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THE INTERNATIONAL MONETARY SYSTEM AND THE LIQUIDITY NEEDS OF DEVELOPING COUNTRIES

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CM/231 (Part 3)

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The International Monetary System and the Liquidity needs of developing countries

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THE INTERNATIONAL MONETARY SYSTEM AND THE LIQUIDITY NEEDS OF DEVELOPING COUNTRIES

I. Appraisal of the System

1. In recent years, there has been increasing discussion in official, financial and academic circles of the present international Monetary System. This system comprises a spectrum of Institutional and legal arrangements which govern the conduct of international economic transactions, the methods of financing deficits and surpluses in international payments, and the manner in which countries are expected to respond to such deficits and surpluses.

2. In its widest sense, the International Monetary System includes the broad network of banking and commercial practices through which day-to-day International transactions are undertaken. The pricing of International shipments, the extension of credit, and the settlement of accounts take place in terms of many currencies. Mainly, these are the currencies of Western Europe and the United States, and more particularly within that group, the major "trading currencies", i.e. the U.S. dollar, the pound sterling and the French franc.

3. Present public and political revival was initiated largely as a result of co-operative studies undertaken in recent years by the Fund and the Group of Ten.

4. In appraising the International Monetary System, the essential concern for the purposes of this report is with the impact it had through the years on the needs of the developing countries.

5. The rules of International trade and payments that were embodied in the Bretton Woods Agreements were drawn up in an International climate quite different from that prevailing today. The principal pre-occupation of those days was how to prevent a recurrence of the economic chaos of the 1930's - how to construct a world economic system in which the industrially developed countries would be able to follow full employment policies without sacrificing the benefits of an expanding world trade. Most of the non-industrial countries of the world did not yet have independent governments; while those that did, had not yet articulated their interest in a system of world trade and payments that would be responsive to the requirements of world-wide development, and in any case were in a weak position to influence the course of events.

6. The ~~working of the system reflected an almost exclusive concern with~~ the ~~problems of the~~ industrially developed western economics that had set it up. The basic assumptions were apparently that all countries should be governed by the same set of rules irrespective of differences in circumstances and levels of development obtained; that the diffusion of economic development both nationally and internationally would take place largely through market forces operating in as free an environment as possible; that in the main, correction was required only for maintaining full employment in the developed countries; and that international disequilibrium could be adequately dealt with through responsible monetary and fiscal management and private capital movements stimulated by it.

7. The narrowness of these assumptions has become increasingly apparent in the course of the post-war period. Indeed the idea of identical rules to govern the trade of rich and poor countries alike, has in effect already been abandoned. The Final Act of the First United Nations Conference on Trade and Development (UNCTAD), held in 1964 in Geneva, records general acceptance of the view that developing countries need special treatment, and encouragement in the field of trade, and that trading advantages should be extended to them by the developed countries on a basis of non-reciprocity. Although in the international monetary field the concept of uniform codes of discipline for all countries has not been as widely challenged, the payments difficulties in developing countries that result from internal and external structural imbalance are increasingly recognized, and efforts, admittedly of very limited scope thus far, have been made to deal with them. There is also growing acknowledgement of the need to make provision, in the international trade and monetary arrangements, for various kinds of economic and social systems and for more rational, deliberate and continuous co-operation between them.

8. A start has been made, through the first United Nations Conference on Trade and Development, in undertaking the reform of the world trading system, including consideration of the problems of control of commodity prices. Parallel efforts are now needed to reform the International Monetary System. It is felt, however, that such reform would not, even if otherwise adequate in form and extent, meet the full requirements of development finance in developing countries, and that supplementary measures for ensuring a great degree of commitment in this regard on the part of developed countries are necessary if the objectives of the Development Decade are to be fully achieved.

II. The Liquidity needs of Developing Countries

9. The liquidity requirements of developing countries are greater relatively to their imports than those of the developed countries. Prices of primary commodities exported by developing countries tend to be subject to far wider short-term disturbances than the prices of manufactures exported by developed countries. This, together with the greater suceptibility of agricultural products to flactuations in volume, make the developing countries particularly vulnerable to destabilizing influences of a short term character. The disturbances are especially great and disruptive in relation to the small reserves of devaloping countries.

10. The difficulties which beset developing countries experiencing a short-age of liquidity can hardly be exaggerated. Many of these countries have adopted restrictions on imports and payments and comprehensive systems of foreign exchange budgeting for the purpose of adjusting external payments to external receipts. Yet the absence of adequate reserves and short-term resources imposes intolerable strains on the administration of these systems from the point of view of the smooth functioning of the economy. Even such eventualities as relatively minor errors in forecasting, strikes in ports and modest short-falls in production which in normal circumstances ought to be accommadated by changes in reserves, now assume enormous proportions and play havoc with the proper functioning of the economy. They drive developing countries to seek credits from suppliers and through other channels on terms which are often unsatisfactory, and to impose further and more drastic curbs on imports which reach out far beyond the category of inessentials and embrace even raw materials and intermediate goods needed for the utilization of existing productive capacity. What is more, all these difficulties tend to be aggravated by the fact that inadequacy of reserves, and the consequent problems posed for developing countries in meeting external payments commitments, lead to a weakening confidence and to a deterioration even in the terms of credit that are normally made available by the international banking system.

