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COOPERATIVE MONETARY ACTION:
A FEW SUGGESTIONS FOR THE DEVELOPING COUNTRIES

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The major reforms which the developing countries as a whole, including the oil-exporting countries, have sought in the international monetary system are: (1) to re-establish a system of stable exchange rates; (2) to 'internationalise' reserve creation; and (3) to link the resource transfer involved in reserve creation to development. Let us see what, if any, success the developing countries have achieved in these areas.

Exchange rate system

The system which currently obtains is of managed floating exchange rates. It came into existence after the breakdown of the par value system early in 1973 and has operated ever since. A variety of exchange regimes have come to be adopted by different countries or groups of countries. On the one hand, some 30 developed countries, accounting for some 70 to 75 percent of the world trade, have allowed their currencies to float, some independently, some jointly, subject, however, to varying degrees of management through official intervention. On the other hand, the vast majority of developing countries have tried to keep some sort of a fixed link for their respective currencies. Being largely exporters of primary commodities which have traditionally experienced wide fluctuations in prices, export earnings of the developing countries have been subject to considerable uncertainties. The

fact that now the 'major' currencies have chosen to float, has exposed them to an additional uncertainty, linked to the exchange rate. This last uncertainty, the developing countries have sought generally to reduce by keeping, all the same, a fixed link for their own currencies.

No doubt there was always the argument that since under a floating exchange rate system the need for maintaining exchange reserves would be considerably lower than under a system of fixed exchange rates, even the developing countries stood to gain from the switch over to a regime of floating rates. This argument is no longer valid in the light of the actual experience over the past one decade or so. During this period, not only have exchange rates fluctuated violently and erratically but also the balance of payments deficits have mounted enormously. This was particularly so of the developing countries. As a result, the need for exchange reserves has been greater than ever before, especially for these countries.

International reserve creation

The developing countries' espousal of a system of fixed exchange rates should not however be construed to mean that the par value system, set up at the end of World War II, operated in any significant measure to the advantage of the developing countries. The principal beneficiaries of the par value system were really the developed countries. But, as the major benefit of the old system accrued through reserve creation, it was distributed unevenly even among the developed countries. Let me elaborate on it a little. Though gold was then the ultimate reserve

asset, the day-to-day liquidity requirements of the international monetary system were supposed to be met by what Machlup has chosen to refer to as cloakroom type of operations of the IMF. In actual practice, however, these cloakroom operations were found to be extremely inadequate. The result was that the international monetary system had to meet its liquidity requirements out of the foreign liabilities of a few (indeed one) reserve currency countries. The system was largely provided with its reserves by the United States through the creation of dollar liabilities abroad. See Table 1. The dollar liabilities were created by the U.S.A. by either running current account deficits in balance of payments or making investments abroad or through some combination of the two types of transactions -- one involving claim to current real transfers and the second involving claim to real transfers in the future.

What the developing countries have been arguing for is that whatever the regime of exchange rate (though their own preference, as is explained above, has been for stable exchange rates), its liquidity requirements should be met through a system of multilateral reserve creation under which countries can draw upon the international reserves on the basis of their needs and not on the basis of the economic strength they happen to enjoy. Indeed, the 1943 Keynes' Plan envisaged the creation of deposit liabilities by an international agency, to be called International Clearing Union (ICU), with the purpose of extending credit to countries in balance of payments deficits. These internationally created deposits, according to this plan, were to be accepted by the countries in balance of payments surplus as international reserves. It took the world (i.e., comprising IMF members) quite some years, however,

