system, without clear ILLR facilities, may hurt the poorest countries in two ways. First, pressures to avoid default divert official flows from low-income to middle-income countries - and, recently, towards shorter-term and less concessional official lending. Second, as we shall explain, the inadequacies of ILLR, even without crisis and especially during early recovery, exercise steady deflationary pressure on growth, trade, and hence development prospects.

The lack of an appropriate ILLR - which can take account of the enormous complexity, scale and internationalisation of commercial banking - makes two undesirable developments more likely. Firstly, there remains a possibility that widespread financial distress now characterising the world economy may turn into a major financial crisis (see Kindleberger, 1982, on stages of financial crisis). Secondly, and more plausibly, the combination of actual reschedulings (reducing the banks' liquid base) and fear of defaults may continue to constrain private bank lending to developing countries. Ad hoc anticipatory contractions - by them or banks - are mutually deflationary, and further weaken the prospects of a sustained world economic recovery.

More generally, insufficient ILLR facilities give commercial banks scant reason to accept really effective supervision. This contributes to patterns of capital flows, especially of bank lending to developing countries, in which "euphoric" over-expansion (Kindleberger, 1978) alternates

with over-contraction. Such swings tend to accompany, not to stabilise, business cycles, both at country level (Griffith-Jones, 1980) and world-wide. Adequate supervision would control, diversify, and when necessary limit, "euphoric" expansion. Moreover, such supervision relates each bank's behaviour to the total exposure, not just of that bank, but of the borrowing and lending country. It considerably transcends traditional supervision, 2/ and would be acceptable to commercial banks only if backed by reliable, even if potentially costly, ILLR facilities. With supervision moderating upswings and ILLR buffering downswings, private credit flows would be more regular. The package would produce much more desirable credit patterns - not just for developing countries but for the world economy, and ultimately for the banks also, even though some apparently profitable business would from time to time be frustrated.

The paper focuses on issues closely linked to the need, or otherwise, for ILLR. However, this problen cannot be treated in isolation from other major issues (covered in depth in other papers in this series). In particular, any ILLR facility is complementary to - and by no means a substitute for - measures to make its use less likely or less necessary. This covers, in general, measures to promote sustained world economic recovery, and, in particular, the expansion of official and private flows, which may be more appropriate to finance lending in some developing countries than is current short - or medium-term bank lending with floating interest rates (ICIDI, 1983). We share doubts about the genuine appropriateness of medium-term variable-interest bank loans for the finance of some developing countries. However, such flows remain essential, particularly while alternative mechanisms - either private or official - remain only as proposals.

In Section II, we define the role of a LLR, pointing to the key issue of how "onerous terms" for its use must deter imprudence by potential users. We then ask why a special ILLR is needed at all (Section III). Next - in the context of central bankers' decision to make ILLR deliberately uncertain and vague, so as to create a form of "onerous terms" - we outline existing ILLR facilities, and associated supervision procedures (Section IV). We then assess (Section V) whether they are - and are perceived to be - sufficient to contain a "crisis" that might be caused by various sorts of non-repayment of foreign debt. In that context, we also enquire how these uncertain ILLR facilities affect the level and stability of commercial bank lending and of world flows of credit. Do these facilities encourage banks and customers to distribute credit, among users, in ways that favour steady and sound

economic expansion, especially by developing countries? Finally, in Section VI, we review our conclusions and make our proposal - to replace damaging uncertainty about ILLR by a revival, in a form that suits today's needs, of Bagehot's original conditions for "onerous terms".

II. Role of National LLR, and International Aspects

A LLR is a central bank, group of banks, or treasury that has the power, and accepts the responsibility, to lend without limit - or to the limit of plausible requirements - but on onerous terms, to institutions in trouble or crisis. "Institutions" were taken by Bagehot to mean "all comers" but nowadays are confined to banks, or, at most, institutions taking financial deposits against interest for onlending.

"Trouble" has normally been taken to mean a significant risk of not being able to repay depositors and creditors on request, either because the bank is unusually illiquid, or because depositors seem likely to ask for their money in unusually large numbers (a run); if depositors are confident of LLR facilities they will, it is assumed, be prepared to restrain withdrawals. In fact, "trouble" could be more broadly defined as incapacity by a bank, even well short of any risk of collapse, to carry on with normal _lending_ operations. For instance, when British commercial banks recalled money from discount houses and forced them into the Bank of England at the "penal" Bank Rate, this was often conventionally taken as a first-stage LLR operation, though nobody suggested that either commercial banks or discount houses were in danger of not meeting obligations; recourse to the central bank is had in order not to forfeit normal, profitable business. Similarly, recent "liability management" by US banks implies that" even borrowing from the Fed should be considered a source of funds" (Cargill, 1979, p. 92).

It is crucial, in understanding the case for LLR (or ILLR) as a "social good" like health or roads to be provided by the State, to realise that this case depends not only, nor mainly, on the wish to rescue depositors. The main basis is the need to maintain the capacity of the banking system to _lend_: to prevent "trouble" facing one bank, especially if it threatens to degenerate into a "crisis" of confidence in many banks, from stifling the flow of credit to countries and enterprises. Of course, panic transfers of cash among banks by depositors, or rushes by them into cash (or foreign currency, or physical or financial assets bought with foreign currency), would make it even harder for firms to borrow, as banks became more

cautious and less liquid. But the principal reason for a LLR to commercial banks is not to safeguard depositors (which can be achieved by other mechanisms - see below). It is to preserve and stabilise productive activity, by underpinning the capacity of the banking system to lend to enterprises and countries.

Before we define "onerous terms", we should build on these points to clarify what a LLR is not. "LLR"is sometimes vaguely or inexactly used to describe three entirely different sorts of operation. The first is deposit insurance. This covers, for example, US deposits below $100,000 - about two-thirds of the total, but excluding almost all major foreign deposits. Since 1934, deposit insurance through FDIC* has been dramatically successful in reducing US bank failures (Cargill, 1979, especially p. 168) and since 1967 Canada, France, Germany, Japan, Netherlands, Switzerland and the UK have set up similar schemes. Coverage is usually incomplete or small (e.g. 75% of deposits up to £10,000 in Britain) and foreign-currency or company deposits are sometimes excluded (IMF, 1983, p. 21). These schemes provide valuable safeguards for small depositors, but their extension would probably create larger and less predictable burdens for central banks (and ultimately taxpayers). More fundamentally, deposit insurance may not fulfil the prime function of LLR as a social good - maintenance of the commercial banks' capacity to lend in support of economic activity. Institutions whose depositors have just been baled out are normally compelled - by prudence, by central bankers, by depositors themselves - to contract advances; and there is no clear guarantee that other institutions will replace them, especially in a climate of impaired confidence.

Support for depositors is different from LLR. So is support for borrowers. We share the widespread fear (cf. ICIDI, 1983) that the recently agreed enlargement of IMF resources is insufficient. We share, too, the fear that IMF conditionality can be inappropriate; although aimed

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*Federal Deposit Insurance Corporation (FDIC) administers the federal deposit insurance fund. Banks which participate in the fund have their deposits insured against loss up to $100,000 for each depositor. The fund obtains its resources through annual assessments on participating banks. All members of the Federal Reserve System are required to insure their deposits through the Corporation and non-member banks, normally organised under laws of various states, may apply and qualify for insurance. Ed.

at financial realism for each borrower, it involves - when simultaneously applied to many countries - contractions of demand, including mutual export demand, that will make it harder for the borrowing community as a whole to meet its new and old obligations. Countries with repayment problems, if there are many countries and large problems, certainly need new funds conditional on their adjustment in a manner that does not induce general and mutual deflation. However - while additional provision of such funds (and new modalities for conditionality) may reduce the risk of calls upon ILLR - provision of such funds to borrowers is distinct from LLR facilities for banks.

Both depositors and borrowers, if their activities have not been speculative, may be provided with emergency facilities through some sort of safety net. Such help for customers, while it may ease the strain on a LLR, is not truly a substitute for LLR to the banking or near-banking intermediaries. Nor, third, are general open-market operations a true form of LLR in near-crisis. Generalised new liquidity will not - unless enormous - go to distressed banks, or their clients.

To advocate provision of LLR proper, as Bagehot did - and to deny the adequacy of substitutes - is not to express general lack of trust in the operation of financial markets. A series of bank troubles, leading to a crisis that feeds on itself for want of a LLR, is not a market, but a gap, a discontinuity, between two sets of situations, in each of which market forces can operate, but between which they can no more mediate than people can see round sharp corners. LLR is not a substitute for financial markets, but a necessary condition for their contribution to stable growth.