11. There are several ways of increasing the amount, or availability of liquid resources for developing countries. These include principally the following:

a) additions to reserves through the creation of new reserve assets or by other means;

b) expanding credit facilities in addition to those of the Fund;

c) easing and rationalizing the conditions governing drawings within the IMF credit tranches;

d) raising Fund quotas of developing countries either by themselves or as part of a general increase.

12. ~~Preference is for expansion of reserves~~ in line with the ~~growing needs~~ of developing countries. Most countries ~~whether developing or developed~~ would wish, as an ideal, that reserves were sufficient in quantity to meet such flactuations ~~as might~~ normally be expected in the light of their experience, while access to credit would handle contingencies whose scale and character could not be foreseen. There is an obvious need for a minimum level of working balances necessary for the satisfactory conduct of day-to-day exchange transactions. Countries which are unable to maintain this minimum level often need to seek credit at short notice in order to augment their working balances. But the ability of developing countries to secure credit is itself dependent on the strength of their reserve positions, because foreign banks often require that reserves in the form of investments in foreign securities be pledged as collateral against credit facilities.

13. There is another and far more important element in the picture. Developing countries, just as much as developed countries, should be able to fashion and pursue their policies with some degree of independence and flexibility free from the contraints imposed by creditor conditions in the event of the slightest reversal in their economic fortunes. This is indeed the rationale for the holding of reserves.

14. Reserves could be increased by the use of expanded aid flows. Increasing attention is being paid to the reserve requirements of developing countries in aid programmes and the increasing collaboration between the Fund and the Bank in dealing with the problems of individual countries is clearly conducive towards this end. However, it would be most regretable if an improvement in a developing country's reserve position weakened its claim for long-term development assistance. A country should not have to await the onset of a payments crisis before attracting the attention of donors.

15. Some developed countries have made provisions for bilateral credit arrangements designed originally to deal with speculative capital movements and, in general, to afford a second line of defence against payments problems. The developing countries have similar problems including those created by capital flights, and are therefore also in need of greater credit facilities.

16. At present the principal source of short-term credit available to developing countries is the International Monetary Fund. Other sources of credit exist, but, as already noted their availability often depends on the pledging of collateral and hence on the level of reserves, and they usually carry high rates of interest.

17. In addition to fund facilities there would be an expansion of other short-term sources of credit and a reduction or subsidization of interest rates charged. Some developing countries already have access to such facilities from the banking systems or treasuries of certain developed countries. Such arrangements might be extended and improved upon where possible. Where developing countries hold their reserves in the currencies of developed countries, the central banks of these countries could grant special credit facilities in suitable circumstances. Also, the Governments of these countries could facilitate access to their money markets by providing guarantees. Regional pooling of reserves among developing countries as a means of providing credit is another possibility which again depends on monetary co-operation among the countries concerned.

18. The fact that several developing countries in severe balance-of-payments difficulties still have unused facilities in the Fund, suggests that they find the conditions on which these are available too onerous. Important improvements in the scale of Fund facilities and in the policies governing them have been made in recent years. There remains, however, much scope for further improvements. The most important of these relate to the period of repayment, the degree of conditionality applicable to Fund drawings and the size of facilities available through the Fund.

19. The Fund's normal repayment period is three to five years. In order to repay its drawings, a country must not merely eliminate its balance-of-payments deficit, but begin to show a surplus. A shift as radical and rapid as this may not be possible without serious disruption of a country's economy. The obligation to ensure early repayment of drawings may result in the imposition of conditions which could disrupt development programmes under way. A lengthening of the period of repayment would make it possible to plan for balance-of-payments adjustment in a much more orderly and less disruptive fashion. It would therefore be desirable that the period of repayment be fixed at six to eight years.

20. The Fund and the Bank might also explore the possibility of assisting developing countries to meet their repayment obligations arising from short-term and medium-term borrowings. This would help to fill the existing gap between the type of credit now extended by the Fund and bank loans, and prevent the developing countries from having to go to the Fund periodically under the pressure of such repayment obligations.

21. Such improvements would also make it possible to view the problems of stability and growth in terms of a longer time horizon and reduce the pressure to sacrifice programmes that show results only in the long-term. They

may also make it less necessary to spell out stabilization programmes in excessive detail. In the nature of the case, it is impossible for any international institution to be so familiar with all the detailed characteristics and developments of every one of its member countries as to be able to draw up policy blueprints for them all. A country should be judged more by the results it achieve than by its adherance to specific policy conditions. It is particularly dangerous for an international institution to become associated in the public mind with specific policy measures that may be highly unpopular, thereby reducing the international influence that can be exerted on future occasions.

22. The Articles of Agreement do not stipulate policy prescriptions by the Fund in connexion with drawings on the credit tranches. In practice, however, such conditions are applied - with increasing severity in the upper credit tranches. The developing countries, owing to the low level of their reserves and their limited ability to mobilize other sources of credit outside the Fund, reach the conditional tranches much sooner than developed countries. There is therefore a strong case for increased flexibility of drawing rights within the Fund. It seems desirable that drawings on the second credit tranches should be available on the same conditions as are applicable to first credit tranche drawings and that the conditions applicable to third and to the fourth tranches should be eased.

