

Reforming the International Monetary System: an Agenda for the Developing Countries

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Introduction

When economists have gathered to consider the connection between reform of the international monetary system and the concerns and aspirations of the developing countries, they have typically begun by asking how the monetary system should be reformed and have then gone on to ask how the reform might be designed to serve the interests of the developing countries. The long debate about international liquidity supplies the clearest illustration. We began by trying to devise a persuasive case for adding to the stock of reserve assets by issuing Special Drawing Rights (SDRs), then sought ways to distribute them that would transfer real resources to the developing countries – the so-called “link” in its various versions.

That strategy was unsuccessful. Some have even said that it was self-defeating, because it raised questions about the integrity of the basic case for monetary reform.¹ Were the advocates of SDR creation moved mainly by concerns about a global reserve shortage, or were they chiefly interested in transferring resources to developing countries? It is impossible to answer that question decisively, and there is no point in trying. It is important to concede that we can no longer tie the two issues together, because there is almost no interest today in any large-scale reform of the monetary system.

In Western Europe, the energies of those concerned with monetary matters are focused on rebuilding and safeguarding the exchange-rate mechanism of the European Monetary System (EMS) and, over the longer run, implementing the plan for monetary union in the Maastricht Treaty. In the United States, the Clinton administration wants to revive macroeconomic cooperation among the G-7 countries. It is worried, with good reason, about the short-run effects of simultaneous fiscal contractions in no fewer than five of the G-7 countries (Britain, France, Germany, Italy, and the United States), which plan to raise taxes in 1994 or 1995. It has been pushing Japan in the

¹ John Williamson, “International Monetary Reform and the Prospects for Economic Development,” in J.J. Teunissen, ed., “Fragile Finance: Rethinking the International Monetary System”, Forum on Debt and Development, The Hague, 1992.

opposite direction and, with rather less success, has been urging the Bundesbank to cut German interest rates. But the new administration has shown no interest in returning to intensive exchange-rate management of the sort that followed the Louvre Accord in 1987. At the Little Rock economic summit, the President-elect said that he favoured a strong dollar. Weeks later, however, Lloyd Bentsen, the new Secretary of the Treasury, was widely praised in Washington for talking up the yen and thus talking down the dollar. Not surprisingly, Japanese businessmen, economists, and officials have begun to express dissatisfaction with the existing monetary system, but no one else seems to be listening.

There is thus little point today in pursuing the old strategy – calling for reform of the monetary system and then asking how the developing countries can turn reform to their advantage. We have instead to ask what changes in the monetary system might most directly meet the needs of the developing countries themselves. To be realistic, moreover, we must confine our attention to those changes in the system that do not impose unacceptable costs on the industrial countries and do not crowd out other forms of development assistance.

This last constraint is daunting. Let us make no mistake about it. The governments of the industrial countries are deeply preoccupied with their own economic and social problems. Democracies are stingy when resources are seen to be scarce, because elected political leaders must look first to the needs and aspirations of their own citizens, even when their citizens are far better off than those of other countries. They cannot be expected to worry about prenatal care and nutritional needs in Brazil or Nigeria when they are trying to find ways of financing adequate medical care for their own citizens. They cannot be expected to worry about ethnic violence in India or Sri Lanka when they must deal with poverty and violence in their own cities. And when they have managed to convince themselves that they have no moral obligation to intervene militarily when thousands must flee for their lives in Bosnia, they find it far too easy to convince themselves that they have no moral obligation to intervene economically when millions of people live at the edge of subsistence all over the world. There are limits to altruism and even tighter limits to tax-financed altruism.

The outlook may be brighter two or three years hence, when the industrial countries have worked their way out of the current recession, but I would not count on that. Fundamental changes in technology and trade may have diminished the ability of the advanced industrial economies to create new jobs or, more precisely, their ability to absorb large numbers of semi-skilled and low-skilled workers. Those countries may face more inequality at home, which will further reduce their political capacity to combat inequality in the outside world.