However, if a LLR is not to be transferred into a mechanism to "bale out the banks", and if LLR facilities are not to encourage reckless lending in the belief that there is no lender's risk, then a precise content must be given to the concept of "onerous terms". Three different methods for applying the concept of "onerous terms" today seem possible. (a) Bagehot did this with a twin condition: lending had to be on "good collateral", and there should be "a very high rate of interest" (Fetter, 1965).
(b) Another approach is to define clearly conditions where LLR will not be available, e.g. if there is good reason to suspect fraud, or if there has been gross breach of banking practice and/or explicit supervisory conditions. (c) A final approach is to maintain uncertainty about the nature, duration, entitlement or cost of LLR facilities. We shall argue that current reliance on (c) in ILLR has

gone too far for the health and stability of the banking system - but that (a) and (b) can be revived only with supervision, redefined, as the counterpart to a more assured ILLR.

III. The Internationalisation of Banking and of its Risks

Why cannot the requirements of ILLR facilities simply be met by national authorities? Six trends in international banking since the early 1970s have increased the need for an ILLR, and for new forms of international central-bank co-ordination and supervision. These are well known, and have been analysed in depth elsewhere, we sketch them very briefly here.

1. Private bank lending to oil-importing developing countries grew at 19.7% annually at constant prices between 1970 and 1980 (World Bank, 1981, Table 5-3). Recently a very high proportion of such countries' current-account deficits has been financed by borrowing - and very recently by short term borrowing - from international banks. Of all such deficits, in 1977-81, 53% was financed on average, by increases in international bank claims. (For the large borrowers, the ratios were much higher). Thus, by end-1981, the total obligations of non-oil developing countries to banks reached on average 3.56 times the level of their official international reserves (this ratio being higher than 10 for Mexico, Philippines and South Africa). Furthermore, an increasing proportion of this borrowing had short maturities; as a result, by end-1981, 45% of the bank debt of the non-oil developing countries was due in less than one year (IMF, 1983, pp.6-7). Under-reporting of much military, short-term, and non-publicly-guaranteed debt-while less serious than hitherto - still means that the truth is even more worrying than such official estimates suggest.

2. Non-oil LDCs' current-account deficits (of which banks covered a rising proportion) themselves grew dramatically - from $11.3 bn. in 1973 to $107.7 bn. in 1981.*
This added to fears that an ILLR might be needed, and perhaps found wanting.

3. The speed at which debt service, especially and increasingly to banks, has been expanded and internationalised has involved more and more dangerous strains. By

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* The current account deficit declined, however, to $86 billion in 1982 and is projected to decline further to $68 billion in 1983, principally because bank lending contracted sharply from $53 billion in 1981 to $25 billion in 1982 and is expected to contract further to $15-20 billion in 1983. (IMF, World Economic Outlook, 1983) Ed.

1982, the debt service "ratio" (DSR) to annual exports of goods and services was24% for non-oil developing countries, as a group.* Yet, even for any one LDC, the risk of serious debt repayment difficulty rises sharply as DSR increases; even in 1965-74, when risks were far smaller, difficulties arose in 38 of the 102 cases where an LDC had a DSR above 20% in a particular year, but only in 2 of the 478 cases with DSR below 20% (Feder, 1979; Lipton, 1981, fn.10). Even the alarming recent DSRs exclude servicing of much unreported debt (see para. 1), and the position of several Comecon countries increases the dangers further. Nor, on past evidence, need "recovery" - especially if patchy - reduce the risk; for some debtors, it could even worsen terms of trade and/or raise interest-rates. Hence there is no validity whatever in popular, and populist, claims that the internationalised threat to financial stability is somehow unreal, or no greater than before (Lal, 1981, p. 17), or that urgent demands for ILLR or other action constitute some sort of "banker's ramp". There has been an explosion of demonstrably risky credit, in forms for which there is, as we shall see, no clearly demonstrable LLR (McNamara, 1982). Morgan Guaranty (1983) has estimated that almost half of LDC debt is in arrears, was being rescheduled or had been rescheduled at the time!

4. The debts - and risks - are the more alarming for being very concentrated on a few big debtors and banks. At end-June, 1982, of $347.5 bn. owed by the hundred-plus developing countries to BIS reporting banks (excluding offshore centres), some 49.6% was owed by Argentina, Brazil, Mexico and Venezuela (Morgan Guaranty, 1983, p. 3). In early 1983 Argentina, Mexico, Venezuela, Brazil, Chile and Colombia had reported debt service ratios well over 100%. Exposure to the first three alone by the 10 leading US banks was $38 bn. - over 40% of the countries' bank debt, and over 140% of the banks' total equity! (*Economist*, April 1983, pp. 13, 18.) The Federal Reserve estimated that about 70% of total US banks' exposure to the 12 largest LDC borrowers was with the 9 largest US banks.

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* This compares with a ratio of 14-16 per cent in 1973-1977. In 1983, the debt service ratio is expected to fall to about 19 per cent, reflecting a combination of three factors: lower average interest rates, reversal of the 1982 decline in export earnings and debt rescheduling (IMF, World Economic Outlook, 1983). *Ed*.

5. Banking was further internationalised as Eurodollars and other "Euro-currencies" were placed in overseas banks, subsidiaries and offshore centres. "Recycling" of OPEC funds meant that, by December 1981, 16% of total deposits of private banks in the BIS reporting area (which includes Group of Ten countries plus the offshore branches of US banks in the Bahamas, the Cayman Islands, Hong Kong, Panama, and Singapore) originated from the oil-exporting countries; and about 38% of these banks' net external resources (deposits minus credits) came from oil-exporting countries, mainly Saudi Arabia, Kuwait and the UAE (BIS, 1981, 1983). The 1982 oil price fall somewhat reduced inflows from major oil exporters; however, their deposits - and current-account surpluses - are seriously understated by published data (IMF, 1982, pp. 142).

Finally, lending and banking increasingly involve agents of several nationalities in single transactions - so that responsibility for both supervision and ILLR is unclear. This means, for example, (a) syndicated lending, with the participation of banks from different countries, to finance developing-country and Comecon borrowing; (b) the rapid growth of a much larger, international, surprisingly vulnerable, interbank market; (c) a growing search by banks for legal means to avoid exposure limits and to reduce tax liability. All this means a great variety of foreign branches, subsidiaries, affiliates, so-called holding companies, etc., largely in offshore centres with parent banks based in other countries. Furthermore, the main depositors are often from yet other countries - as are the currencies in which the bank is operating. As a result of this internationalisation, a large proportion of operations and flows do not clearly fall within the purview of any national supervisory or LLR authorities.

IV. Existing Provisions for ILLR Facilities

There is now, as we have stressed (p. 7), uncertainty about LLR for foreign activities. Central bank representatives repeatedly aver that even indications of the possible provisions of their support as ILLRs, or any apparent generalisation from past cases where their services were provided, may reduce bank prudence. Governor Wallich (1978, pp. 95-6), of the US Federal Reserve Board, stated:

> "There are dangers in trying to define and publicise specific rules for emergency assistance to troubled banks, notably the possibility of causing undue reliance on such facilities and possible relaxation of caution ... The Federal Reserve has always avoided comprehensive

statements of conditions for its assistance to member banks. Emergency assistance is indirectly a process of negotiation and judgement, with a range of possible actions varying with certain circumstances and need. Therefore, a predetermined set of conditions for emergency lending would be inappropriate".

Bank of England Executive Director (now Deputy Governor) MacMahon expressed a very similar view (1978, pp. 108-109):

"... close consideration and cooperation among the central banks most concerned with the security of the international banking markets is essential. By the same token, however, it is not possible for them to define in advance with any precision the circumstances in which last resort finance might be forthcoming. Indeed, if they tried to do so, banks might be tempted to sail too close to the wind with the presumption that support would automatically be forthcoming if they got into difficulties. The primary purpose of agreement among central banks on the provision of last resort finance is to safeguard the international banking systems on which that is founded. The provision of such a safeguard does not - indeed cannot - entail automatic support to any bank facing difficulties regardless of the particular circumstances".

Central bankers, therefore, deliberately do not make explicit existing ILLR arrangements. Thus the major official statement, the September 1974 Communiqué, issued by the Central Bank Governors of the Group of 10 and Switzerland, a few months after the collapse of Bankhaus Herstatt, is kept brief and unspecific (IMF, 1983, p. 34):

"... The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognised that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary". 3/

Note that this leaves open the possibility that "temporary liquidity" may be supplied to borrowers, to lenders, or through open-market operations. It is _not_ explicitly assured to the troubled bank.