23. A serious asymmetry arises from the fact that Fund discipline can be imposed only on borrowing countries. The elimination of balance-of-payments disequilibria calls for concerted action by surplus and deficit countries alike. Any system which leave the surplus countries free to maintain restrictive policies imposes correspondingly greater burdens of adjustment on the deficit countries. It should be the responsibility of the Fund to exert to the maximum possible degree its moral influence with the surplus countries as well.

24. Such influence might perhaps best be deployed through the annual consultations, which provide a useful occasion for the monetary authorities of member countries to review their policies in conjunction with the IMF staff. In connexion with these consultations, recommendations should be addressed to all countries as required, not merely to those that happen to be borrowers or maintain exchange restrictions.

25. An increase in Fund quotas is another means of providing additional liquid reserves to members. Developing countries have participated in the general quota increases (1959) and many have already taken advantage of the Fund's facility allowing, individual quota increases. Further quota increases for developing countries could provide a valuable addition to the conditional liquidity now available to them.

III. Recent Reforms

26. The preceding sections outlined the broad background to the need for reform in the International Monetary System. The remaining portion of this report will attempt to highlight in turn the immediate pressures for reform, the reforms finally agreed on by the Group of Ten and the Executive Directors of the Fund and the remaining gaps between needs and reforms envisaged with special reference to the position of the developing world.

27. Immediate pressures for reform were dictated by two factors that governed the situation since 1961:-

i) Since 1961 most of the currencies of the EEC became "convertible" and thus used by the International Monetary Fund for "drawings" by members of the Fund. Thus developed an anamolous situation whereby these countries had only 17% of the aggregate quotas and voting power (the U.S. has 20% and the U.K. alone has 12% of aggregate quotas), while 60% of total drawings were made in their currencies, thus surpassing the combined drawings on dollar and sterling. Thus they advocate reform on the lines of present and actual conditions of international finance.

ii) The second factor is that in 1966, no additions to international liquidity were made by the U.S. because in that year it had a Balance of Payments equilibrium (no surplus or deficit in its accounts with the outside world). This was further aggravated by the fact that while the stock of mined gold (therefore additions to liquidity) stood at 250 million U.S. dollars in 1965, gold mined in 1966 came to very nearly nill. The combined effect of a U.S. Balance in its accounts and the fall in gold production made 1966 a critical year for world liquidity. Furthermore, the continuous weakness of the British economy and the subsequent periodic "runs" on the Pound undermined confidence in sterling as a reserve currency.

28. Reform of the system was thus deemed to be absolutely necessary. A mandate was given to the Executive Directors of the Fund to conduct discussions with representatives of the "Group of Ten" and to undertake joint studies on the topic of general reform.

29. Broad fields of reform were defined as

a) The "deliberate creation of reserves"

b) Better adjustment process.

c) Voting arrangements in a new scheme having (a) and (b) above as the major objectives.

The New Proposals:

30. The new agreements finally published in April 22nd 1968 are contained in a complicated 80 page document. It would appear convenient, therefore to highlight the broad areas of agreement, mainly because the proposals will have only marginal influence (if any) on the central theme of this report - the liquidity needs of the developing countries.

31. The agreements can be grouped into two main headings:-

(i) A plan for adding to the world's monetary reserves by a scheme named Special Drawing Rights (SDRs)

(ii) Reform of the International Monetary Fund.

These two main proposals would be briefly outlined here. Their relevance and impact on the liquidity needs of the developing countries will then be taken up.

32. Special Drawing Rights

Special Drawing Rights (SDRs) will be distributed (allocated) to members according to existing IMF quotas. The basic financial obligation of each participant is to provide its own currency, when requested by the IMF, to a total of three times its own allocation of SDRs. The country providing currency will then receive an equivalent amount of SDRs. Total annual allocations of SDRs are generally agreed for a period of five years. A feature of this system is an "opting-out procedure", whereby any country which is against the activation of the scheme can vote against it and then, if beaten, opt out of both the distribution of the SDRs and of obligations to accept them in exchange for their own currency although, having done so, it can later decide to opt in. Activation of the scheme would require a simple majority of the votes cast, representing at least two thirds of the total voting power of IMF members.

TABLE I

Annual Share-out of SDR's

(Assuming that all member countries participate)

		Allocation of U.S. $1 Billion a year U.S. $ Million
1.	United States	246
2.	Britain	116
3.	Germany (West)	57
4.	France	47
5.	India	36
6.	Japan	35
7.	Canada	35
8.	Italy	30
9.	Netherlands	25
10.	Australia	24
11.	Belgium	20
12.	Sweden	10
13.	All other countries	319
		1,000 million (1 billion)

Reform of the Fund

33. Fund reform in the new proposals mainly devolves round three procedural matters:-

- Voting procedure
- Drawing rights and length of repayment period
- Interpretation of the IMF's Articles of Agreement.

34. (i) Voting procedure: All important decisions on SDRs (including activation and amounts of allocation) will require an 85 percent majority of the IMF's voting power. It might be raised in passing that this rule would allow the Common Market countries, if they were of like mind, a veto. Furthermore, 85 percent, instead of the present 80 percent, will become the necessary majority for any general change in existing IMF quotas.