These same basic changes in the demand for labour, especially those that are seen to reflect the migration of manufacturing to developing countries, raise another issue that must be mentioned briefly. If the developing countries were forced to choose between ways to make the monetary system more responsive to their needs and ways to strengthen the multilateral trading system, they would be well advised to opt for strengthening the trading system and, in particular, for the speedy and decisive adjudication of trade-policy disputes. They must work to halt the tendency of the industrial countries – including my own – to define arbitrarily and enforce unilaterally rules against dumping and other “unfair” practices. An efficient GATT system for settling trade disputes will come down hard on certain developing countries, because of their trade practices. But the developing countries will be far worse off if the dispute-settlement process is not reformed, as they will be the principal victims of new trade restrictions imposed in the name of the environment or fair labour standards but designed to exclude their exports from the developed countries’ markets. Ironically, some of the same people who most strongly support measures to alleviate poverty in the developing countries may prove to be those countries’ most dangerous enemies, because they favour the use of trade measures to advance environmental causes.

Returning to my main theme, the monetary system, let me offer one more warning. The last two years have shown that the G-7 countries are willing to innovate and improvise when it suits their purposes – to tap the resources and modify the policies of the International Monetary Fund (IMF) in order to mobilise aid for Russia. I am indeed concerned that they have done so in ways that will injure the Fund financially and impair its ability to deal appropriately with its other members’ problems. Their willingness to take those steps in this particular case, however, speaks to the severity of the financial and political constraints that prevent them from using their own resources for foreign-policy purposes. It would be naive for developing countries to treat the Russian case as a compelling precedent for making broader changes in the rules of the Fund, although I shall argue shortly that such changes should be made.

I. THE CHANGING ECONOMIC ENVIRONMENT

Before examining ways in which the international monetary system can be adapted or reformed to make it friendlier to the needs of developing countries, let us pause to consider two major changes in the policies and circumstances of those countries themselves. The first is the change in their own exchange-rate arrangements. The second is the change in the nature and

degree of their access to international capital markets. Both bear on their need for reserves and on the cost of acquiring them.²

The migration to exchange rate flexibility

A country's need for international reserves depends on the way in which its nominal exchange rate is determined. If its exchange rate floats freely, without official intervention, the country does not need reserves (unless it wants to retain the option of intervening in the future). If its exchange rate is pegged to another country's currency or to a basket of currencies, it must have enough reserves to bridge temporary gaps between demand and supply in the foreign-exchange market, regardless of the underlying reasons for the gaps. When some market participants want to sell more of a country's currency than other market participants want to buy at the existing exchange rate, the central bank must draw down its stock of reserves to buy up the excess supply of its currency; otherwise, the currency is bound to depreciate.

Much importance attaches to the word "temporary" in the previous paragraph. No finite stock of reserves can bridge a permanent gap between supply and demand in the foreign-exchange market. Even in such cases, however, reserves can be used to buy time for a government to make the policy changes needed to eliminate a permanent gap – tightening its monetary and fiscal policies in order to reduce aggregate demand and thus the demand for imports or raising its nominal interest rate relative to rates in the outside world in order to attract capital inflows and discourage capital outflows.

In general, then, the size of the stock of reserves required to keep an exchange rate pegged depends on the size and duration of the temporary shifts of demand and supply in the foreign-exchange market and the speed with which a government can make the policy changes needed to reverse or offset a permanent shift in demand or supply reflecting a fundamental change in the foreign demand for its exports and assets or its own demand for imports and for foreign assets. But three additional considerations bear on the adequacy of a country's reserves:

1. The larger the stock of reserves, the less likely a "run" on a country's currency resulting from expectations that it will be forced to devalue its currency.
2. Dependable access to credit facilities, like those of the Fund, reduces the need to hold reserves, although reserves and reserve credit are not perfect substitutes.

² The next sections draw on a previous paper: Peter B. Kenen, "Financial Opening and the Exchange-Rate Regime," in H. Reisen and B. Fischer, eds., "Financial Opening: Policy Issues and Experiences in Developing Countries", OECD Development Centre, Paris, 1993.

3. As a country can always run down its reserves to build up its capital stock, there is an opportunity cost to holding reserves; it can be represented by the rate of return on the resulting addition to the capital stock less the rate of return on reserve assets.