to appreciate the need for internationally created reserves. Initial attempts at expanding world liquidity concentrated on quota increases. Later, i.e., in 1969, when it was agreed that, instead of letting the U.S.A. create international reserves through the expansion of its deposit liabilities abroad, the IMF should be authorised to create deposits of its own, this agreement could be reached on the condition that such deposits would be created in specified amounts only and that the IMF would allocate these deposits among its member countries in the same proportions as their quotas with the Fund. These deposits were to be denominated in gold — like the dollar as it was then — and were to be called Special Drawing Rights (SDRs, for short). It was agreed that 9.5 billion SDRs will be created over a period of three years, extending from 1970 to 1972 and allocated to member countries according to their quotas in the Fund. No further creation of SDRs could be agreed upon until 1973 when it was agreed that a further 12 billion SDRs would be issued over a three-year period, 1979 to 1981. The principle of allocation according to the balance of payments needs could not be agreed upon due to the stiff opposition of the small minority of the developed countries who control the Fund decision making.

The first decision to create SDRs was taken in less troubled times. The world was still struggling to stay on the par value system, with gold as its ultimate anchor. It was hoped that, with the creation of the SDRs, the role of the dollar as the international reserve currency would be reduced though the question of the overhang of dollar liabilities held abroad, even as it then stood, raised issues which were hard to face, and still to tackle. By the time, however, that the sanctioned figure of 9.5 billion was reached towards the end of 1972, international monetary events

had taken a turn quite different than could have been anticipated in 1969. Between end-1969 and end-1972, the actual increase in foreign exchange or currency reserves turned out to be seven times larger than the SDRs created during the same period. So, in quantitative terms at least, the creation of SDRs proved to be a virtual non-event, already.

When, in January 1976, the Interim Committee of the IMF decided to put its stamp of approval to the system of managed floating, and decided also to designate the SDR instead of gold as the principal reserve asset of the international monetary system, it still failed to make any provision whatsoever for the creation of reserves under international auspices. Indeed, it even refused to allow any expansion of the SDRs, with all their restrictive and regressive system of allocation among the IMF member countries. This refusal to expand the SDRs was made, knowing fully well that, since 1969, when the SDR creation was first agreed upon, the currency reserves, indeed dollar reserves, had expanded phenomenally from \$33 billion at the end of 1969 to \$165 billion at the end of 1975 as against \$9.5 billion of SDRs created during the same period. (Revalued in terms of the 16-currency basket, adopted in 1974, the dollar value of these SDRs at the end of 1975 would come to about \$11 billion). As for the far more massive problem of the dollar overhang in 1976— more massive than it was in 1969 — it remained swept under the carpet.

The plea of the developing countries in general, and the non-oil LDC's in particular, that the failure to internationalise reserve creation continued to effect transfer of real resources in a highly regressive and

inefficient manner fell flat on the few developed countries in whom continued to be concentrated the vast bulk of the IMF quotas and, therefore, its voting rights.

The link

The developing countries have been arguing not only for internationalising reserve creation but also for linking such reserve creation with development assistance. This made sense in the light of the fact that the developed countries, as a group, had been running a sizeable current account surplus in the balance of payments for years on end till the quadrupling of oil prices in October 1973. Also, given the payments arrangements worked out between the developed countries, e.g., the General Agreement to Borrow (GAB) of the Group of Ten, the countries really in need of balance of payments assistance would be the developing countries.

This plea for the link has been strongly resisted on two major grounds: (Unfortunately, the Western academic community, barring a few exceptions, has provided strong support to such opposition). One is that the national reserve creation does not cause a large transfer of resources to such countries; they only perform a normal banking role for which they probably get paid in the form of interest charges. The argument ignores that even a normal domestic banking operation within an economy involves transfer of resources from savers (some of whom may not be saving voluntarily) to spenders. At the international level, the banker-countries are also very often the spender-countries. Indeed, not only

do real resources get transferred to a reserve-creating country but they get so transferred at concessional rates of interest, to such an extent that the reserve-creating country is, in effect, able to borrow on long-term, indeed permanent basis, at rates of interest which are usually quite low. The experience of post-World War II phenomenon, of a continuing build-up of dollar liabilities abroad, provides an ample demonstration of what can happen on the above lines.