Of more interest is the fact that ~~the majority needed~~ for a uniform change in the par values of member's countries (that is to say, for a rise in the price of gold) is also increased to 85 percent, in the event of such a change being made, the same majority is also required for a decision to waive the maintenance of the gold value of the Fund's assets (i.e. member's liabilities in the form of drawings on the Fund). This means that, in theory, if the gold price were to be doubled, the common market countries could, for instance and if they chose, insist that Britain's repayment obligations to the IMF were doubled also.

(ii)Change in drawing rights: Among other changes in IMF procedure, gold tranche drawings are to be made more fully automatic. A very slight amendment on repayment procedure has been made: countries whose reserves improve fast have to repay fast, quicker than the normal practice of making repayments between three and five years from the date of drawing. On the other hand, no country will have to repay at an annual rate exceeding 25 percent of its quota, Final repayment, however, has to be made within five years as before. A totally new feature is that interest will be paid to countries in creditor positions on normal Fund transactions, as well as to those holding an excess of SDRs.

(iii)Interpretation of Fund Articles of Agreement: Interpretation of the Articles is to be entrusted to a standing Committee instead of the Executive Directors of the Fund. The decision of this Committee will be regarded as final unless the Board of Governors, by an 85 percent majority decides otherwise.

35. Activation of the scheme summarized in the preceding paragraphs will require the following steps:-

a) The IMF's board of governors has to vote (by post, by May 31st, 1968) on the scheme. A simple majority of the votes cast, representing at least two thirds of the total voting power, carries the day at this stage.

b) Formal ratifications, involving whatever parliamentary processes may be necessary, must be obtained from three-fifths (60%) of the member countries, having at least four-fifths (80%) of the total voting power. This means that sixty-five of the 107 IMF members accounting for 80% of the vote in the IMF, must approve the scheme before it becomes effective. The United States became the first nation to approve the new plan when congressional action was completed (June 6, 1968) on legislation agreeing to an amendment to the Fund's Articles to establish the new system.

(iv) Comment

36. The ~~new reforms as outlined (in paragraphs 30 to 35) have two main~~ features:-

i) a plan adding to the world's liquidity, and

ii) reform of the International Monetary Fund.

37. It can be pointed out at the outset that the above plan for reform has made two very serious omissions. First, there is no provision for assistance to developing nations in the plan. Second, no improvement is made in the Balance-of-payments adjustment mechanism. More detailed discussion of the omissions will be attempted after examining the significance of the provisions for the international monetary scene.

38. The plan for augmenting world liquidity (para 32) has four features and one major objective.

Feature 1

39. The Special Drawing Rights (SDRs) plan is superimposed, so to speak, on the existing system of national reserve currencies and the ad hoc arrangements existing among IMF members (developing ones only) and national central banks. In this sense the SDRs plan is intended to be an addition to the existing system, rather than a replacement of it.

Feature II

40. Participation in the scheme is not mandatory but voluntary. The "opting-out" procedure insures this.

Feature III

41. The plan would require that each country (if willing) place specified amounts (based on existing IMF quotas), of thier national currencies with the Fund, which in turn would credit the country or countries involved with an equal amount of SDRs. The SDRs can then be bought with the desired currency e.g. the Swiss Franc.

Feature IV

42. $1 billion ~~is the~~ presently slated increase in reserve and is agreed for a period of five years.

(The Objective:)

43. The SDRs proposal is designed to achieve several objectives, but the major one is to provide a means for increasing world monetary reserves.

44. The principal advantage of the SDRs ~~is the creation of~~ a "safe" reserve unit. The SDRs, backed by the IMF and behind this by the gold guarantees attached to the currencies paid in, should not be subject to the same challenges with respect to quality that sporadically plague current reserve currencies.

45. But with reserve creation limited to the rate of $1 billion for a five-year period, SDRs cannot replace and therefore will merely supplement the dollar and pound as reserves.

46. If the surplus countries continue to be continental Europeans, SDRs should reduce their anxiety about earning more dollars and pounds.

47. The plan therefore, seems politically wise for it will reduce European complaints against sole reliance on the dollar and pound as reserves since the SDRs, backed by their currencies as well has reserve status.

48. But there are a number of criticisms that can be levelled against this proposal. The most obvious one is that the "growth" figure, $1 billion for a five-year period, is quite arbitrary. It may or may not fit the world's needs. A decline of world trade (or a dishoarding of gold) would render it too large; a decline of other reserves - e.g., a U.S. surplus which removes dollars, could make it too small.

49. Perhaps the major criticism is that even with SDRs added to the existing system, in the magnitudes currently proposed, major reliance on the reserve currencies will continue with many of the attendant problems. For example, if the United States achieves a surplus, the total supply of reserves would probably still diminish. A U.S. surplus realistically implies that one or more of the European Countries incur deficits. In such an event, the dificit countries in keeping their currency from falling on the foreign exchange market will probably sell their existing dollar holdings first, rather than use their SDRs and gold reserves. As these foreign-held (reserve) dollars are liquidated, world reserves decline equally.

50. On the other hand, should the United States continue to run a deficit, the current surplus countries could either demand SDRs and gold or hold the dollars and the problem remains. If the United States should

lose gold and SDRs rather than finance part of the U.S. deficit by having others accumulate dollar balances, the existing situation will remain.