There is no need to dwell at length on these familiar propositions, but brief comments are in order.

Although large reserves may help to ward off speculative pressures, no country can hope to defend a pegged exchange rate unless it pursues domestic policies that impart credibility to the exchange rate. The recent literature on exchange-rate policy has argued that a firm commitment to a pegged exchange rate can impart credibility to domestic policies, and this argument has influenced exchange-rate policy in several developing countries. But a two-way process is involved here. By committing itself to a pegged exchange rate, a government can perhaps persuade firms, workers, and foreign investors that it is ready to gear its monetary policy to the pursuit of price stability, without which it cannot defend a pegged rate. If so, it can affect their behaviour in ways that will help it achieve price stability. In the long run, however, the success of a commitment to a pegged exchange rate will depend on the domestic policies actually pursued. Credibility can be borrowed by pegging the exchange rate, but it must be repaid from the credibility earned by domestic policies. Large reserves can help, but they cannot insulate a pegged exchange rate from speculative pressures induced by a deterioration of the so-called fundamentals.

Recent European experience illustrates my point. On the eve of the 1992 EMS crisis, Britain had larger foreign-exchange reserves than Italy, and Italy had larger reserves than France. Going back to the start of the EMS, moreover, you will find that the French franc was devalued in terms of the Deutsche mark almost as often as was the Italian lira (six times for the franc, compared to eight for the lira, including occasions on which the mark was revalued in terms of all other EMS currencies). Yet the franc survived the September crisis, and the lira and pound did not, partly because French policies had earned more credibility than British or Italian policies.

The 1992 EMS crisis teaches us another lesson. Under the rules of the EMS, member countries are entitled to expect that they will be able to draw unlimited amounts of reserve credit from other EMS countries, and these facilities were used extensively during the 1992 crisis. But the availability of these credit facilities did not deter speculation, partly because market participants know that short-term credit has to be repaid. When a country draws down its own reserves to defend a pegged exchange rate, it can decide for itself when and to what extent it should rebuild them. When it uses reserve credit, by contrast, it must repay what it borrows and on terms

acceptable to its creditors. It has less flexibility.³ That is why I said before that owned reserves and reserve credit are not perfect substitutes.

The third point made earlier deserves particular emphasis, as it calls into question a common belief about the cost of acquiring reserves. Countries that have access to international capital markets, it is said, can acquire reserves by borrowing. Countries that lack access to those markets must sacrifice real resources. As John Williamson put it, “poor countries have to provide reverse aid to the rich in order to build up a prudent level of international liquidity.”⁴ This statement is half right – but that makes it half wrong.

A country that has access to international capital markets can, of course, borrow to build up reserves, augment its capital stock, or even spend more on current consumption. It must therefore decide how much to borrow and how to use the proceeds by comparing the cost of servicing additional debt with the benefits conferred by each potential use of the proceeds of new borrowing, and one would expect it to use some of the proceeds for reserve accumulation. A country that does not have access to international capital markets cannot engage in this sort of optimisation. Yet the two countries’ cases are not so very different. Both of them must sacrifice current or future consumption to build up their reserves. They differ only in respect of the margin at which they must make their choices. The country that can tap international capital markets enjoys an extra degree of freedom. It can use borrowed resources, as well as its own resources, for reserve accumulation or capital formation.

Has this distinction any practical significance? It can perhaps explain why the developed countries have rejected the view expressed by Williamson and many others that the international monetary system is unfair to the poorer countries and that the inequity should be corrected by creating SDRs.