The second argument is that it is wrong and improper to mix up development assistance with balance of payments assistance, because the considerations going into the determination of the two are entirely different. But this second argument is grossly misplaced, if not altogether dishonest. Once it is conceded that there takes place transfer of resources in the process of reserve creation, then it cannot be denied that this transfer so far has been benefitting a few rich countries -- indeed only one, and that too the richest of these countries. It is this resource-transfer aspect of international reserve creation that the link seeks drastically to correct.

Sometimes, an additional argument advanced against the link is that it will amount to an exercise in deficit financing on a global scale. It is not clear, however, how the link as such is more inflationary than reserve creation by a reserve currency country (e.g., the U.S.), which enables the latter to run large balance of payments deficits. As an UNCTAD document points out: "More generally, the problem of matching total claims on resources with total supplies arises not merely in the context of the link but also in connection with any building up of reserves that affects real economy activity."

Interestingly, the two countries which have been most unbending in their opposition to the link are the United States and West Germany. The reasons for the U.S. opposition are quite obvious. The United States has been the principal, if not only, beneficiary of the system of reserve creation that has prevailed so far. Lately, however, West Germany too has been the beneficiary. Marks held in the foreign exchange reserves of various countries are already estimated to exceed \$20 billion. This figure is no doubt, very much lower than \$200 billion with respect to dollar holdings but it is quite substantial in itself. At the same time, one must take note that West Germany has been the largest single holder of dollar liabilities abroad. However, the West German support of the prevalent system of international reserve creation derives principally from (a) the belief that the edifice of post-World War II economic growth in West Germany rests crucially on the U.S. demand for its exports, and (b) its strong suspicion that a reserve currency role for the Mark will subject the country to sudden changes in its short term liabilities held abroad and will, as a result, greatly complicate the operation of its monetary policy. Also the exchange rate of Mark might then deviate from its long term trend with costly growth constraining consequences. Given the size of the U.S. economy, that country is much less concerned with these matters.

The upshot of all this has been that, not only the demand for the link, but even the creation of reserves under international auspices has so far been virtually ignored, unless one considers the decisions with regard to the limited creation of SDRs and quota increases as an

attempt, however limited, to increase world liquidity under international auspices. One might add here that while the next review of quotas is likely to be rather protracted and lengthy, the prospect of further creation of SDRs over the next few years of Reagan administration is absolutely bleak.

Thus, issues in international monetary reform which are of concern to the developing countries remain altogether unresolved. The exchange rate system is now quite volatile, and since the payments deficits of the developing countries have mounted enormously their need of exchange reserves is very much greater than before. At the same time, though monetary authorities all over hold on to their gold stocks, now largely revalued at market price, the main source of international reserves remains to be the dollar. The one important change, however, is that dollar liabilities abroad are now issued not only by the U.S. official agencies but also by the U.S. commercial banks operating outside. The latter comprise most of what is commonly referred to as the Euro-dollar market. Since currencies are no longer denominated in gold, it follows that for its deposit liabilities held abroad there is no obligation on the part of the reserve currency country to convert them into gold. The gold convertibility obligation under the old system possibly acted as some check on the reserve currency country when it created its deposit obligations abroad. The new system has removed that check altogether and replaced it by virtually none. The recent attempt on the part of the European countries, especially West Germany, to revive the substitution account idea came to nothing, largely I feel, because of the U.S. unwillingness to accept any limitation whatsoever on its right to create dollar liabilities abroad. Thus, not only has the attempt to internationalise the creation of reserves failed miserably, but the regressive and

inefficient system of currency reserves creation stands now more strongly entrenched than ever before. As for the link, which would have ensured equitable distribution of the resource transfer involved in international reserve creation, it can almost be forgotten, because the prospect now seems to be of a freeze on both SDR creation and IMF quota increases.