In April 1980, the same Group - in a further communique, mainly about supervision - referred even less explicity to ILLR issues:

> "In view of the present volume of international bank lending and of its prospective future role the Governors are agreed on the importance of maintaining the soundness and stability of the international banking system and of seeking to avoid any undesirable effects either worldwide or on the conduct of policy in particular countries".

This 1980 Communique announced the creation of the Standing Committee on the Euromarkets. This has been interpreted (IMF, 1983, p.34) as a responsibility for "coordination of responsibilities of lenders of last resort". It has also been suggested that the BIS "bridging loans" in 1982 and 1983 represented a sort of ILLR facility; and that, behind the 1974 Communique, there lay "an agreed plan with respect both to the allocation of responsibilities of lender of last resort and the circumstances under which such support would be provided to banks experiencing difficulties" (IMF, 1983, p.34). However, supervisory authorities (in conversations with us) questioned all this; they suggested BIS functioned, in respect of ILLR, not independently but as a monthly meeting-place for central bank Governors of the Group of Ten and Switzerland. Moreover, as the IMF document (1983, p. 34) itself points out, "subsequent developments with respect to individual banks, as in the case of Banco Ambrosiano, have cast doubts on whether such firm commitments exist". 3/

Some indirect evidence on the distribution of ILLR responsibilities can be extracted from the actions of central banks following the few recent failures of individual banks with significant international operations: Bankhaus Herstatt, the Franklin National Bank, the Israel-British Bank and Banco Ambrosiano. 4/ Except for Franklin, all four cases revealed important ambiguities as to final responsibilities in case of bank failures. With Herstatt and Israel-British, there was prolonged uncertainty as to whether all creditors would recover their funds. 5/.

The ambiguities were much greater in the case of Ambrosiano, leading (so far) to the loss of money by creditors of Banco Ambrosiano Holdings of Luxembourg, though the parent bank's creditors were granted full protection. The Luxembourg authorities and naturally the creditors of Banco Ambrosiano Holdings, objected. The issue was made more difficult by technical questions; 6/

and it has also been put to us that the problem arose from open fraud, not from international over-exposure as such. However, we are unconvinced that existing ILLR - overview facilities would prevent even a perfectly "innocent" bank from failing, if its overseas operations were overstretched. The Ambrosiano failure clearly points to gaps in the coverage of both supervisory and ILLR facilities. Luxembourg lacked an indigenous central bank, or any other LLR capacity for Euro-banks; while Italy did not supervise adequately Ambrosiano's consolidated accounts. These elements could surely be repeated in other cases - Italy and Luxembourg are relatively sophisticated financial centres, after all. More generally, the problems of non-banking (and other) subsidiaries, etc., without clear supervision from their parent country, particularly in centres with no LLR obligations, do reveal a more serious gap, both in supervisory and ILLR facilities. 7/ It is not clear whether this case has led to adaptations of these facilities.

A recent authoritative report confirms our fears that major deficiencies and gaps exist in supervision and ILLR facilities, both brought more clearly into focus by the (admittedly special) case of Ambrosiano (Dale, 1982):

> "It is a matter for concern that lender of last resort facilities differ considerably from country to country. A few financial centres have no LLR capacity. Some national authorities can provide only temporary liquidity assistance on a secure basis, while others are able and willing to sustain even insolvent institutions in order to protect depositors. These disparities apart, there is a danger that some authorities may be prevented from extending collaterallized assistance to banks' foreign branches where national laws confer on branch depositors preferential claims to branch assets".

International bank failures since 1973 have been at fairly long intervals, and each has been relatively small. It has been reasonable, therefore, to see the main ILLR task as being to safeguard the interests of depositors and other creditors. If a major international bank - or a closely-spaced sequence of minor banks - were to be "in trouble" or to fail, the main issue would not be to safeguard those interests, but to sustain that bank's (and others') lending capacity. It is in this context that true ILLR - not just deposit insurance, which in essence is what was applied to these four cases - acquires fundamental importance. (Even deposit insurance may require international coordination, if it is not to cut across and

and destabilize ILLR operations. 8/) <u>Reliance on ad hoc solutions, however brilliantly managed, may be acceptable for a Herstatt case, or even an Ambrosiano case, but the prospect of open default by LDC or Comecon creditors requires formal ILLR safeguards.</u>

The inadequacy of existing safeguards is well summarised by the Group of Thirty report (Dale, 1982). The main disparities and gaps in LLR operations at a national level, which create problems at an international level, are in their view (we follow closely Dale, 1982, pp. 16-17):

i) When monetary authorities provide financial assistance to commercial banks experiencing temporary liquidity difficulties, there are varying national distinctions made between formalised routine use of the official discount window, and longer-term support operations undertaken on a discretionary basis.
ii) Although emergency assistance is typically extended directly by the central bank, there are different alternative methods of support in different countries (e.g. special joint facility of the authorities and the banks; lending below market rates to institutions prepared to acquire or assist the problem bank; general support, with or without official encouragement, by one or more large domestic banks).
iii) Crucially, several financial centres - notably Luxembourg, Hong Kong and Singapore - have no indigenous central banks. (Luxembourg has no LLR at all.) This (and other problems) would appear even more widespread and serious among financial centres not included in the Group of Thirty study (e.g. Cayman Islands, Bahamas).
iv) Frequently emergency support can be offered only on a secured basis to solvent institutions. Some countries have broader powers of intervention where insolvency is threatened; elsewhere, the deposit insurance agency has LLR powers which - for potentially insolvent institutions - may exceed those of a central bank.
v) Some central banks are permitted to act as LLR in domestic currency only, although these funds may in principal be converted. Elsewhere, the capacity to provide foreign currency assistance has specific limits.
vi) To varying degrees, countries conceal the precise scope of LLR, as a matter of policy. In general, they expect foreign parent banks to provide all necessary assistance to their local subsidiaries, although the threat of shareholders' actions could in theory limit their commitment.
vii) Finally, where banks do fail, national liquidation proceedings sometimes favour local depositors. (US and many other deposit insurance schemes, too, leave big and/or foreign depositors virtually unprotected.) For this, several

countries treat branches of foreign banks as separate entities requiring their own liquidators; such creditors may also enjoy a preferential claim to branch assets.

In Appendix A we sketch the national supervision practices for international bank lending. These have national differences and international gaps, as do LLR facilities. But does it matter? In practice, can real harm be done by any shortcoming of current practice in ILLR facilities?

V. ILLR and International Expansion: Acute and Chronic Problems

Are ILLR facilities - and the accompanying supervision - adequate to limit damage in times of crisis or widespread distress? Perhaps even more important, in less "abnormal times", do existing arrangements encourage the right scale of lending; do they avoid "euphoric" lending, followed by panicky curtailment of lending; and do they promote, without over-centralist "hands-on" intervention (McMahon, 1983, p.8), an appropriate structure (by types of loan) and distribution (amongst developing countries) of bank lending?

A first conclusion of this study - shared by many other analysts - is that current arrangements, based on general uncertainty and attempted *ex post* coordination of ILLR in cases of distress, are dangerously insufficient.

There are a number of reasons - some familiar from the historical literature, others arising from the current situation - which make a reliable, predictable ILLR essential amid complexities of international banking today.

As Kindleberger (1978, 1982) has pointed out, responsibility for international banking stability (like health and welfare) is a public good, even if public provision of it may somewhat diminish private self-reliance. The good is too risky, and fraught with externalities to be provided by one, or even several, private agents acting alone. This approach does not necessarily rest on the perception of some analysts that the U.S. and other banking systems are inherently fragile, but on the possibility that the international capital market is mostly resilient but can very occasionally break down, with huge, unpredictable, lasting, and maldistributed costs.

National LLRs cannot cope with the problems of an international bank. As central banks or other national authorities represent their own national interests, they

will be unlikely to take a cosmopolitan view of their responsibility in a crisis - unless, implausibly, potential loss from absence of ILLR, and potential cost of ILLR rescue, are in the same ratio for all creditor countries involved. It may be feared that as a consequence no single lender of last resort may be willing to save a given bank (whose activities transcend its frontiers) from a liquidity crisis, because the domestic effects of inaction do not seem to be larger than the cost of support, even though the world consequences may be. Inevitable conflicts of interest will arise where parent banks, subsidiaries, holding companies, depositors and borrowers have varying nationalities. Each central bank will try to minimise its proportion of the costs of any ILLR operation. Delays and disputes about responsiblity can themselves reduce confidence and deepen crisis. We repeat: the world can put up with such costs in the event of a Herstatt or an Ambrosiano; but in the event that overt default, in one or several developing countries, threatens the liquid base of major banks? We should perhaps thank the Ambrosianos, for alerting us, in time, to the crucial need for a formal, transparent, swift ILLR. But are we in fact alerted?

