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Latin America and the international monetary system: Some comments and suggestions

*Carlos Massad**

I

The functioning of the system

In this paper, I intend to emphasize aspects of the present system of international economic relations in the monetary and financial area that create difficulties for an adequate insertion of Latin America in the world economy. I do not propose to make a comprehensive study of all transfers of resources between developed and developing countries.

My comments will be arranged under three main headings: the workings of the present international monetary system; the effect of the present system on Latin American countries and less developed countries in general, and changes in the system that could help to minimize the present difficulties.

Generalized floating of currencies became unavoidable as the Bretton Woods system proved incapable of providing enough adjustment incentives for reserve currency countries, essentially the United States and the countries with surpluses. In fact, IMF "discipline" could only apply to non-reserve-currency deficit countries. Reserve currency deficit countries could finance their deficits with their own

currency, while countries with surpluses did not need to request IMF assistance.

The lack of international incentives to adjust created a situation where convertibility in terms of gold could not be maintained, and the Bretton Woods system collapsed. As a matter of fact, the lack of adjustment incentives, together with some domestic banking regulations, gave rise to an explosive growth of private financial markets as financial intermediation between surplus and deficit countries became more and more in demand. Between 1973 and 1978 the net size of the Euro-currencies market grew at a rate of about 19% per year.

Those changes are not only important quality-wise, however: they also represent a complete qualitative transformation of the system.

1. The role of the monetary authorities and of the private sector

The first important qualitative change is that which took place in the market intervention role and reserve holdings of the monetary authorities versus those of the private sector. In a fixed exchange rate system, the authorities have to maintain exchange rates through intervention in the market, for which purpose they must hold foreign exchange, gold and SDR reserves. In a floating system, such a role is transferred totally or partially to the private sector, and it is the latter which has an incentive to accumulate "reserves" in order to "intervene" in foreign exchange markets.

This fact implies a higher sensitivity, or elasticity, of the composition of reserves to economic incentives. Usually, central banks are less sensitive to changes in expectations

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than private holders of foreign exchange. The latter tend to adjust the composition of their holdings rapidly when relative interest rates or exchange rates are expected to vary. Hence, the more important the role of private holders in foreign exchange markets, the faster will be the reaction to changes in expectations. The expectation of devaluation of a reserve currency—or a currency important in international trade—brings about an immediate change in the composition of assets and liabilities of the private sector and this helps to produce the expected devaluation. In a sense, it could be said that under the present system, since central banks cannot resist the pressure of private speculators, generalized expectations will never be wrong.

Another consequence of the increased importance of the private sector in intervention is a relative reduction in the demand for SDRs. In fact, SDRs cannot be held by the private sector, but insofar as the relative importance of private “reserve” currency holdings increases, the demand for SDRs will decrease relative to that for currencies. All this has important implications for the system as a whole (the implications for LDCs will be developed later).

(a) Exchange rate changes tend to “overshoot the mark”, so that the magnitudes of such changes tend to be relatively large. It has been observed that prices tend to react faster than quantities to exchange rate changes in industrial countries. Thus, when a particular currency suffers a devaluation, the export prices of the devaluing country tend to fall and import prices to rise soon after devaluation, but export and import volumes react more slowly, so that, for a time, a devaluation increases the imbalance it was supposed to correct. Private holders of the currency will see their devaluation expectations reinforced, and the exchange rate will reflect such strengthened expectations with further devaluation. Then, after some time, the effect of devaluation will show itself in the balance of payments, in the form of a relative reduction of imports as compared to exports, and the opposite process will be generated. As this process is better understood and the pattern of events repeats itself, the private sector may “learn” to speculate better

and the destabilizing effect of expectations formed in the way described above should tend to disappear. The length of the learning period is, however, unknown.