3 The need to return to the status quo ante, by rebuilding reserves in the one case and repaying reserve credit in the other, should in principle affect the choice between financing and adjustment, even in the case of a temporary shock. If a government finances a current-account deficit by using reserves or reserve credit, it must plan to run a current-account surplus at a later date. Hence, it may not be optimal for a government to finance a deficit fully but rather to reduce the deficit partially by altering its macroeconomic policies. The optimal choice between financing and adjustment will depend on the extent to which a government discounts the future cost of rebuilding reserves and repaying reserve credit and on the expected distribution of future balance-of-payments shocks. If “good” and “bad” shocks are distributed symmetrically, a government may not have to plan on taking costly measures to generate a current-account surplus in the future; it can plan to take advantage of good outcomes in the future to rebuild the reserves or repay the reserve credit it is using to finance a bad outcome now. This possibility reinforces the case for holding and using reserves rather than relying on reserve credit, as a government cannot know in advance when it will experience a good outcome. See Peter B. Kenen, “Financing, Adjustment, and the International Monetary Fund”, The Brookings Institution, Washington, 1986.

4 Williamson, “International Monetary Reform,” p. 91.

Suppose that the developed countries increased their own untied aid to the poorer countries. A rational recipient would presumably allocate some of the extra aid to reserve accumulation, some to capital formation, and some perhaps to current consumption (if it were free to do so). And that is how we should expect it to behave if it received more aid *via* an SDR allocation. We should not expect it to build up its reserves by the full amount of the allocation but rather to use some of the new SDRs for capital formation or extra consumption. In other words, we should expect the poorer countries to use some of the new SDRs to acquire real resources from the developed countries.

Let me add at once that, though we should expect this outcome, we should not object to it. Five years ago, I might have agreed with those who believed that any additional transfer of resources to the developing countries should be matched by a tax-financed increase of untied aid, not by creating and spending additional SDRs. In other words, SDR creation might have intensified inflationary pressures, not by raising world reserves – the silliest of monetarist fallacies – but by adding to aggregate demand in the developed countries. Right now, however, there is deficient demand in the developed countries, taken as a group, and no conceivable reason to worry about the small increase in aggregate demand that they would experience if the developing countries chose to spend some of their SDRs rather than add them to their reserves. In brief, an SDR allocation would be the only available substitute for more untied aid, and I can think of many ways in which the developed countries might then use *their* SDRs to help the developing countries – to grant interest subsidies or debt relief to the low-income countries or even to finance the next IDA replenishment. But the case for a new allocation should be made frankly and pragmatically. An SDR allocation would not greatly improve the functioning of the international monetary system or make the system fairer. It would be a way to offset an apparent imperfection in international capital markets or, more generally, a way to redistribute real resources from rich to poor countries.

Thus far, I have focused implicitly on the role of reserves under pegged exchange rates. In the 1980s, however, many developing countries migrated from pegged to flexible exchange rates, and some of them moved all the way to floating rates. The extent of the migration is described by Table 1, which is based on the classification of exchange-rate arrangements maintained by the IMF. The numbers in the table must be used with caution, because they depend on the way in which individual governments report their exchange-rate arrangements to the Fund, and some governments have failed to keep the Fund fully informed. Although Poland pegged its exchange rate at the beginning of 1990, with the support of the Fund itself, you will find no trace of the decision in the Fund's listing of exchange-rate arrangements. And

some other well-known but short-lived innovations in exchange-rate policy are not recorded in Table 1; they were not reported by the governments concerned. Nevertheless, my own statistical analysis of the Fund's numbers suggests that, by and large, they capture the broad trends in exchange-rate policies and in actual exchange-rate behaviour.⁵

Table 1 describes the exchange-rate arrangements adopted by 37 "small" developing countries and 81 "large" developing countries. The countries are those that appear continuously in the Fund's tabulations from 1982 through 1991, and the small ones are those with populations no larger than 2 million.

Table 1 Classification of Developing Countries' Exchange-Rate Arrangements (ends of calendar years)

Arrangement	Small Countries		Large Countries	
	1982	1991	1982	1991
Pegged to single currency	19	18	34	21
Pegged to SDR	5	1	9	5
Pegged to other composite	7	9	11	14
Flexibility limited in terms of single currency	5	3	5	1
Adjusted according to set of indicators	0	0	4	4
Other managed floating	1	4	14	17
Independently floating	0	2	4	19
Total	37	37	81	81

Source: Peter B. Kenen, "Financial Opening and the Exchange-Rate Regime," in H. Reisen and B. Fischer, eds., *Financial Opening: Policy Issues and Experiences in Developing Countries*. OECD Development Centre, Paris, 1993.