The review of existing national LLR facilities, and more importantly the recent experience of international bank troubles - with interlocking, multiple losers and unclear responsibilities - raised concerns that the financial crises of the 1870s and 1930s may be repeated, and showed that these concerns are not merely theoretical and historical. Furthermore, even if a national LLR had - and if it was willing to commit - unlimited resources in domestic currency, the fact that international deposits and loans may be denominated in foreign currencies could cause it serious problems and lead to its unwillingness to provide foreign currency to support commercial banks' international operators. Such a balance-of-payments constraint may have been one factor in Argentina's partial denial of its responsibility to foreign creditors in the failure of Banco Intercambio Regional (IMF, 1983).

Amongst industrial countries' central banks, this problem has so far been overcome by mutual balance-of-payments support operations. Such operations, however, could be much more clearly and swiftly handled in the framework of an ILLR. The role of the US Federal Reserve would necessarily be crucial, as such a large proportion of international banking operations is still in dollars. Therefore, the position of the US Government and of the US Federal Reserve Board in these matter will inevitably have a great influence on arrangements agreed.

Guttentag and Herring (1981) also stress special characteristics of international banking that make a transparent ILLR essential. Inter-bank credit lines may cause one bank's failure to damage the solvency of other banks. Furthermore, several of the largest international banks hold similar assets in their portfolios. Here, one bank's weakness may raise suspicions about other banks. On either ground, failure of one bank may result in deposit outflows from other banks. Thus uncertainties about ILLR may make uninsured depositors more prone to abrupt reassessments of the creditworthiness of banks. This creates, under current conditions, unacceptable risks to the stability of the international banks.

Such authors as Guttentag and Herring recognise the problem of moral hazard, but attempt to overcome it by mechanisms which they percieve as far more efficient (i.e. effective bank supervision). Moreoever, if uncertainty is used to control moral hazard, private banks may not know what behaviour would disqualify them from support; they will therefore not know what activities they should avoid (Shafer, 1982). Most important, "uncertainty" in time of crisis must involve delay, speculation and dangers of further destabilisation - especially if uncertainty is combined with unclear division of responsibility among central banks.

So much for the problems of ILLR in time of fear of crisis. Even in more normal times, the lack of <u>clear</u> ILLR protection, and of appropriate supervision, not just of the prudence of individual bank lending but of the adequacy and stability of the structure of total bank credits especially to LDCs, has serious disadvantages. Great swings of expansion and contraction, e.g. in lending by banks to Mexico or Brazil, indicate several things. First, each bank, initially lending in hope of a sound return, continues to do so to defend its previous lending, or to avoid admitting past errors. Then, when a country's balance of payments deteriorates, the withdrawal of some banks imperils the position of others, and they too withdraw. Finally, in the downswing, erosion of the cash base - and measures, by banks and borrowers, to anticipate it - reduce the volume of <u>sound</u> lending and delay recovery (McNamara, 1982; Lipton, 1981).

VI. Towards a Solution

Neither more lending nor less lending - only more appropriate lending, with better structure, distribution, steadiness and insurance (e.g. via ILLR) - can remedy this recurrent, deepening, and more and more destabilising sequence. Recovery alone cannot. If it turns out to be

sustained and ideal for debtors - pushing up oil prices for Mexico, and commodity prices and general export demand (but not interest rates) for other LDC and Comecon lenders - "men of affairs" may, as in Britain in 1858-65, conclude all is well; credit will again be blown hard into the balloon marked "sovereign risk". But more lending on the same pattern as before will only mean bigger problems later. As for less lending as such, that either destroys recovery or precipitates default; national and international authorities realise this, as the recent frenzied, brilliant, and partly successful attempts to ensure that large numbers of banks continued to lend to Brazil, Mexico and other countries, show.

What does "more appropriate lending" mean, and how could a more clearly defined ILLR help? More appropriate lending involves three things: better information; sustained, counter-cyclical flows; and diversification.

Commercial banks considering loans to country X, which is likely to have a given production structure implying a particular set of foreign-exchange flows to and from X, would ideally know (a) what, in total, other banks and official institutions propose to lend to X, and have already lent to X - and what are the maturity structures; (b) what X's customers, suppliers and competitors plan to do in respect of the commodities to and from which X's foreign exchange is expected to flow. That sounds a frightening requirement, almost a world economic model, and if taken too far would choke off all credit; but what is needed is something much more modest. Unless a loan is secured very firmly, a commercial bank needs to know - from its own sources, and from the central bank and perhaps indirectly from BIS/IMF - something about the applicant's total credit position, actual and potential, as affected by the commodities and manufactures he proposes to trade in. Surer access to ILLR could well be a "carrot, persuading commercial banks to supply, and to seek, more such information.

Secondly, stricter supervision and surer ILLR, respectively, should stabilise the growth of lending in the "euphoric" stage and minimise its contraction during more critical times. Sustained, possibly counter-cyclical flows would seem to be one of the most crucial likely achievements of those mechanisms - if they can be properly specified. However, an ILLR with "uncertainty" cannot be relied on to stabilise credit flows.

The third aspect of better lending, diversification, is also intimately linked to the availability of ILLR. We

have pointed to the extreme concentration of bank credit expansion to developing countries in the 1970s on a handful of Latin American and Far Eastern countries. At the time, this concentration on a few apparently credit-worthy middle-income lenders, plus neglect of almost all really poor countries, seemed prudential to each bank and each syndicate. Each, however, by its own prudent concentration of extra lending, produced a somewhat imprudent concentration of the rapidly expanded volume of total lending. Prolonged recession, high interest and oil price gyrations then turned what was sound for each lender, and mildly imprudent for all lenders *ex ante*, into what seemed like disastrous imprudence after the event.

However, almost nobody was in 1973-4, or even 1978-80, pressing the banks not to recycle, or urging them to diversify their portfolios towards, say, Bangladesh or Mali. Probably it was felt that absolute risk (and lack of banking information) about low-income countries was so high, and their reliance on official flows (especially aid) so well-established, that the dangers and doubts about bank lending to these countries - not all of whom wanted bank money anyway - outweighed any possible gains from a better spread of risks.

Nevertheless, in retrospect (and for future reference), greater diversity of customers among LDCs, to take in some LICs, could have improved the safety of many banks' asset structures. So, perhaps, would a larger share of project lending, as against balance-of-payments lending. However, the gains from such shifts are available to bankers *as a whole*, if they move together; for any *one* bank, the shifts in some cases could increase risks, and would certainly increase information costs. In such circumstances, how can the authorities nudge banks in these directions? If ILLR obligations were made explicit by some group of central bankers, they could include - in the supervisory package that must be (as it is nationally) part of the quid pro quo for LLR support - appropriate pressures to induce *all* banks, participating in an assured ILLR facility, to move gradually towards such restructurings, as well as to obtain better information about creditor countries' *total* debt position and prospects, and to stabilise credit (including interbank) flows towards each borrowing country over time.

All this - even the last proposal - should not amount to pressure on individual banks to support particular countries. *This* "interference with the market", indeed, has come, in practice, not from a carefully conceived ILLR/ supervision package, but from the hasty cobbling together

of rescheduling and new loan packages to specific countries half-forced on numerous reluctant banks since late 1982 precisely because ILLR is and was inadequate.

How could improvements be brought about? In abandoning uncertainty as a way to raise costs of ILLR - because it defeats ILLR's very purposes - authorities can and should, we believe, replace it by adapting to the needs of today Bagehot's original concept of "onerous terms": good collateral and the penal rate.