(b) The degree of stringency of monetary policy becomes more difficult to evaluate. Let us take, for example, a German-based company that holds US dollars in its assets. If such a company expects a reduction in the value of the dollar relative to the German mark, it will try to sell its dollars for marks, while if the Bundesbank wants to give at least partial support to the dollar to avoid an excessive strengthening of the mark, it will buy the dollars in exchange for marks. The figures in Germany will show an increase in the money supply, whereas all that has happened is a change in the composition of assets of the German-based company. There is no reason for this action to change the desired spending pattern of the company, so that the increase in the money supply in Germany will have no direct inflationary effect. Of course, the real world is not this simple, but I hope that this example serves to illustrate the essence of my argument.

(c) Exchange rates become more volatile through changes in transactions on capital account (capital flows). If private capital and money markets are well developed, with reserves diversified in terms of currencies, changes in expectations will affect the market rapidly and fully: desired changes in the composition of assets and liabilities of economic agents will be reflected in market actions which will result in changes in exchange rates. The money markets for developed countries' currencies are sufficiently deep to allow the operation of a futures market where interested parties can buy “coverage” for exchange risks. With or without coverage, however, changes in domestic interest rates or other factors affecting the desired composition of assets and liabilities will tend to produce sizable capital movements, unless interest rate policy is closely associated with expected exchange rates. Such association is very difficult to achieve in practice, so exchange rates must be expected to vary sharply in short periods of time.

Furthermore, changes produced through the capital account may tend to reinforce those

in the current account. An unfavourable current account will produce devaluation expectations. At the same time, the expected cost of borrowing abroad or the expected benefit of external investment will increase (due to the expected devaluation), producing as a consequence an imbalance in the capital account with the same sign as that in the current account. Since, as pointed out above, the adjustments in the current account come about only slowly, one must expect relatively sharp movements in exchange rates on this account, on at least a movement in a particular direction for some time and then a reversal, in a cycle which will take two or three years to develop fully.

(d) Sharp changes in exchange rates help to stimulate protectionist tendencies in world trade. As some currencies appreciate, the issuing countries will face some loss of competitiveness, while deficit countries, whose currencies depreciate, tend to yield more easily to protectionist lobbyists on balance-of-payments grounds. Thus, global resistance to protectionism is substantially weakened, and if at the same time, for this and other reasons, the world economy is expanding slowly, the stage is set for the proliferation of direct controls, regulations and increased tariffs on trade.

2. *The international transmission of economic disturbances*

With fixed exchange rates, it was expected that inflation rates in the world would tend towards equality, since it was argued that any discrepancy would bring about imbalances in foreign payments that would force adjustment. As exchange rates were not completely fixed, however, some discrepancy in inflation rates was allowed for, over and above that coming from different rates of change in productivity. Between 1960 and 1970 the average yearly rate of inflation for 9 industrial countries¹ was 3.5%, with a standard deviation of 1.5 and a coefficient of variability of 0.43. Floating, it was argued, would allow for more freedom in domestic monetary policy, since variation in

exchange rates would insulate countries from external shocks. On these grounds, rates of inflation should have diverged after 1973 more than they did before, and particularly before 1970.

However, empirical evidence does not lend support to this expectation. For the same 9 countries considered, yearly inflation between 1974 and 1977 averaged 11.3%, with a standard deviation of 4.8 and a coefficient of variability of 0.42: i.e., practically identical to that prevailing in the 1960s, while for the period 1970-1973—a transitional period—the average rate of inflation was 6.5%, with a standard deviation of 1.7 and a coefficient of variability of 0.26. It therefore looks as though floating rates have not helped very much to insulate countries from external disturbances. An alternative hypothesis, which I have put forward elsewhere, could be formulated to explain this behaviour. For our purposes, it is sufficient to point out that floating has not insulated countries from external shocks. Floating is no substitute for responsible domestic policies.

3. *Creation of international liquidity*

The present system has considerably obscured the concept of international liquidity itself. When the authorities accumulated most of their external reserves the concept was clear-cut. But as soon as the private sector assumed, partly or wholly, the responsibility for intervening in the market, the concept of international liquidity became vague and ill-defined. Should it be only official reserves which were considered? Or should one take account of private holdings in some way? These questions are not academic, for the difference between official holdings and "total" holdings of foreign exchange—and gold and SDRs—is enormous (the second is at least twice the first).