The experience of the developing countries over the past 13-14 years, in deliberations on international monetary reform in the various forms provided by the International Monetary Fund, should have provided ample demonstration that the way the Fund is constituted at present, it is virtually impossible to get any decision through if it even remotely affects the interests of the industrialised countries in general and the U.S.A. in particular. The votes of the industrialised countries add up to over 62 percent and of this the U.S. votes alone account for 21 per cent. Since no major decision can be taken without the backing of at least 85% of the total votes, the U.S.A is in a position to exercise a veto on all such decisions.

It appears, therefore, that the world financial community, will take quite some time to accept the idea, that Keynes mooted in 1943, of providing for the creation of international reserves under multilateral auspices in amounts that are adequate to the requirements of the exchange rate system that is generally accepted as the best suited to the world economy. It will take the world probably still longer to agree to link such international reserve creation to development. In the circumstances, one has to search for what may otherwise be regarded as 'second best' solutions.

I have two major propositions to make in this context. One suggests a search for collective payments arrangements within the developing world with the active association of the surplus oil exporting countries and the other suggests the deployment of the exchange reserves, including holdings of monetary gold, of the non-oil developing countries to build up reserves of commodities which are both stackable and of major interest to the developing countries either as export earners or as essential imports. I shall elaborate on these suggestions one by one.

Mutual payments arrangements

When one looks at the figures of recent years (see Table 2), the closeness of the surpluses placed by the oil-exporting countries in the Euro-dollar market and the borrowings from that very market by the non-oil developing countries cannot be missed. During the period 1974 to 1980 while the official Euro-dollar placements ^{of} the oil exporting countries went up by \$136 billion, the amounts borrowed by non-oil developing countries from private financial institutions including foreign commercial banks added up to \$120 billion. Thus practically all of the oil countries' surpluses placed in the Euro-dollar market over a seven-year period can be said to have ^{been} recycled to the non-oil developing countries.

Now, there is reason to believe that both the oil-exporting surplus and the non-oil deficit developing countries cannot be too happy with the way the Euro-dollar market functions. It is well documented that the non-oil developing countries have to pay between 50 to 75 percent higher margins on their borrowing from this market than the developed

countries. Also, the maturities for commercial lending to the developing countries have been much smaller. The World Bank's forecast for the 1980s is that they will face even tougher terms hereafter. But the oil-exporting countries cannot be very happy either, because they face a strongly monopsonistic credit market which virtually dictates the terms on which it will borrow from these countries. It must be one of their major concerns that their surplus funds should yield them a maximum possible real rate of return and be at the same time safe and readily realisable.

In these circumstances, the question we ought to be addressing is: Couldn't recycling of funds within the developing world be achieved under its own auspices? Then, not only can the terms of finance be realistically adapted to the needs and repaying abilities of the borrowing countries but also the oil-exporting creditor countries can be given an important role not only in the fixation of the terms of their deposits but also in their disposition. The intermediation now by the Euro-dollar market secures neither. Worse, it keeps out most of the poorer developing countries, whatever be the terms on which this market now lends.

We must, I feel, think of evolving a mutual payments arrangement/s within the developing world in which the surplus oil-exporting countries are assured of an effective voice so that they can confidently entrust it with a good part, if not all, of their surpluses. There can be no doubt that in evolving the above type of payments arrangement/s the wholehearted participation of the oil-exporting countries is as necessary as the willingness on the part of the non-oil developing countries to assure them that their surpluses will be as safely placed with them and in as liquid a form as anywhere else in the world.



There is no reason also why a payments arrangement that comprises all the developing countries, should be conceived of as a mere recycling agency. That would show a very narrow vision. The payments arrangement will have to be conceived of as an agency which, apart from recycling funds, would seek to promote mutual trade and other economic contracts as would foster their mutual development. May be such an agency, in due course will be able to create even its own deposits which will be acceptable not only among its own membership but also outside. In this context, it should be of interest that the European Monetary System envisages deposits creation. This could well mark the beginning of a genuinely international system of reserve creation that has eluded the world so far. To start with, however, the sights would have to be set much less ambitiously.