At first glance, this seems difficult. The only "collateral" for sovereign debt is the willingness and ability of the governments to repay and service it, or to guarantee that the private sector does so. This collateral is by definition not very "good" in hard times. Thus, if net capital inflows become severely negative alongside large trade deficits - as in much of Eastern Europe and Latin American since 1982 - the need to reschedule, even to go into arrears, merges imperceptibly into a temptation to default outright, as is now under active discussion at semi-official levels in Brazil and Mexico (*The Economist*, May 1983, p. 28; Whitley, 1983, p.4). Indeed, leading bankers argue that "Poland, Mexico, Argentina, Brazil and now Romania have all unilaterally defaulted on their debts" already (Rohatyn, 1983, p.17). What, then, can "quality collateral" mean? And how high (and how self-defeating) would "penal rates" be? There is not, as yet, a clear consensus among bankers about proposals for "debt restructuring" (Avramovic, 1983; Guth, 1983; Rohatyn, 1982; ICIDI, 1983; compare, however, Lal, 1983, p. 17; Taylor, 1983, p.10; MacMahon, 1983, p. 8).

Our suggestion is that such proposals be prepared in the form of a contingency plan, for use as part of an ILLR call *when needed by a bank.* Then, and *only then*, the ILLR would purchase some or all of the bank's claims upon sovereign debt at a substantial discount. This would impose a *de facto* "penal rate", and turn large but doubtful claims on now insecure "sovereign debt" into a smaller amount of "good collateral" *a la* Bagehot. The private bank would thus suffer "onerous terms" for using ILLR; but the private bank, its deposits, above all its capacity to lend, would survive.

Afterwards, the ILLR would negotiate with borrowers (e.g. developing countries) to recover the debt - presumably at a considerably lengthened maturity - at a rate above that implicit in the discount price paid to the commercial bank for the claim, but somewhat below the original rate due. The better maturity and perhaps rate,

reduce constraints on the borrowing country's development; this would be "traded in" by the new owner of the claim - the ILLR - against a firmer commitment by the borrowing country to ensure repayment. The more favourable conditions for LDCs would imply a less severe constraint on their future growth as well as a greater willingness by their governments to repay the debts.

Thus - 110 years later - Bagehot's proposals would again come into their own. Their two components for onerous terms - penal interest and good (in a sense) collateral - would have merged into one.

This proposal obviously raises problems, too complex to consider in detail here. Valuing the discounted collateral could be difficult, where no markets are functioning at the time. Other holders of sovereign debt, who are not in need of LLR facilities, must be considered (though presumably they would, on balance, welcome a valuation). Terms must encourage neither debtor countries to seek them, nor banks to seek ILLR facilities. International arrangements - the role of IMF and BIS, the extent to which commercial banks pay a fee or contribute funds for ILLR access, the treatment of lending institutions that "contract out" - need to be specified. The question of funding the operations of such an ILLR is of course crucial. However, we believe that these problems though difficult, are soluble; and that the proposal provides, by reviving truly "onerous terms", a much better way than "uncertainty" to overcome the moral hazard created by existing inadequate and crisis-prone ILLR arrangements.

The proposal would be complementary to the strengthening of international supervisory functions. Although much progress has been made, particularly since the 1975 Concordat, it is difficult to establish complementary and tightly coordinated international supervision. How can one resolve problems about differences in supervision procedures (Appendix A) amongst industrialised countries, and - even more - problems with supervising banks in developing countries and offshore centres? Even if such "piecemeal" difficulties can be overcome, what does an ILLR system with a supervision _quid pro quo_ do about banks that opt out, and then hope that the authorities will allow them to free-ride on the ILLR facility, and will regard the cost of not doing so, in an interlocked financial system, as socially unacceptable? Finally, how does one strike a balance which assures adequate supervision and control, but which does not imply excessive centralised overview or impose unacceptable quasi-governmental controls on private lending? In any case, the existence of a clearer ILLR must

increase the leverage of existing supervisory authorities, allowing them more timely and appropriate control of lending, insofar as a condition for access to ILLR functions would be to have respected the rules agreed with the supervisory authorities.

We feel that our proposal does not create the problems; it merely makes them explicit. In fact they have become serious partly because - in the interests of using "uncertainty" to police commercial-bank lending and to reduce moral hazard - the authorities have never clearly outlined and divided ILLR and supervisory responsibility, nor acquired the leverage to enforce what provisions do exist. Fundamentally such problems are always latent because of the complexity and internationalisation which now characterise banking.

As for the problem of "free riders", if closer supervision accompanies clear-cut ILLR arrangements, both will reinforce each other. Rigorous supervision should become more acceptable to commercial banks especially big international lenders, if accompanied by an explicit ILLR facility. On the other hand, an ILLR can work without excessive costs - whether from imprudent lending, or from the use of uncertainty to deter it - only with previous effective supervision. Both sides of the coin are currently somewhat tarnished (see below). They need to be etched clearly - and simultaneously.

As we have discussed, the establishment (or otherwise) of an ILLR, together with more stringent supervision of bank lending - would affect the nature, level and distribution of private credit flows to different categories of developing countries. We have for example argued that the supervisory component could be used to improve the distribution, among LDCs, of commercial bank lending; it could be linked to achieving a more appropriate balance of different types of private loans (e.g. different maturities; project vs. country loans; fixed vs. variable interest) to LDCs. Such matters inevitably have a major impact on the prospects of growth and development of the so-called Third World countries, who would borrow - or wish to do so - from the private capital markets; it would naturally also have a large impact on the interests of those developing-country Governments who are major depositors in the private capital markets, such as the capital surplus oil-exporters. It would therefore seem appropriate that LDC Governments should somehow be represented in the debate on the establishment of an ILLR and appropriate supervision. We are by no means suggesting incorporation of all or even many LDCs, as this would make any agreement infinitely more difficult; merely that the interests and concerns of the middle income and the poorest borrowers from - as well as the capital surplus lenders to - the international capital markets be clearly represented and considered.

APPENDIX A

Supervision of International Banking

As we have seen, the issue of appropriate international supervision is clearly separate from - though intimately linked to - that of an ILLR. As it is not absolutely central to our concern, and as it has been amply and adequately recently discussed elsewhere - in particular in IMF (1983), Dale (1982), as well as in several of Mr. Cooke's recent speeches, published in the Bank of England Quarterly Bulletins - we will discuss these issues only very briefly here.

As is widely recognised, the techniques of bank supervision lagged behind the internationalisation of banking through the early 1970s. The financial problems of 1974 highlighted this lag in a dramatic way. They led to the establishment by the governors of the central banks of the Group of Ten, plus representatives of Luxembourg and Switzerland, of a committee of bank supervising authorities. One of the earliest and most important achievements of this Committee (now called the "Cooke Committee" after its Chairman) was to develop broad guidelines for the division of responsibilities between national supervising authorities in respect of international banking activities undertaken in their territories. These guidelines - approved by the Central Bank Governors of the Group of Ten in December 1975 - are known as the "Basle Concordat". Cooke (1983) summarises thus the Concordat's priorities: "Supervision was deemed to be the joint responsibility of parent and host authorities...The supervision of liquidity was seen as the responsibility of host authorities in the first instance...The solvency of branches, which are an integral part of the parent bank, was seen as primarily a matter for parent authorities, while that of subsidiaries fell rather to the host, though it was recognised that parent supervisors, in their supervision of the parent bank, needed to take accounts of its foreign subsidiaries and joint ventures in view of its moral commitments in their regard".

A later important recommendation of the Cooke Committee (currently being implemented in some countries), was the consolidation of the data in banks' international business, so as to provide a global picture of banks' activities. A number of other initiatives have been taken, by the Cooke Committee and other bodies, within OECD and EEC, to improve coordination of supervision; these include contacts with banking supervisors in offshore centres, not initially subscribing to the 1975 Concordat.

Many problems for coordinated international supervision still remain. Some of them result from different national traditions of supervision, in crucial aspects such as formality of the methods of control; the relative importance attached by supervisors to quantitative limits on banks, as against adequacy of bank management; the nature of "acceptable" business activities; definitions of appropriate methods to evaluate country risk exposure; and the role of on-site bank examination. Others result from different interpretations of the key principle of parental responsibility, the need to regulate liquidity in the Eurocurrency market and the limited application of the principle of coordination. As a result of several of these factors, it seems that certain banks may, for some purposes at least, be largely unsupervised. A revised Concordat, to be published shortly,* emphasises "that the central bank in the parent bank's home country has supervisory responsibility for the solvency of the parent bank and its subsidiaries", whenever "central banks of the countries in which foreign subsidiaries operate will be responsible for those units' liquidity" (Hughes, 1983, p.2).

However, Cooke rightly stresses that there is no "unsupervised horde" of international lenders. The real problem, as we indicate, is the inadequate _scope_ of supervision - its concentration on the exposure of particular banks, rather than of the total system and of borrowers from it - and the lack of leverage, such as the grant or denial of ILLR facilities that may be needed later to enforce supervision rules.