In a floating system, it is legitimate to consider private holdings of foreign exchange as "international liquidity", since there should be a demand in the private sector for such holdings, and if the demand is not satisfied, the private sector will look for ways to satisfy it, even creating new liquidity instruments. In a world where the foreign exchange operations of banks in industrial countries and offshore

¹Belgium, Canada, France, Germany, Italy, Japan, Netherlands, United Kingdom and United States.

centres are usually not subjected to the same types of controls as their domestic currency operations, the supply of international liquidity becomes demand-determined. And insofar as the foreign exchange holdings of the private sector are a good substitute for domestic (or national) money, changes in the supply of the first will affect the demand for the second. Through this process, national central banks lose control over the relevant monetary aggregates. This is not because they cannot control

the supply of domestic money in the short run, but because the demand for such money changes, with the result that control or regulation not only of the rate of growth of international liquidity, but also of liquidity in general, becomes much less effective. Of course, if the supply of liquidity in the form of foreign exchange becomes essentially demand-determined, the relative importance of SDRs is bound to suffer.

II

The effects on Latin American and other developing countries

As the system, or lack of it, works at present, one must expect relatively sharp and recurrent variations in the exchange rates of the principal currencies. Most Latin American countries, as well as other less developed countries (LDCs), peg their own currencies to one or another of the principal currencies, or to a basket of them. Pegging is necessary because most LDCs do not have financial or money markets deep enough to do otherwise, the Central Bank being the only entity capable of absorbing short-run excess supply or demand for the domestic currency. But pegging means that the domestic currency moves together with the currency or currencies to which it is pegged, and the fluctuations of those currencies are geared to the adjustment needs of the issuing countries, not of the pegging country. Hence, floating imposes a cost on LDCs in terms of destabilizing influences on their economies. Floating also tends to discourage the allocation of additional resources to the production of tradeable goods, since an uncertainty element is introduced in all calculations regarding activities connected with foreign trade. In most cases, the LDCs exporters cannot even buy coverage, because there is no futures market for their own currencies.

There are more deep-seated problems than this, however. Thus, if floating does not

insulate countries from external shocks, it does not solve the adjustment problem in the short or medium run either, and may even complicate it. As everyone knows, if there is a group of countries running a protracted surplus on current account, there must be another group running a deficit, and floating will not correct the situation. Floating could perhaps equilibrate the balance of payments as a whole, in the long run, but it might never produce equilibrium in the balance-of-payments current account. As we have already seen, the short-run effect of floating on the current account of the balance of payments and on the balance of payments as a whole may actually be destabilizing.

As a matter of fact, equilibrium on the current account is not an ideal situation. Non-oil-exporting developing countries are net capital importers, so that the desired position of their current account is one of deficit, to be financed with a surplus on the capital account. In the case of Latin America, the average deficit on the current account of the non-oil-exporting countries for the period 1974-1978 is five times larger than for the period 1966-1970. The capital surplus should be high enough to cover the deficit on the current account and the necessary increase in reserve holdings. But a surplus on the capital account is only a more

respectable way to refer to a net increase in foreign debt, since unrequited transfers are negligible and direct foreign investment is not on the increase and is concentrated in a few

countries. At all events, new net indebtedness accounts for at least 80% of the surplus on the capital account of the non-oil-exporting Latin American countries.

Table 1
EXTERNAL FINANCING OF LATIN AMERICAN NON-OIL-EXPORTING COUNTRIES
(Billions of dollars)