51. The American quota of the $1 billion SDRS comes to $246 million, which is insignificant vis-a-vis its massive annual deficits. Thus the SDRs will not forestall for long the necessity for the United States to eliminate its deficits.

52. Finally, the SDRs system may increase the rigidity of exchange rates. Since the national currencies transferred to the IMF for SDRs must carry a gold guarantee, the reluctance of any country to devalue, even with a fundamental disequilibrium in its balance of payments, may increase. Again, the SDRs system, like other similar proposals which focus on liquidity, tends to worsen the system's flexibility and the use of the available machanism of adjustment via exchange rate changes

53. The second main item of reform proposed is the reform of the International Monetary Fund. This proposal has four main components:-

- reform in the voting procedure of the Fund,
- Drawing rights in the Fund,
- Length of repayment period of Fund drawings, and
- Interpretation of the IMF's Article of Agreement.

54. The change in voting procedure consists in the provision that all decisions in the Fund will now require an 85 percent majority of members of the Fund. Previously the relevant majority requirement was 80 percent.

55. The significance of this change is strictly relevant to the EEC. This rule would now allow the Common Market Countries a blocking minority, if not a veto, in the dicision-making process of the Fund.

56. The potential of this change, and indeed even the old majority figure of 80 percent, to the developing countries is important. At this juncture however, due to the lack of dynamism of this group of countries within the IMF, this reform cannot be regarded as an concession to the developing countries.

57. The reform in the Drawing Rights of member countries is restricted to the gold tranche positions of Fund members. The provision would permit the automatic withdrawal of the 25% of a member's quota initially contributed in gold.

58. This reform, though no doubt welcome to the hard-pressed group of developing countries, comes as a bit of a disappointment. The automacity of the gold tranche positions now provided, does away with a long-standing anomaly in Fund drawing procedures. Statistically the IMF considered the gold tranche position as part of a member's owned foreign reserves, yet in practice when the need arose for a drawing, delaying tactics were employed which reduced the ready availability of this reserve component.

59. The long over-due establishment of equivalence between the theoretical automacity and the practical difficulties put in the course of drawings at the gold tranche positions is therefore to be welcomed.

60. The deplorable omission in this field is that no change has been proposed in the conditions attached to drawings at the credit tranches (the 75% contributed in national currencies). The conditionality attached to first and second drawings at the credit tranches has long been criticised. Because of this omission, reform under this heading (Drawing Rights) can be considered as at best negligible. The insignificance of this reform with regard to the developing countries in general and Africa in particular, will be pointed up when the positions of the developing countries vis-a-vis these proposals will be dealt with at more detail.

61. A very slight amendment has been made with regard to repayments of Fund drawings (at the credit tranches). First, as of ratification of the agreement on reforms, no country will have to repay at an annual rate exceeding 25% of its IMF quota. Second, there need be no repayment if <u>gross</u> reserves are less than 150 percent of the Fund quota. Third, a totally new feature has been introduced - interest will now be paid to countries in creditor positions on normal Fund transactions, as well as to those holding an excess of SDRs.

62. This last new feature is an unashamed concession to the common market countries who have been running surpluses in their balance of payments; and who therefore accumulated a great deal of gold and dollar

reserves which rendered their currencies attractive in Fund drawings and who are also likely to accumulate SDRs when the system is activated.

63. Final reform in IMF procedure requires that interpretation of Fund Articles of Agreement be entrusted to a Standing Committee instead of the Executive Directors as previously. The decision of the Committee will be considered as final unless the Fund Board of Governors, by an 85 percent majority decides otherwise. This again is a concession to the EEC countries who felt that the Articles as previously interpreted gave a predominantly Anglo-American opinion.

64. The possible impact of the reforms has, so far been given general treatment. A restricted commentary on the benefits and omissions with regard to the needs of the developing countries will now be attempted.

65. The liquidity needs of this group of countries has been treated at length in a previous section of this report and need not be repeated. For better impact, however, several points need be emphasized.

66. The need for foreign reserves by the developing countries is based on two fundamental features. First, the capital needs to finance development programmes and the deficient export performance that does not accommodate this need. Secondly, the absence of ad hoc monetary arrangements - "currency swaps", inflow of short-term capital etc. - that is available to monetary authorities in the developed countries.

67. The reserve needs prompted by export shortfalls in the short-run can be separated from the long-term need for capital imports to finance comprehensive long-term development plans spanning periods as long as twenty years. Though both factors are covered by the first point raised in the previous paragraph, separate treatment is called for because the possible solutions differ both in magnitude and time-span. The ad hoc arrangements referred to above involve a change of heart in the monetary authorities of Western Europe and North America and need even more separate treatment. The whole field is rather precariously based on factors like self-interest and the confidence in the national currencies of the developing countries. The solutions to the problems raised basically lie with IMF and/or the monetary authorities of the developed countries. Now, how far do the envisaged reforms come up with solutions to these problems?

68. The reforms summarized above have, from the point of view of the developing world, only three features of interest. First, the increase in liquidity; secondly, the reform in drawings at the gold tranche positions and thirdly, the slight modification in repayment requirements.