Financing commodity reserves fund

The non-oil exporting developing countries together possess foreign exchange reserves close to \$75 billion. By holding these reserves these countries are placing them at the disposal of the richer countries, instead of using their resources for meeting their own urgent development and other requirements. This type of retrograde transfer is, of course, the outcome of the world monetary system that the developed countries have succeeded in imposing upon the world. However, there is no reason why the non-oil developing countries must acquiesce in these arrangements to the extent of allowing resource-transfer from themselves to the rich reserve-creating countries. All the same, the accumulation of foreign exchange reserves, at the level they are currently held, offers the non-oil developing countries an opportunity to attend, on their own, to the

urgent matter of strengthening their position in the international commodity markets and to stabilize their export earnings.

I suggest, therefore, that the non-oil-exporting developing countries should urgently consider:

1. establishing immediately an integrated commodities fund with a subscribed capital of \$10 billion to comprehend (i) a \$5 billion Common Fund, and (ii) a \$5 billion Facility for Stabilizing Export Earnings;
2. raising among themselves the entire subscribed capital of \$10 billion, but leaving room for the surplus oil exporting countries, as well as the developed countries, to join in later and pay up their respective shares of the subscribed capital;
3. allocating the shares in such a manner that the non-oil developing countries command at least 51 percent of the voting rights in the proposed fund;
4. offering necessary government guarantees to raise additional \$10 billion, as and when required, in loans from surplus oil exporting countries and the international capital market;
5. proceeding to establish separate international commodity agreements, on the basis of consensus among producer countries alone, if necessary, within one year; and
6. establishing necessary organizational machinery, laying down rules and procedures for its functioning.

To implement the above suggestions, it is necessary that those non-oil developing countries that have accumulated sizeable foreign exchange reserves are prepared, temporarily though, to subscribe to the capital in excess of their due share. This excess subscription should be linked directly to the ratio of the accumulated monetary reserves of a country to its imports, say, the average of the past three years, and be payable only by countries holding reserves in excess of the all-world average. It will be useful if, at the same time, these countries with excess accumulations agree to underwrite additional loans. These loans will become necessary to guard against any possible attempt, direct or indirect, on the part of the developed countries to obstruct the raising of the required amount in the international capital market. Collectively, the non-oil exporting countries may thus have to earmark a maximum of \$20 billion (i.e., less than a third of their present foreign exchange holdings) to implement the above suggestions.

I would suggest also that the non-oil developing countries should, at the same time, announce their intention to replace, to the maximum, the balance of their exchange reserves, including gold held by them in monetary reserves with commodity stockpiles, at country level, in a coordinated manner. These individual commodity stockpiles may also cover (i) commodities which, though stockable, do not get covered by international commodity agreements (e.g., there are commodities such as pepper and cardamom, of significant export interest to India, which do not figure in the UNCTAD list), and (ii) commodities and manufactured goods which, though largely imported (e.g., foodgrains and fertilizers), are of crucial importance to their economies, individually as well as collectively.

Several oil exporting countries are also severely dependent on imports of foodgrains and essential industrial inputs. These countries

might feel inclined to support a programme of commodity stocking at national as well as international levels if the list of commodities is so drawn as to take care of the interests of these countries as well.

To the extent that the non-oil developing countries thus replace their foreign exchange holdings by commodity stocks, they will no longer incur the risks of the decline in real value associated with holding liquid liabilities of a reserve currency country. On the other hand, the commodity prices should then improve, over the long run at least. At the same time, there need be no great fear that commodity reserves are less liquid than currency reserves, since international borrowing against the security of commodity stocks is by now very well established.