	1966-1970	1974	1975	1976	1977	1978 ^d
Deficit on current account ^a	-2.0	-13.1	-16.1	-11.5	-8.0	-9.5
Increase in reserves ^b	0.4	-0.7	2.2	4.9	3.9	8.5
Use of external financing (uses)	2.4	12.4	13.9	16.4	11.9	18.0
Net external financing (sources)	2.5	12.6	14.4	16.2	10.5	16.0
Direct investment	0.7	1.6	2.3	2.2	(2.3)	3.0
Donations	0.1	0.1	0.1	0.2	0.2	
Net loans ^c	1.7	10.9	12.0	13.8	(8.0)	13.0
Loans from official sources	0.9	1.9	1.9	(2.0)	(2.2)	3.0
Multilateral	0.4	0.9	0.8	(0.9)	(1.0)	
Bilateral	0.5	1.1	1.0	(1.1)	(1.2)	
Borrowing from private sources	0.8	9.0	10.1	11.8	(5.8)	10.0
Supplier credits	0.4	0.2	0.1	0.6	(0.6)	1.5
Commercial banks	0.3	8.2	8.2	7.5	4.7	5.5
Bonds	—	0.1	0.2	0.5	(1.0)	2.0
Others and unallocated	0.1	0.6	0.6	2.2	-0.5	1.0

Sources: International Monetary Fund, *Balance of Payments Yearbook*; Bank for International Settlements: supplements for July and December 1978 and *Yearbook*; CEPAL estimates.

^aExcluding official donations.

^bPositive figure indicates an increase in reserves.

^cIncludes long, medium and short-term non-compensatory and compensatory loans.

^dAll figures for 1978 are provisional.

Table 2
ESTIMATED OVERALL INDEBTEDNESS
OF LATIN AMERICAN NON-OIL-
EXPORTING COUNTRIES
(Billions of dollars)

Years	Officially-guaranteed debt	Non-guaranteed debt to banks	Overall indebtedness ^a
1974	31.51	19.76	51.72
1975	38.05	24.50	63.48
1976	48.74	30.65	81.28
1977	59.00	32.00	91.00
1978 ^b	68.00	37.00	106.00

^aIncludes debt to IMF.

^bFigures for 1978 are provisional.

Despite the levels already reached by such debt (over 100 billion dollars for the non-oil-exporting countries of Latin America by the end of 1978) it must go on increasing for many years if the development process is to continue and if world resources are to be more efficiently allocated. The additional short-run instability in the balance of payments which is a by-product of floating, however, does not facilitate official decisions in industrial countries about long-term development finance, while private financial markets expand rapidly. Thus, the terms of the new financing are substantially worse than those of the past, both in terms of interest rates and of amortizations schedules. "Debt burden" becomes a problem for further borrowing, a problem which is more a consequence of the present system than of "mis-

behaviour", even though the latter is not always absent. Moreover, as debt terms deteriorate, borrowing countries need to increase their reserve holdings, both in order to present a better "image" and in order to be ready to offset possible outflows. So, as the terms deteriorate, the necessary rate of accumulation of reserves tends to grow, and so does the necessary net borrowing per year.

An obvious way out of this problem for LDCs would be to expand exports. If exports grew at a rapid rate, both the "debt burden" and the current account deficit could be reduced. However, as pointed out above, in the present circumstances the developed countries tend to yield more easily to protectionist pres-

ures, so that this way out does not seem to be feasible. In fact, a recent article in *IMF Survey* reaches the conclusions that protectionism has increased significantly in the recent past, and the trend does not show signs of abating.² Regrettably, this trend has emerged precisely when a good number of LDCs, at least in Latin America, are following an outward-oriented strategy.

This strategy, to be successful, requires two prerequisites: foreign markets and foreign finance. The former are being increasingly protected from outside competition. The latter is available, but on terms that are compatible only with a rapid growth of LDC exports.

III

What can be done to solve, or at least alleviate, the present difficulties in the monetary and financial system?

At least some of the roots of the difficulties pointed out above can be traced to problems of the adjustment process and of liquidity creation. If the adjustment process worked smoothly, and international liquidity grew at a reasonably stable rate, excessive fluctuating of exchange rates would be flattened out and there would be less of a weakening of the will to resist protectionist measures.

One could argue that the adjustment process is working smoothly when the choice between fixed or floating exchange rates becomes irrelevant. In other words, if the domestic policies of the main industrial countries were strictly co-ordinated, there would be no need to vary their exchange rates *vis-à-vis* each other in the short run, and there would therefore be no need for floating. I hope it is obvious by now how great an interest LDCs have in more stable exchange rates and a smoother adjustment process.