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* Since published. For the text, see _IMF Survey_, July 11, 1983, p.202-204. _Ed_.

Footnotes

1. Grubel (1971) derived the concept of "moral hazard" from the economics of commerce, where it initially referred to the danger that persons would take greater risks because they were insured. Now it has acquired the more general definition used here and elsewhere (see IMF, 1983).

2. Viz. control of each bank: for fraud; for overall lending, relative to cash and to capital; and for exposure to particular borrowers, or in particular countries or sectors.

3. The 1975 Concordat - sometimes wrongly thought to apply to ILLR - deals only with the separate, though linked, issue of bank supervision (Appendix A).

4. Such cases have been examined in some detail (e.g. Spero, 1980).

5. The issues were later clarified. The German authorities granted favourable treatment to the creditors of Herstatt. The Israeli authorities accepted responsibility for the Israel British Bank - even though the Bank of England contributed as a compromise, but not as a precedent, £3 million to the bank's pool of assets.

6. Banco Ambrosiano Holdings was technically, in the view of the Luxembourg and the Italian authorities, a holding company and not a bank, for whom neither authorities had accepted supervision or LLR responsibilities.

7. Ambrosiano's failure, however, is one of the main factors leading to a revision of the Basle Condordat on banking supervision (Hughes, 1983, p.2)

8. "Not all countries have deposit insurance schemes and those that do offer widely differing coverage with respect to the size, type, currency denomination and status of deposits. In order to avert the danger that perceived differences in national protective arrangements could provoke destabilising capital movements in times of uncertainty, greater co-ordination in this area is desirable" (Dale, 1982, pp. 3-4; see also pp. 14-16, and IMF, 1983, p. 21).

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SUMMARY OF THE INTERNATIONAL TRADING SYSTEM'S PROBLEMS

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The problems of the system of international trade may be said to be of two kinds. On the one hand there are those caused by exogenous shocks and stresses, like wars and large, autonomous changes in key commodity prices, as well as by cyclical movements. On the other hand there are the difficulties inherent in the system itself: the endogenous problems. For want of a better expression all of the former may be lumped together under the heading "conjunctural", while the latter may be referred to as "systemic". The two classes are by no means independent of each other, but the logical distinction is useful for purposes of exposition and also, to some extent, for policy formulation.

Conjunctural Problems

During the past ten or fifteen years the evolution of the world economy has been characterized by falling rates of growth of production and trade; by the secular expansion of unemployment (due to technological, social and political influences operating from the mid-1960s); by the growth of international liquidity and accelerating inflation from the later stages of the Vietnam war and the Smithsonian settlement to beyond the generalized floating of 1973; by the price shocks of 1973/74 and 1979/80, with the cyclical behaviour of (real) oil prices and employment between and after; by wide swings of current account balances and exchange rates; and by the responsive growth in OECD countries of monetarism and state intervention in industry and trade - the one being, among other things, a political counterpoise to the other. During this whole period the attempt has been made to uphold the principles of multilateralism and non-discrimination, and at the same time to press ahead with further liberalization of trade: but there were stronger counter-currents.

For the environment of world trade the chief consequence of the growth of secular and cyclical unemployment was the generalized increase in protection that came to be dubbed "the new protectionism". None of the technical devices employed in the trade protection of the 1970s was novel when viewed in isolation, but together they took on a new complexion in their scale, in their emphases (non-tariff, sectoral, bilateral) and in their rationale. This last had much to do with the wholesale nature of the destabilizing influences compared, for example, with the marginalist logic of GATT's Article XIX.

In the past ten years or so most major currencies have been subject to fluctuations whose effects on international trade flows have dwarfed those of the import duty tariffs - which had in any case been diminished and largely immobilized in GATT. For example, the pound sterling has moved within a range of over $2.5 and under $1.5[1/]. It followed that there was difficulty for government in judging what would be competitive, on a comparative cost basis, in the long run, and what should be let go. Some enterprises that fail to break-even at the first rate of exchange can make profits on their exports at the second, and this could account for a good deal of the ambivalence of governments in the matter of industrial policy.

Positive adjustment is of course easier in concept and in hindsight than in practice, where the uncertainties of the future must be added to the uncertainties of the present. For some countries it was more than difficult enough to judge what the position would have been given free market conditions in others, without having to construct alternative scenarios based on assumed future price relativities. As practically all countries had price structures reflecting varying but substantial degrees of government intervention, this would to some extent have vitiated attempts at adjustment to free market conditions by any one of them. Moreover, as suggested above, the influence of expectations (i.e. the speculative element in exchange rates) and the alleged prevalance of "dirty floating" and exchange rate "overshooting" sometimes constituted a perverse element in the process of adjustment, and added to the difficulties of industrial policy.

Though the chain of causation was not at all one way, a consequence of these and many other distortions and uncertainties was resort by government on a large scale to short-term measures of market organization involving subsidy (open and concealed), local content rules, minimum price rules, fiscal devices, regional industrial policies, purchasing programmes, aid and export credit packages, administrative intervention and direct control of bilateral trade flows, all of which in varying degrees embodied elements that could be described as protectionist. The EEC, Japan and the United States tended to sort out their problems between themselves, partly because fully multilateral solutions would in all probability have eluded them elsewhere.

The growth of multinational enterprise and the close working relationship of business with government in a number of countries have greatly facilitated the management of international commerce outside the traditional norms - and this on the sides of both physical shipments and multilateral payments. As noted by the UNCTAD Secretariat, between 30 and 40 per cent of international trade transactions is between

related parties (i.e. intra-firm trade), and a further 30 per cent is likely to constitute transactions where at least one of the parties is either the state or an enterprise owned or controlled by it.[2/] Some of the most characteristic modern forms of corporate control of trade flows have been activated in response to cyclical disturbances, and have themselves been facilitated by long-term changes in the institutional, financial and technological environment of business.

In the period 1973-81, when oil prices were high (nothwithstanding their erosion in real terms by inflation between times), trade restructuring reflected the need for oil importing countries to pay more, in exports of merchandise (including arms) or services, for the oil. Capital-surplus oil exporting countries could place funds with the Euroloan market, which was increasingly tapped by developing countries. Collectively, developing countries were the "soft" markets, increased exports to which helped OECD countries to contain their current deficits and curtail the erosion of their monetary autonomy that would have resulted from an over-large growth of foreign claims on them: at the same time the anti-inflationary monetary policies pursued by OECD countries made theirs the "hard" markets. These characteristics are reflected in world trade patterns as follows.

Share of world merchandise trade, per cent

Exports from/to	1973	1981
Developed countries/developing countries	12.0	15.7a
Developing countries/developing countries	3.9	7.2b
Developing countries/developed countries	14.0	18.7b
Developed countries/developed countries	51.2	40.9
Socialist countries/socialist countries	5.7	4.7
Others	13.2	12.8
	100.0	100.0

a Growth in share mainly attributable to manufactures.
b Growth in share largely due to oil.
Source: UNCTAD document TD/274, paragraph 15.

The changes depicted above are very large for so short a period, and would imply a considerable shift in the commodity pattern of world trade even had technology stood still. They called for an adjustment of industry that was

rendered all the more difficult by the pursuit of policies which, however necessary, brought the growth of world production and trade to a halt. The result was to hasten the erosion of GATT norms, and the declining relative role of GATT-type trade, by the organization and management of markets in the search for stability. "The degree of management is now very large and extends to all sectors and groups in all countries, regardless of their economic and social systems or levels of development."[3] The particular devices employed have of course varied, in accordance with detailed objectives, institutional structures, and in some cases international agreements. There is a growing realization that trade-as-industrial-policy remains largely outside the scope of GATT rules.

One form of trade management that has featured in the past - in the arms offset arrangements of the West, in investment-related trade arrangements with centrally planned countries, and in special deals like the rice-rubber pact of China and Sri Lanka - has now come to the fore as a means of ensuring supplies and stabilizing market outlets against the upheavals of disturbed trading conditions. This is counter-purchase[4] which, like so many other forms of managed trade, is not in direct conflict with the GATT but rather outside it. J.J. Walsh quotes recent OECD estimates of counter-trade covering 15-20 per cent of East-West trade and less than 10 per cent of intra-OECD trade, while an earlier estimate of developing country trade had put the coverage of counter-trade arrangements at about 40 per cent in the mid-1970s. The present ratio is said to be higher. "As the IMF recently noted, there has been a surge in bilateral trade arrangements since 1979. Most have been initiated by developing countries to correct payments deficits. Some developed countries use counter-trade arrangements to assure supplies of essential imports. All such arrangements are made in response to governmental policies and programmes."[5]

The GATT had been designed for a non-discriminatory, free-market system of fixed parities and marginal adjustments, in which the role of government was strictly limited. But experience suggests that the market system can only operate efficiently within a framework of basic stability of prices and wages, in the absence of which there is a seemingly inevitable drift towards state corporatism. GATT was thus not at all adapted to dealing with the trade implications of such gross macro-economic disturbances as have been experienced over the past ten years, and during this period the relevance, and hence the authority of GATT have suffered a severe decline.