Look first at the small countries. In 1982, when the Fund introduced the categories used in Table 1, most of the small countries had pegged rates; 19 were pegging to a single foreign currency, and 12 more were pegging to baskets of currencies, including the SDR.⁶ A decade later, in 1991, the

⁵ Peter B. Kenen, "Floating Exchange Rates Reconsidered," in P.B. Kenen, F. Papadia, and F. Saccomanni, eds., "The International Monetary System: Essays in Memory of Rinaldo Ossola", Cambridge University Press, Cambridge & New York, forthcoming.

⁶ As a practical matter, moreover, the five countries with flexibility limited in terms of a single currency may be regarded as having pegged rates; their nominal exchange rates have not been much more volatile in the short run than those of the countries with strictly pegged exchange rates.

situation had not changed very much; 28 small countries had pegged rates, compared to a total of 31 in 1982. This finding reminds us of McKinnon's contribution to the theory of optimum currency areas.⁷

But look next at the large countries. In 1982, 54 of them had pegged exchange rates; 34 were pegging to a single foreign currency, and 20 more were pegging to baskets of currencies. At the opposite extreme, only four countries had independently floating rates. A decade later, however, only 40 of these countries had pegged rates, and 19 had independently floating rates. As recently as 1989-91, 12 of these countries moved from pegged-rate arrangements to more flexible arrangements, with seven moving all the way to independent floating.

Taken by itself, the migration of the developing countries to exchange-rate flexibility would appear to cast doubt on the case for increasing the stock of reserves. There is, of course, no simple, inverse relationship between the extent of exchange-rate flexibility and the need for reserve assets. A country that has pegged its exchange rate firmly for many years is apt to need smaller reserves than one that has changed its pegged rate often or by large amounts. Furthermore, most countries with flexible exchange rates do not let their rates float freely and they thus need reserves. They may, in fact, require larger reserves than countries with firmly fixed exchange rates. Much will depend on each country's exposure to international capital flows – which takes us to the other important development mentioned at the start of this section.

The resumption of capital inflows

Let us look first at the good news. There has been a remarkable revival of foreign investment in several developing countries, mainly in Latin America and Southeast Asia. In 1986-88, the net capital flow to developing countries totaled only \$7.7 billion; in 1989-91, it totaled \$132.3 billion.⁸ The inflow included a huge increase of foreign direct investment, which rose from \$49.3 billion in 1986-88 to \$120.7 billion in 1989-91.⁹ It also included portfolio

7 Ronald I. McKinnon, "Optimum Currency Areas," In: *American Economic Review*, 63, 1963.

8 International Monetary Fund, "Balance of Payments Statistics Yearbook", 1992, Part II, Tables A-2 and A-4; figures exclude exceptional financing. The corresponding figures for Asia, Africa, and the Western Hemisphere are – \$12.0 billion (a net outflow) and \$68.0 billion. The gaps between these figures and those in the text reflects large inflows to countries of the Persian Gulf.

9 *Ibid.*, Table C-17; these are total direct-investment inflows, not net of the investments made by the developing countries themselves. The corresponding figures for Africa, Asia, and the Western Hemisphere were \$44.2 billion in 1986-88 and \$83.6 billion in 1989-91.

investment and net lending by foreign banks, shown in Table 2. The banks' claims on the Asian countries rose by \$79.2 billion in 1989-92, and though the banks' claims on the Western Hemisphere countries fell in that same period, the reduction was smaller than the cut resulting from negotiated debt reductions.

Table 2 Cross-Border Claims of Foreign Banks on Developing Countries (billions of U.S. dollars)

Region	Interbank					Other				
	1988	1989	1990	1991	1992	1988	1989	1990	1991	1992
Africa	13.44	13.67	13.22	13.73	14.33	44.33	42.91	47.08	43.66	40.56
Asia	64.11	64.21	76.49	96.49	107.06	87.64	90.65	101.42	114.95	123.94
Western Hemisphere	137.43	142.72	144.30	150.57	141.47	173.27	160.48	145.04	147.40	155.33

Source: International Monetary Fund, *International Financial Statistics*, May 1993. Interbank and other claims on Africa exclude claims on South Africa; interbank claims on Asia exclude claims on Hong Kong and Singapore; interbank claims on the Western Hemisphere exclude claims on the Bahamas and Cayman Islands, and other claims exclude claims on the Cayman Islands and Netherlands Antilles. (Interbank claims for 1992 exclude mid-year claims on the Bahamas, as end-year data were not available.)