But of course close co-ordination of domestic policies is an ideal which is very difficult to reach. Different countries have different institutions, different interest groups and different

social and political forces. For example, some countries can export their unemployed and so can accept more restrictive economic policies than others.

However difficult it is, I believe one should continue trying to secure closer co-ordination of economic policies among industrial countries. Naturally, such co-ordination should take global needs into account, so as to facilitate the necessary current account deficit of the LDCs and its adequate financing. In this way, a smoother process of real resource transfers would be achieved. In order to ensure the consideration of global needs, LDCs should be represented in some way in discussions on policy co-ordination among industrial countries.

Reports that take a global look at the world economy play an important role here. For example, the excellent IMF periodic reports on the world economic outlook should be given wider circulation. The Interim Committee of

²"Retreat from liberal trade becomes clearer as more restrictive practices take effect", *IMF Survey*, April 9, 1979.

the Board of Governors of the Fund should perhaps devote at least one full meeting a year to evaluating and discussing the world economic situation. But policy co-ordination touches some very sensitive points in many countries, and for this reason it requires some degree of regular involvement of governments at the highest political level.

At the same time, however, improving the adjustment process is in the interests of all countries, developing and developed alike.

All the effort expended in attaining the goal of policy co-ordination is well spent. However, one cannot expect such efforts to be fully effective alone, so some action should be taken in especially difficult areas even before co-ordination is improved:

(a) Asset settlement of international obligations should be established, in order to create an incentive for reserve currency countries to adjust.

If asset settlement were the norm, countries could not settle their international obligations by simply increasing their liabilities abroad. Hence, if a reserve currency country were in deficit, it would pay for it with assets, like any other country. The adjustment incentive would appear as those assets were depleted.

(b) An account aimed at the substitution of SDRs for reserve currencies should be set up in the IMF. Its role would be to minimize pressure on exchange rates due to desired changes in foreign exchange portfolios of monetary authorities. The countries issuing the currency accumulated in the account would recover it in an agreed period, in exchange for SDRs. In fact, this would be a form of short-term debt consolidation for some industrial countries. As these countries recover their currencies from the account, the SDRs accumulated there could be used for long-term lending to LDCs. One might call this operation the "substitution link".

(c) Countries with net reserves higher than, say, 4 months' imports and with reserves growing faster than a given rate per year would pay a tax on their reserves. One way to apply this concept, for example, would be not to allocate SDRs to such countries in a future allocation, the SDRs not allocated to them

being assigned to LDCs in proportion to their quotas in the IMF. In this way, an incentive for surplus countries to adjust would be established. One might call this the "adjustment link".

(d) A debt refinancing facility should be established, perhaps as a joint undertaking of the World Bank and the IMF. This facility would operate under a system similar to that of the Oil Facility of the IMF. LDCs would have voluntary access to it on the basis of a pre-established set of indicators, but the amount and conditions of refinancing would be studied case by case. A refinancing facility would be a natural LDC counterpart to a substitution account for reserve currency countries.

(e) A forum should be established where monetary, trade and development matters, which are so closely linked, are regularly jointly discussed, with main tendencies being highlighted and policy measures suggested. Such a forum could assess the global contribution of each industrial country to development, taking into account their contribution both through trade and through aid and other financial flows. The ideal could be to create some form of international economic court that could pass judgement, particularly on restrictive trade practices, and establish compensation for the economic damage caused. Countries could then evaluate whether or not it was in their own interests to apply protectionist measures and to pay compensation for them. This concept of "compensated protectionism" could be further evolved as a way to allow countries some freedom in this respect, but with compensatory payments to countries damaged in the process. The multipolarity of the present world lends some realism to this proposal.

Of course, most of these ideas are neither new or realistic. However, the problem of development will be with us for a sufficiently long time to permit some unrealistic approaches at present. I believe that, as time passes, it will be increasingly clear that development is not a problem of developing countries alone, but of the world as a whole. This is my justification for considering not only problems of the Latin American countries, or of all developing countries, but also problems of the world economy to which the latter are so closely linked.