Now the break in oil prices has revealed the weakness of a trade adjustment based to such an extent on debt. At the same time it may provide the opportunity for reorganising the debt structure of developing countries, and remove the occasion for some of the hastily imposed measures of industrial and trade protection, by concerted expansionist policies in OECD. These would make OECD markets softer, developing country markets harder, and support the revival of commodity prices and a new adjustment in the geographical pattern of trade. Some of these changes might prove temporary, however, if at the same time attention were not given to the long-standing need for a system of trade and payments legally and institutionally capable of ensuring adequate, and adequately co-ordinated, policy response both to conjunctural shocks and to secular change. The GATT has recently warned that if rates of recovery vary among different nations, current account imbalances would probably widen and could become a source of pressure for further protectionist measures.

Trade Systemics

The system of international trade relations has been defined as "the series of principles and norms which form the basis of the international consensus regarding the role of government in the conduct of international trade, the contractual rights and obligations of participants as regards the use of trade regulating devices, and the international agreements and institutions by means of which trade policies are implemented. The GATT clearly constitutes the basis of what might be called the 'multilateral' system of trade relations".6/

On this definition it may be said that the chief problems of the system as such are threefold, arising from 1) the breakup of the international consensus on the role of government; 2) the perceived lack of balance in the rights and obligations as between contracting parties; and 3) the rigidity of GATT law and of the institutional procedures and negotiating modalities of GATT, which has retarded adaptation of the norms and the obligations to changing commercial and industrial realities. These three causes are closely interlinked in practice: together they weaken such consensus as exists in favour of the GATT system as a whole.

At the Davos Symposium of the European Management Forum, early 1983, the need was expressed for a package of initiatives to resolve linked problems of developing country indebtedness and protectionism. For this, it was said that there was a need to "strengthen" GATT, for which purpose the Contracting Parties should meet every two years at ministeral level. While it may be allowed that such meetings would heighten awareness of trade-linked problems and give political impetus to the work programme, it is difficult to envisage any real strengthening of the multilateral trade system without an agreed diagnosis of GATT's weaknesses. To "reaffirm" GATT would be insufficient. The fundamental weakness is that GATT has lost the consensus on which it was based.

The GATT is a balance of "interests" and if, in the passage of time, through the evolution of trade, industry, and government, this balance becomes distorted, the need is felt for a new balance. This can only come about by exchange of substantive interests (concessions). Without a balance of rights and obligations that is broadly seen to be fair and in the interests of all, the normal processes of consultation become increasingly sterile, and it is vain to expect conciliation and dispute settlement procedures to be effective. The law would have lost its sanction, which is mutual interest; and large numbers of countries would be tacitly ignoring the law. It is probably not too strong to say that this is what has been happening in trade in agricultural products. There may indeed be a need to strengthen GATT, but this can hardly go far enough to meet present needs without a new consensus among contracting parties i.e. between governments.

The plea for a new consensus based on an agreed diagnosis surfaced in the preparatory work for the GATT Ministerial in 1982, for which developing countries had been co-ordinating their positions elsewhere. However, the result of the Ministerial Session was a good deal less fundamental. It was a series of "reformist" measures, for which the GATT Council established procedural arrangements, mostly distributing the work among its existing organs and, where necessary, setting up new ones. This result should not have been unexpected, as it follows largely from the way GATT works. Indeed, the secretariats of UNCTAD and the UNCTAD/UNDP MTN project more than five years ago concluded that no fundamental change to the "framework" of world trade law would be likely to emergy from negotiating machinery set up in GATT.

Some reasons for the weakening official consensus among GATT's membership may be offered by way of example. In the first place, developments in trade and payments over the years have made parts of the Agreement obsolete, and

contribute to a felt lack of balance which has in turn been used in justification of non-adherence to some of its provisions. Some of these developments have been noted above, in the course of the discussion on the response to conjunctural shocks. But others, like the growth of trade in services, high technology, and trade-related investment, may be used to illustrate long-term trends that (whether or not related provisions should be written into the General Agreement) can seriously undermine the balance of national interests over a period of time.

Similarly, politico-economic developments of a rather fundamental kind can upset the balance. Such have been, for example, the resurgence of Western Europe in the shape of the EEC, and the growth of Japan, which have introduced tensions reflecting different industrial cultures, and a _de facto_ division of power in GATT between these two and the United States. Also, the emergence of Third World countries as a politically coherent force, and their now dominant membership of GATT in terms of numbers, has highlighted a north/south divide on the concept and operative significance of "reciprocity" in GATT, and shown a need for the development of new negotiating modalities for these and other countries.

Then again, the increase in government involvement in trade is calling into question many of the presuppositions on which GATT was based. Giuseppe Porro argues that control of state aids is a necessary condition for the preservation of a system based on free trade. But, he says: "It seems inconceivable that, in the name of safeguarding free trade, states should refrain from intervening in order to restructure industry, preserve employment and permit the re-training of manpower, or assist depressed areas. 7/ For these and similar reasons it is now sometimes argued that the terms of GATT and its powers of multilateral surveillance should be extended to encompass not only trade but also investment and industrial policy - in a manner that calls to mind the charter of the stillborn International Trade Organization. Now, as then, this would create juridical as well as informational problems: as a senior US trade official recently observed, there is nothing so domestic as international trade. However, the difficulties should not be made an excuse for avoidance of necessary effort.

The problems do, indeed, go deep, and some are both technically complex and long-standing. In many contexts "comparative advantage" follows more the dynamics of industrial organization than the usual Ricardian, Heckscher-Ohlin or product-cycle logic; and when governments intervene in the market they are not necessarily failing to perceive that comparative advantage is there, but perhaps reacting to

realities that the model has assumed away. The world is not composed of the equal units implicit in the original one-world GATT view, but of very different kinds of economies, with different sorts of governments and different industrial policies. The theoretical benefits of free trade are generally admitted on all sides, but they abstract from the realities of market and political power. The concept of (completely) free trade (including, e.g. a unified rate structure and no subsidies on official export credits) implies free movement of capital and labour, which are always likely to be limited.These are the really difficult problems for government, the problems of degree in a world of economic imperfections. While the doctrine of comparative advantage is theoretically unassailed, its practical utility depends entirely on the validity in the real world of its <u>ex ante</u> assumptions.

There may be justifiable apprehension at a state of affairs in which most countries subscribe to a theoretical consensus while basing policy on its practical exceptions. With a sharper focus on the international allocation of savings and investment as the crucial welfare variable, governments would perhaps be able to acknowledge even to themselves what they are actually doing, and to tackle the consequences, notably those concerning the international order, in a less haphazard and contradictory manner. As it is, the great variety and scale of government intervention in the economic process, including the activities of state trading entities and the provision of subsidized export credit, have contributed to the present felt lack of balance in the rights and obligations of GATT. There is need for a new balance to be negotiated, for consensus to be re-established. The new balance would need to accommodate, inter alia, the smaller primary producing countriew with their agricultural interests; the developing countries with their wide range of concerns, particularly about commodity production and trade, special and differential treatment, and negotiating modalities; as well as the advanced countries for which investment-related trade, and trade in services and high-technology goods, are becoming a major focus of attention.

<u>The Way Ahead</u>

There are two main schools of thought on the way to proceed. The first has been dubbed the "GATT or chaos" school, its adherents arguing that there is no chance of a new consensus. It is a choice of either GATT as it is, with reformist measures to try to make it work better, or breakup of the system. US trade officials have recently been floating ideas for "strengthening" GATT, one involving negotiations with developing countries, and one reviving a 1969 Atlantic Council proposal to create a sort of GATT-within-GATT consisting of the industrial countries and a few

advanced developing countries. As would be expected, these suggestions have evoked little enthusiasm, and indeed they would be regarded by many as themselves constituting breakdown of the system. An alternative scenario would see the EEC becoming selectively more protectionist in its attempt to preserve (and establish) free trade within its borders, while UNCTAD would promote South/South co-operation under its own auspices and within a separate legal framework. All of this, hypothetical as it is at this stage, would be analogous to the earlier breakdown of the par-value system of currencies, in as much as it would produce greater unilateral and group "freedom" of action but at the cost of greater uncertainty. It would hamper a return to greater stability of exchange rates.