Most of the countries receiving large capital inflows have used some of the proceeds to absorb real resources; they have run current-account deficits or reduced their current-account surpluses. But most of these countries have also built up their reserves. The balance-of-payments accounts for six of the capital-importing countries are summarised in Tables 3A and 3B. In the Mexican case, net capital inflows rose from \$1.0 billion in 1989 to \$20.4 billion in 1991, apart from exceptional financing; the current-account deficit grew by \$9.3 billion; and reserve accumulation grew by \$7.6 billion (from \$0.5 billion to \$8.1 billion). In the Indonesian case, net inflows rose from \$2.9 billion in 1989 to \$6.1 billion in 1991; the current-account deficit grew from \$1.1 billion to \$4.1 billion, and reserve accumulation grew by \$1.7 billion (from a loss of \$0.5 billion in 1989 to a gain of \$1.2 billion in 1991).

Many explanations have been given for the revival of capital inflows. They include the measures taken by the capital-importing countries to stabilise and liberalise their economies, assisted in some cases by negotiated debt reduction. But events in the outside world also played a role, most notably the

fall in interest rates on dollar assets, which prompted foreign banks to lend more (at higher interest rates) to developing countries.¹⁰

The reasons are important, because they bear on the sustainability of the situation. It would not take an outright withdrawal of foreign capital, merely a cessation of the inflow, to cause painful problems for the capital-importing countries. Recall that the 1982 debt crisis was not triggered by a sudden capital outflow, but by the cessation of additional bank lending. Yet the sustainability of the situation also depends on the way that the capital-importing countries deal with the monetary consequences. They must strike a

Table 3A Balance-of-Payments Accounts for Argentina, Mexico, and Venezuela (billions of U.S. dollars)

Category	Argentina			Mexico			Venezuela		
	1990	1991	1992	1989	1990	1991	1989	1990	1991
Trade balance	8.63	4.58	-1.68	-0.65	-4.43	-11.06	5.63	10.64	4.79
Current-account balance	1.90	-2.80	-8.55	-3.96	-7.12	-13.28	2.16	8.28	1.66
Direct investment	2.01	2.44	4.69	2.65	2.55	4.74	0.08	0.10	1.77
Portfolio investment	-1.61	-0.20	-3.11	0.44	-5.36	6.94	-0.16	13.58	0.11
Other capital:									
Official sector	-0.56	-0.43	-0.62	-0.10	1.80	-0.87	-1.31	-16.50	-0.43
Banking sector	0.10	-0.03	-0.06	-0.14	8.50	6.53	0.33	-0.91	0.17
Other sectors	-2.36	-5.12	9.41	-1.88	0.96	3.04	-4.17	-0.82	1.31
Exceptional financing	3.22	9.09	2.67	0.39	0.08	0.02	1.85	1.43	0.29
Errors and omissions	0.71	-0.34	0.14	2.78	0.89	0.87	1.42	-1.74	-2.42
Use (+) of IMF credit	-0.26	-0.59	-0.07	0.36	0.96	0.16	0.96	1.90	0.22
Increase (-) in reserves	-3.15	-2.02	-4.50	-0.54	-3.26	-8.15	-1.16	-5.32	-2.68

Source: International Monetary Fund, *International Financial Statistics*, May 1993; detail may not add to total because of rounding. For Argentina and Venezuela, changes in liabilities constituting reserves of foreign monetary authorities are netted against changes in reserves.