69. Reform in IMF drawing rights and modifications in repayment requirements are unfortunately of marginal significance.

70. The desirable reform should have covered more than the gold tranche positions. The first and second drawings at the credit tranches should have been made less conditional on IMF "Consultation" if not made semi-automatic. The Fund requirement that countries (developing ones only) should consult the IMF and acquiesce to an over-all review of the economy concerned, in practice led to the unwillingness on the part of the developing countries to submit to this sort of humiliation. Anybody familiar with so-called "Fund Consultations" on credit tranche drawings would sympathize with the reluctance of developing countries to accommodate the impropriety of fund officials who after a cursory look at the monetary scene of these countries - the less developed the more meddlesome the officials - come up with dogmatic prescriptions which oddly enough are distinctly anti-development (deflationary in their terminology) and are, on the whole, politically unacceptable to the Government concerned. Little wonder then, that these countries look elsewhere for the short-term accommodation that normally should have been forthcoming through less restrictive utilization of the credit tranches.

71. Present reform in this sphere could therefore, be interpreted as a deliberate red-herring introduced to give the developing nations an illusory concession.

72. Repayment modifications introduced by the reform are at best insignificant, and at worse a statistical trick. The provision that no country will have to repay at an annual rate exceeding 25% of its quota side-steps the issue. (The issue is the meagre foreign reserve resources available to developing countries). When this percentage is translated into absolute figures for a small-sized African country whose IMF quota is about U.S.$12 million, and which therefore has to repay at a rate of 4 million dollars (25% of the quota) annually, the emptiness of the provision becomes obvious. Furthermore, the concession that there need be

no repayment if ~~gross~~-reserves are less than 150% of the quota is no ~~great~~ help either. 150% of the quota ~~of $12 million would be U.S.$20 million~~ "gross". The implication of "gross" here takes advantage of certain statistical idiosyncrasies such as the inclusion of gold tranche positions as owned reserves of members in Fund financial statistics. If the gold tranche position of the example (that is 25% of $12 million) is deducted from the gross figures of 20 million we are left with US$ 16 million i.e. 125% (and not 150%) of the quota. The inclusion of the word "gross" in effect is equivalent to a reduction of the liquidity of our example to the tune of 4 million dollars. The concession due is so minute that it would be wiped out by the increase of transport costs in the imports of East African countries by such factors as the closure of the Suez canal for more than one month.

73. All concessions are however, wiped out by the insistance that final payment has to be made within the five-year period provided by the IMF Articles of Agreement. It may be pointed out that this period is the shortest conceivable under the plans of developing countries - the shortest of such plans is normally a five-year plan.

74. The final item of reform of interest to the developing countries is the reserve creation envisaged by the SDRs. The slated total is U.S.$ 1 billion. Of this the total allocated to all the developing world (less India but plus Switzerland, New Zealand, Norway, Denmark, Austria, Spain, Portugal, Greece, Turkey and South Africa) is put at U.S.$319 million (Table I)

75. Even if all the developed countries grouped with the developing world "opt-out", the magnitude of the reform is minimal.

76. The reserve needs of the developing countries (dealt with in Section II) has not been catered for. Nor did the reformers discuss the development finance needs of these countries.

77. It should be interesting to ponder what share of the SDRs would be allocated to an average sized African country when Sweden is allo . a mere U.S.$10 million, and what effect would this reform have on the desired growth of the economies of the "Third World". Various economists and expert groups and such U.N. Agencies as UNCTAD have estimated the minimum liquidity needs of the developing world at U.S.$8 billion! The total effects of the reform, if quantified, would not come to one sixteenth of that figure.

78. These measures are ~~even more disappointing~~ when one considers the fact that the adjustment mechanizm available ~~to international~~ settlements remains unchanged. With a more rational settlement ~~of deficits and~~ surpluses in payments, and covering a longer time span than the present yearly accounts, the position of the developing third world would have improved.

79. The most serious blow to the position of the developing countries however, is the total disregard of a link between reserve creation (as has happened now after a fashion) and development finance needs. This link, together with the enlargement of compensatory financing facilities in the IMF has been the two most promising contributions put forward by UNCTAD and, before it, a U.N. expert committee mandated to look into the reserve and development finance needs of developing countries.

80. The envisaged link between world reserve needs and the development finance needs of the developing world would have at one blow cured the critical shortage in world liquidity (now recognized by the reformers by introducing the $ 1 billion SDRs) and the capital needs of the development programmes of developing countries.

81. The plan for the link is simpler now that SDRs have been introduced. No change in the presently slated $1 billion is envisaged. The only modification needed is a transfer of the currencies (exchanged for SDRs) of the countries (less India) listed in Table I, from the IMF to the IBRD and its affiliates against IBRD bonds in proportion to the Fund's acquisition of the currencies concerned.

82. The additional currencies thus acquired by the bank would be utilized by the Bank in the course of its operations to finance development loans. Since Bank loans are not tied to purchases in specific countries but are disbursed against orders placed after global tenders, the currencies disbursed by the Bank (and originally obtained from the Fund) may not return to the countries of their origin (though they will remain within Western Europe and North America, the original owners and by far the winners of World Bank tenders). In this manner Bank disbursements might entail some redistribution of reserves among this group of Western Countries.