Concluding Observations

The proposals outlined above call for action on the part of the developing countries, individually, regionally and collectively. To the extent they can be successfully implemented, the present international monetary scene will be possible to rid of its most retrograde and objectionable aspects. Moreover, not only the non-oil developing countries will have attended to the serious problem of stabilizing

their commodity prices and incomes, which has been eluding solution for so long but also the oil exporting countries can ensure themselves thereby of imports of commodities of major interest to them at stable prices. The developing world cannot go on waiting for a world trading system which ensures them equitable terms for their exports and imports. Nor, of course, can they wait for ever for a world monetary system in which the gains from reserve generation are equitably distributed.

Both my proposals are however crucially predicated on a sort of coming together of the developing countries, including the oil-exporting countries, for forging a monetary management of their own, with the underpinnings provided by the commodity stockpiles financed out of their own funds.

Table 1

(a) Total International Reserves, 1955 to 1980

| | (1) (In billions of SDRs) | | | | | | |
|-------------------------|------------------------------|-------------|-------------|--------------|--------------|--------------|--------------|
| | 1955 | 1960 | 1969 | 1972 | 1975 | 1976 | 1980 |
| Gold (2) | 35.0 | 37.7 | 38.9 | 35.6 | 35.5 | 35.4 | 32.8 |
| Foreign Exchange | 13.1 | 19.9 | 33.0 | 95.9 | 137.3 | 160.2 | 293.0 |
| SDRs | - | - | - | 8.7 | 8.8 | 8.7 | 11.8 |
| Reserve Position in IMF | 1.9 | 3.6 | 6.7 | 6.3 | 12.6 | 17.7 | 16.8 |
| Total | 55.0 | 61.2 | 78.6 | 146.5 | 194.7 | 222.0 | 354.4 |

(b) Distribution of Gold and Exchange Reserves, 1974 to 1980

| | (In billion SDRs) | | | | | | |
|--------------------------------------|-------------------|-------|-------|-------|-------|-------|-------|
| | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 |
| <u>I. Gold</u> | | | | | | | |
| i) All countries | 35.6 | 35.6 | 35.4 | 35.5 | 35.8 | 32.5 | 32.8 |
| ii) Oil Exporting countries | 1.2 | 1.2 | 1.3 | 1.2 | 1.3 | 1.3 | 1.4 |
| iii) Non-oil developing countries | 3.8 | 3.8 | 3.5 | 3.4 | 3.5 | 3.6 | 3.7 |
| <u>II. Foreign Exchange Reserves</u> | | | | | | | |
| i) All countries | 126.5 | 137.3 | 160.3 | 200.3 | 221.1 | 246.0 | 293.0 |
| ii) Oil Exporting countries | 34.9 | 42.4 | 49.1 | 55.2 | 40.1 | 51.0 | 67.2 |
| iii) Non-oil developing countries | 25.7 | 25.3 | 36.2 | 43.9 | 52.8 | 58.1 | 59.1 |

Notes: (1) Until 1971 one SDR was equal to one U.S. dollar. Thereafter, the exchange rate has varied.

(2) Valued at SDR 35 per ounce.

Source: International Financial Statistics.

Table 2

Payments Balances and Resort to Euro-dollar Market
by the Developing Countries, 1974 to 1980

(In billions of US doll.)

| | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | T (1) |
|---------------------------------------------------------------------|------|------|------|------|------|------|------|----------|
| <hr/> | | | | | | | | |
| I. Balance of Payments on Current Account | | | | | | | | |
| i) Oil Exporting Countries | 68 | 35 | 40 | 31 | 3 | 68 | 112 | 351 |
| ii) Non Oil Developing Countries | -37 | -47 | -33 | -29 | -38 | -53 | -32 | -32 |
| II. Resort to Euro-Dollar Market | | | | | | | | |
| i) Placements by Oil Exporting Countries | 23 | 9 | 12 | 11 | 5 | 37 | 39 | 13 |
| ii) Financing of deficits of Non- oil Developing Countries | 8 | 9 | 12 | 18 | 23 | 25 | 25 | 12 |

Source: World Economic Outlook, 1980/1981.

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