¹⁰ See, e.g., Pedro Pablo Kuczynski, "International Capital Flows to Latin America: What is the Promise," Proceedings of the World Bank Annual Conference on Development Economics, World Bank, Washington 1992; Stephany Griffith-Jones et al., "The Return of Private Capital to Latin America," in J.J. Teunissen, ed., "Fragile Finance: Rethinking the International Monetary System", Forum on Debt and Development, The Hague, 1992; and Charles Collins, et al., "Private Market Financing for Developing Countries", International Monetary Fund, Washington, 1992.

Table 3B Balance-of-Payments Accounts for Indonesia, Malaysia, and Thailand
(billions of U.S. dollars)

Category	Indonesia			Malaysia			Thailand		
	1989	1990	1991	1989	1990	1991	1989	1990	1991
Trade balance	6.66	5.35	4.80	3.91	1.90	-0.17	-2.92	-6.75	-5.99
Current-account balance	-1.11	-2.99	-4.08	-0.21	-1.63	-4.53	-2.50	-7.28	-7.56
Direct investment	0.68	1.09	1.48	1.67	2.33	4.07	1.73	2.30	1.85
Portfolio investment	-0.17	-0.09	-0.01	-0.11	-0.26	0.17	1.49	-0.04	-0.08
Other capital:									
Official sector	2.78	0.47	1.25	0.03	0.70	0.31	-0.54	-1.22	0.26
Banking sector	—	—	—	0.40	0.58	1.65	0.70	1.03	0.21
Other sectors	-0.37	3.02	3.41	-0.45	-1.10	-0.70	3.23	7.02	9.52
Errors and omissions	-1.31	0.74	-0.52	-0.10	1.33	0.27	0.93	1.42	0.42
Use (+) of IMF credit	—	-0.16	-0.32	—	—	—	-0.36	-0.27	—
Increase (-) in reserves	-0.50	-2.09	-1.21	-1.23	-1.95	-1.24	-4.67	-2.96	-4.62

Source: International Monetary Fund, *International Financial Statistics*, May 1993; detail may not add to total because of rounding.

careful balance between importing real resources and building up reserves and must avoid the monetisation of reserve accumulation.

If a country tilts too far in favour of importing real resources by allowing a large deterioration in its current-account balance, it will make itself very vulnerable to any future interruption of the capital inflow (and to political pressures from sectors adversely affected by the increase of imports that brings in the real resources). If it tilts too far in favour of acquiring reserves, it may end up in the worst of all worlds – with inflation, a larger current-account deficit and, eventually, a loss of reserves.

It is hard for many developing countries to sterilise an increase of reserves; their financial markets are not broad enough for the central bank to sell large amounts of domestic assets, and such sales, when they do occur, add to the government's interest bill and the budget deficit.¹¹ Therefore, reserve accumulations are frequently monetised and tend thus to generate inflationary pressures. Countries that have trouble managing the monetary

¹¹ In some developing countries, moreover, such as Argentina and Malaysia, the central bank cannot sterilise reserves, because it does not hold domestic assets.

consequences of reserve accumulation are compelled to choose between two unpleasant options – refraining from reserve accumulation and allowing the nominal exchange rate to appreciate or engaging in nonsterilised intervention and allowing the domestic price level to rise. In both cases, of course, the currency will appreciate in real terms and the current account will deteriorate. The country will import real resources, whether it wants them or not. In the latter case, moreover, it may lose the reserves it wanted to acquire.

Sustainability also depends on the ability of a capital-importing country to make sure that the real resources it chooses to acquire by running a current-account deficit are used for capital formation, not consumption. Otherwise, its output will not grow apace with the income payments it must make to foreigners.

This should not be done by trying to control the character of the capital inflow – by favouring those forms of foreign investment that seem to be most closely linked to capital formation. A government adopting that approach would have to examine intrusively each and every capital-account transaction. It could not merely favour certain broad classes of foreign investment. It would be wrong, for example, to favour foreign direct investment without ascertaining how much of it is meant to finance “greenfield” projects rather than the acquisition of existing assets. It would likewise be wrong to discriminate against foreign portfolio investment without asking what it can contribute to the broadening and deepening of domestic financial markets, making it easier for local firms to issue new securities and thus raise funds for capital formation.