It is noteworthy that this redistribution of reserves is no different from what takes place now under contributions to IDA or IBRD where IDA or IBRD disbursements (to winners of export orders and global tenders) fail to correspond to the source of the contributions.

83. The essence of the scheme is that the currencies acquired by the Fund (in exchange for SDRs) which are invested in IBRD bonds will represent an eventual transfer of real resources from the developed countries taken as a whole to the developing countries. To the extent of the investment in IBRD bonds, therefore, the developed countries in essence would accept an obligation to transfer real resources (to the developing countries) in consideration of the additonal liquidity already acquired by them.

84. In the final analysis, the developing countries will gain in two ways. They will have their share in the original creation of liquidity ($319 million under the present scheme), and they will obtain real resources for development to the extent that the Fund invests the currencies of the developed countries (the 11 countries listed in Table I) in IBRD bonds.

85. Such investment in IBRD bonds would facilitate the much-needed transfer of real resources from the developed to the developing countries. Moreover, it would avoid the disadvangates of tied aid and bilateral aid.

86. At present, as between the IBRD and the IDA, it is the IDA which needs additional resources more urgently, particularly as IDA-type long-term low-interest loans are more suited to the basic needs of the developing countries. Investment in IBRD bonds is necessitated, however, by the fact that the IDA does not at present float similar negotiable bonds.

87. Since the Fund would need to receive only a very modest rate of interest on the IBRD bonds, the IBRD should find it possible to make loans at low rates of interest itself, or transfer part of its additional resources to the IDA for low interest loans to developing countries.

88. It is felt that this proposal would make a welcome contribution to development finance both in terms of quantity and quality as well as by permitting new initiatives to be taken without in any way detracting from the objective of creating additional international liquidity along sound lines.

89. The advantages of the kind of link that has been sought to establish between the creation of international liquidity (reserves) and the provision of development finance are unquestionable. The question, however, can be raised whether it is proper to establish a link between these two different objectives.

90. There is nothing in the least forced or unusual in the linking together of liquidity creation and transfer of resources. This can be illustrated both in the domestic and the international fields. Every domestic banking system, for example, creates liquidity for individuals in the form of deposits and simultaneously effects a more or less permanent transfer of real resources from those who are normally creditors of the system to those who are normally borrowers. In the international sphere a similar combination is found in the present activities of the International Monetary Fund where real resources are transferred from those countries that hold reserve positions on the Fund to those that have drawings outstanding. The same point would apply even under a gold standard system in that the countries whose monetary authorities acquire gold for their reserves, transfer real resources in the form of exports of goods and services to countries where the gold is mined.

91. While the need for reserves and the need for development resources are distinct in nature and purpose, the view that what the developing countries require is not reserves but development finance is not acceptable. As shown in Section II, the need for one does not rule out - much less contradict - the need for the other. Nor is it persuasive to argue that just because international liquidity and development finance are two distinct problems, it is somehow inappropriate to look for an overlapping solution which provides a partial answer to the one without detracting from a fully satisfactory response to the other.

92. Quite clearly, the central purpose of any reform of the international monetary system must be to provide remedies for the short comings revealed by the working of the present system. But granted the priority of monetary considerations in any scheme of reform of the international monetary system, it is not only legitimate but wise to seek to combine in it the widest possible advance towards the broader objectives of international economic co-operation.

93. A number of objections have been advanced from time to time against the idea of establishing a link between international liquidity and development finance. It would be useful, therefore, to examine whether there is substance in these objections and if so whether they could be eliminated by suitable provisions.

94. Perhaps the most forceful objection relates to the fear that mixing up two distinct things like international liquidity and development finance might introduce extraneous considerations that might militate against proper attention to either. Thus, it is argued that if the creation of additional liquidity is linked with the provision of development finance, there might be pressures for the creation of too much liquidity. It is clear that the amount of any new reserve creation should be determined by the monetary requirements of the world economy and not by the need for development finance. But once the need for additonal reserves has been resolved, the introduction of a link with development finance is entirely proper and desirable.

95. Another objection relates to the fear of inflation in the developed countries as a result of disbursements by the Bank. The inflationary danger should, however, be taken into account in the determination, for each period of time, of the amount of any additional reserves created, after allowance has been made for the extent to which the link would operate - i.e., the extent to which currencies deposited by the developed countries would be placed at the disposal of the Bank.

96. Moreover, the order of magnitude involved should be kept in mind. The total SDRs created come to U.S.$ 1 billion for all countries. If the entire contribution of the developed countries (Table I) were invested in IBRD bonds, the additional pressure on resources in the developed countries would amount to less than one tenth of 1 percent of their gross product.

V. RECOMMENDATIONS:

97. The difficulties which beset developing countries experiencing a shortage of liquidity can hardly be exaggerated. What policy recommendations can be initiated by OAU forums and pursued through all available avenues, whether international or bilateral to bring about a change in this state of affairs?

98. The recommendations ~~that may be usefully pursued can be divided into~~ two broad headings based on the field where reform is to be initiated. The broad fields are:-

a) The International Monetary Fund and
b) A wide area of international transactions (bilateral and multilateral) that ranges from the banking institutions of developed countries to the nature and extent of suppliers' credits.