The other view is persuasively argued by the UNCTAD Secretariat. "There is an urgent need for a new consensus to underline an improved international trading system."8/ In the view of its Secretary-General, as expressed to Ministers representing the GATT Contracting Parties in November 1982, while it was necessary to deal with immediate problems, it was necessary also to build an enduring structure for the future. It was important to recognize, he said, that the problems in the multilateral system had their roots in economic and social stresses arising from shifts in international competitiveness and conflicting national policies. In Mr. Corea's view these problems should first be addressed and analysed, so that any renegotiation of the rules and principles of the system would be based on a common understanding as to the objectives of such an exercise.

The "reformists", who held the centre of the stage at the GATT Ministerial, fear that such an exercise would merely highlight differnces, and lead to a further erosion of credibility for GATT, without producing a new consensus. Against this it can be argued that differences are growing inevitably as a result of political and economic developments independent of GATT, and that to ignore them would not prevent the ultimate fragmentation of the system. In the words of the UNCTAD Secretariat 9/, "political vision and collective responsibility, and a willingness to go beyond negotiating postures and traditional attitudes, are urgently required". Unfortunately, wishing will not make it so, and it has to be recognized that a "new consensus", if it is to have any real meaning and effect, can only be arrived at by genuine compromise all round, by the cession of real or perceived national interests for the sake of larger national interests.

It is the magic of GATT that its negotiating processes are designed to make this possible. The problem now is that they no longer seem capable of doing so.

While being "good at" procedures leading to contractual arrangements, GATT is less successful with free-ranging policy discussions of a type capable of being held in some other organizations. For this reason, and because of its restricted mandate, GATT has some difficulty in addressing the larger issues, like protectionism in their totality. The industrial policy and monetary aspects are set aside, while present procedures for handling even the trade aspects are compartmentalized, tailored to the committee structure of GATT, and linked to the existing legal framework, i.e. the text of the General Agreement.

Among the important consequences of these procedural modalities in GATT is that it is made difficult for developing countries to evolve a coherent position in relation to their special interests. Another consequence is that an eclectic and creative approach to new problems emerging in world trade is inhibited, so that debate is stultified and the GATT legal framework itself becomes increasingly obsolescent. This applies in areas of overlap between international trade, finance and industrial policy, as well as overlap of internal GATT organs. On the other hand it must be frankly acknowledged that, while there exists the possibility in UNCTAD for wide-ranging debate on interlinked trade, industrial and financial issues, uninhibited by the legal GATT/IMF framework, the focus of that organization carries its own limitations for co-operation outside the North/South context. In like manner the OECD has its strengths and weaknesses.

Since the development of a new consensus out of existing organizations seems in the above ways to be fraught with difficulty, there may be a natural tendency to look for salvation in calls for a new globalism. But unlike the situation pertaining in 1944, the world no longer operates in an international juridical nomansland. If the way forward is not to be destructive of what has already been achieved, new arrangements would need to take into account existing commitments.

In the 1982 Commonwealth report "Protectionism", a way forward along these lines was suggested in the following terms:

> "Joint machinery should be established linking GATT, UNCTAD and other international agencies, to discuss protectionism and structural adjustment, including the policy framework for

agricultural, industrial and other sectors;
this could lead to, and facilitate, negotiation
of specific rights and obligations in
appropriate agencies."
(Protectionism: Threat to International Order,
page 135.)

The institutions named or alluded to above, which may be assumed to include the IMF, are of course all creatures of government. The secretariats of these institutions could not be expected on their own to find a new consensus among governments. The recommendation of the Report may thus be interpreted to envisage joint machinery at the inter-governmental level - perhaps a type of C-20 mechanism with a much broader mandate, and serviced by a joint secretariat. A specific function of the UNCTAD Secretariat in this process could be to contribute ideas for the integration of developing countries into the international system on the basis of both equity and efficiency. But it would be governments that would need to make the running, at all stages of what would be a political process. And for the process to gather any momentum it would seem to be highly desirable, perhaps even essential, for the GATT Contracting Parties to meet at ministerial level much more frequently than hitherto.

If the first step may thus be visualized in terms of the creation of such a mechanism for co-ordination at the political level between institutions, the immediate goal of this process would be to reach an agree diagnosis, and accordingly to harmonize short-term policies for dealing with shocks to the system. Its longer-term objective, carried out with the important assistance of existing international secretariats, would be to search for a new consensus by staking new boundaries and defining interrelationships between domestic and international jurisdictions, between the trade and industrial aspects of the system of exchange, between North and South regarding the concepts of reciprocity and graduation, between manufactures and "commodities" as to the market and structuralist concepts of trade organization, as well as the boundaries of institutional competence.

To itemize the agenda in this way is to illustrate the formidable difficulties in the way of reaching a new consensus. It would be an arduous process, and a long process. Success could never be guaranteed. Without it, however, reformist efforts, necessary as they are, could hardly staunch the tendency to fragmentation, and a further loss of authority and effectiveness for international institutions could be expected. With it, the way would open for a preparatory conference, leading to negotiations on specific issues in appropriate agencies and a new balance of rights and obligations. This result would be a major

step towards the sort of "comprehensive" treatment of international commercial interchange envisaged in, for example, the Proposals for Consideration by an International Conference on Trade and Employment, issued at Washington towards the end of 1945.

The Proposals suggested the founding of an International Trade Organization of the United Nations, the members of which would undertake to conduct their commercial relations in accordance with rules laid down in the Charter of the organization. They affirmed the principle of unconditional most-favoured-nation treatment, and laid down for adoption rules intended to govern tariffs and preferences, quantitative trade restrictions, subsidies, state trading, exchange control, restrictive business practices and inter-governmental commodity agreements. General principles were formulated with respect to the maintenance of full employment and international co-operation in employment.

As is generally known, the Proposals were only very partially implemented, mainly because, in the view of the first Executive Secretary of GATT, there was a lack of consensus between those who were wedded to free trade and those who placed the emphasis on full employment on a national basis. The passage of time since then, and the development of new and potentially divisive elements, has only emphasised the need for a fresh effort to find a broad-based consensus. If this could be long-term and in the initial stages low-key it would help to get away from negotiating postures and traditional attitudes in order to address the real problems.

Footnotes

1/ "A depreciation which does no more than offset domestic inflation maintains the same conditions of trade as would obtain under a stable price level with a stable exchange rate." R. Blackhurst and J. Tumlir: "Trade relations under flexible exchange rates". GATT Studies in International Trade, 1980. Writing on the influence of expectations on exchange rates, and the two main elements in these expectations, viz. inflation differentials and current account movements, the authors comment (op. cit., p. 39): "The current position of the pound sterling is a case in point. Despite a domestic inflation well in excess of the average among its trading partners, the United Kingdom's exchange rate has been quite strong. The principal explanation is the positive impact of North Sea petroleum (perhaps in conjunction with the current monetary restraint) on expectations regarding future trends in the current account balance." A similar type of observation could be made about the position obtaining early in 1983, when sterling came under pressure from apprehensions about the ability of OPEC to maintain some semblance of control in the market, in face of heavy discounting. If a conclusion of the GATT study could be the need for closer co-ordination of macro-economic policy among the leading countries, this in itself would not entirely overcome the anticipatory uncertainties and the after-effects of major "real" disturbances such as those that have surrounded the price of oil.

2/ "Protectionism, trade relations and structural adjustment"; UNCTAD Secretariat, January 1983, TD/274, paragraph 23.

3/ TD/274, paragraph 59.

4/ On the Indonesian counter-purchase policy of January 1982, see for example Far Eastern Economic Review, 27/1/83, and the London Financial Times, 24/2/83.

5/ Walsh, J.J.: "Countertrade: Not just for East-West any more?", Journal of World Trade Law, Jan/Feb 1983.

6/ UNCTAD document TD/274, paragraph 65.

7/ "Government Aids: the rules in EFTA, the EEC and GATT", published in EFTA Bulletin No.4, Vol.XXIII, October-December 1982.

8/ TD/274 paragraph 142.

9/ Loc cit.

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