A: Reforms within the IMF

99. Recommendation I: The establishment of a link between reserve creation and development finance. This topic has been dealt with towards the end of Section IV. Essentially the scheme entails that the currencies (held by the IMF) that have been exchanged for SDRs by the Developed Countries (Table I) be passed to the World Bank. The Bank would then lend these currencies at low-interest rates to the developing countries to finance their development programmes. This would ensure development assistance over and above the reserves (SDRs) alloted to this group of countries (See Table 1)

100. Recommendation II: Easing and rationalizing the conditions governing drawings within the IMF credit tranches. The Fund Articles of Agreement do not stipulate policy prescriptions by the Fund in connexion with drawings on the credit tranches. In practice, however, such conditions are applied - with increasing severity in the upper credit tranches. The developing countries, owing to the low level of their reserves and their limited ability to mobilize other sources of credit outside the Fund, reach the conditional tranches much sooner than the developed countries. There is therefore a strong case for increased flexibility of drawing rights within the Fund. It seems desirable that drawings on the first and second credit tranches should be made available at much less discussion and consultation and without policy conditions. This is to say that drawings on the first and second credit tranches be made automatic as is proposed (in the new reforms) for the gold tranches.

101. Recommendation III:

Lengthening of the period required for repayment of Fund drawings:

The Funds normal repayment period is three to five years. In order to repay its drawings, a country must not merely eleminate its balance-of payments deficit, but begin to show a surplus. A shift as radical and rapid as this may not be possible without serious disruption of development programmes under way. A lengthening of the period of repayment would make it possible to plan for balance-of-payments adjustments in a much more orderly and less disruptive fashion. It would therefore be desirable that the period of repayment be fixed at six to eight years.

102. Recommendation IV:

a) No repayment at a rate exceeding 50 percent of a country's gold tranches position or $12\frac{1}{2}$ percent of its quota.

b) No repayment if gross reserves are less than 200 percent of the quota, or if net reserves are less than 175 percent of the quota.

This is an extention of the concessions contained in the latest reforms (see para 61) and should therefore present no new departure. The arithmetic of this (worked out in para 72), has shown that this reform, in its present form, does not ease the payments difficulties of developing countries in any appreciable degree.

In halving the maximum repayments and doubling the amount of reserves allowable under the waiver, the effect of this recommendation would be double that under the new reform.

103. Recommendation V:

Raising of Fund Quotas of developing countries either by themselves or as part of a general increase. An increase in Fund quotas is a means of providing additional liquid reserves to members. Developing countries have participated in the general quota increases (1959) and some have already taken advantage of the Fund's facility allowing individual quota increases. Further quota increases for developing countries could provide a valuable addition to the conditional liquidity now available to them. It may be noted in passing that, in so far as the allocation of SDRs was based on IMF quotas, the effect of the new reform could be likened to an increase in the quotas of those countries participating in the new scheme. There are, however, two differences: one in magnitude - while the SDRs have a ceiling of U.S.$ 1 billion, a general increase in quotas would have netted more than that figure. The other difference lies in the fact that no gold contribution (25% with quotas) is required under the SDRs plan.

B: Recommendations outside the IMF

104. Recommendation VI:

Better utilization of the export-financing facilities and institutions of the advanced countries. In years past, an exporter's success generally hinged on the quality and price of his merchandize. Today, quality and price often play a secondary role in the tense competition for export sales among the developed countries. More and more, it is the exporter's terms of sale - the kind of financing he can offer - that tilt the balance towards his success or failure. There are several reasons for the ascendance of export financing as a competititve weapon. Many countries have rebuilt and modernized their damaged industries, and no country any longer has an overwhelming edge on attractively priced manufactures. This situation is intensified by the fact that the developing countries are gradually coming to rank among the most important markets of the industrialized nations. Because they embark on long-term, capital intensive development programmes and are at the same time short of foreign exchange, developing countries are obliged to give preference to suppliers who can deliver on the best credit terms. In general, export financing is arranged by opening what are commonely termed short-medium or long-term credits. Short-term credits generally extend up to six months only are therefore not useful for our purposes here. Medium-term credits generally run for two to five years and have, again, limited usefulness. Long-term credits which extend beyond five years could be a useful source of development finance. Naturally the better the market prospects in a country or group of countries the better the credit terms. Thus, it is desirable for African countries to negotiate in bloc or in regional groupings for those long-term credits. The East African Community (together with the applicants) could, for example, extract favourable credit-terms from any country or consortium of developed countries if they negotiate with the collective weight of the capital requirements of their investment programmes formulated in the respective national development plans.

105. Recommendation VII:

Monetary Co-operation in the form of regional pooling of reserves among African countries (within the framework of existing groupings) would greatly facilitate access to the money markets of Western Europe and North America and enhance the flow of short-term credit from the central banks of these countries whose currencies are invariably held as reserves by almost all African States. Developed countries normally have bilateral arrangements designed originally to deal with speculative capital movements. The developing countries have similar problems and are therefore, in need of greater credit facilities. At present the principal source of short-term credit available to developing countries is limited to the International Monetary Fund. Other sources of credit exist, but their availability often depends on the pledging of collateral and hence on the level of reserves, and they usually carry high rates of interest.

Regional pooling of reserves and Group negotiations could therefore facilitate the availability of this type of credit and could negotiate for lower interest charges.

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Organization of African Unity