To make the best use of a capital inflow, a capital-importing country must seek to promote investment per se, by residents as well as foreigners. It must follow macroeconomic policies aimed at promoting domestic stability. It must adopt microeconomic policies, especially tax policies, that favour saving and investment rather than consumption.

There are, of course, other valid reasons for capital-importing countries to favour certain sorts of foreign investment – those that do not generate fixed foreign-currency debt-service payments or tie such payments to short-term foreign interest rates. That is why the capital-importing countries can afford to be more comfortable with the medium-term implications of the present situation, involving as it does large inflows of foreign direct investment and, in certain instances, inflows of portfolio investment as well. For this same reason, moreover, one may question the need for an International Debt Restructuring Agency of the sort proposed by Cohen and endorsed by Williamson.¹² It could not possibly “work out” the heterogeneous

¹² Benjamin J. Cohen, “Developing Country Debt”, *Essays in International Finance*, 173. International Finance Section, Princeton University, Princeton, 1989, and Williamson, “International Monetary Reform,” pp. 94-95.

obligations of a country whose “foreign creditors” are mainly direct investors and holders of marketable claims on the private sector.

It must be recognised, however, that the revival of capital inflows is a “fair weather” phenomenon, reflecting the new confidence of foreign investors in the medium-term economic outlook for the capital-importing countries. Those countries cannot count on having access to “liability financing” for use when the weather worsens. They must have adequate reserves of their own, as well as reliable access to reserve credit from the Fund. And this is the case not only for the low-income countries, which have no access whatsoever to international capital markets, but also for the middle-income countries, which must be able to finance temporary balance-of-payments deficits caused by adverse capital-account shocks as well as those resulting from current-account shocks.

II. IMPLICATIONS FOR THE MONETARY SYSTEM

There has been a large increase in the reserves of developing countries. It is shown in Table 4, which traces the growth of their reserves from 1981, the last year before the debt crisis, through 1992 (and also shows their obligations to the IMF). It is shown differently in Table 5, which measures reserves in weeks of imports. The figures in the last two columns of Table 5 are particularly striking. Measured in weeks of imports, reserves have risen uniformly since 1981, in every regional group and every income group. The increase in reserves has been especially large for the African countries and, correspondingly, for the low-income countries (many of which are African countries). In consequence, it is impossible to adduce a strong statistical relationship between the levels of countries’ reserves in 1991 and their per capita incomes.¹³

13 See Table A-2 in the appendix to this paper. There is a significant positive relationship between reserves and incomes for the middle-income countries; see equation (3) in Table A-2. But there is no such relationship for the whole group of developing countries covered by my calculations or for the low-income countries taken by themselves; see equations (1) and (2). These results may reflect the effects of the inverse relationship shown for the African countries by equation (4); it is not statistically significant but may be strong enough to dilute the expected positive relationship between reserves and per capita incomes for the whole set of developing countries and the low income-countries. There is a clearer relationship between reserves and per capita incomes for the Asian and Latin American countries; see equation (5). Table A-2 reports two more calculations. Equation (6) links the changes in reserves between 1981 and 1991 to the 1981 levels and to 1990 per capita incomes. The countries with low reserves in 1981 raised them by larger amounts than the countries with high reserves, and there is a weak but positive link between the sizes of the changes in reserves and per capita incomes; countries with high incomes added more to their reserves. But equation (7) shows that the changes in reserves did not greatly alter the relative positions of the individual countries; levels of reserves in 1991 are strongly and positively correlated with levels of reserves in 1981.

Table 4 Total Reserves of the Developing Countries, Except Gold (billions of SDR)

Country Group	1981	1984	1987	1989	1990	1991	1992	IMF Credit & Loans Outstanding, 1992	
								Billions of SDR	Percent of Quota
Developing countries	137.0	170.2	129.4	153.2	172.8	213.8	260.0	27.8	51.8
Africa	10.3	6.7	7.1	9.0	11.6	14.1	12.9	5.7	69.3
Asia	30.4	56.1	44.0	64.2	76.1	98.1	128.1	5.9	44.5
Europe	4.9	8.5	7.5	14.4	15.1	15.2	14.7	4.6	39.3
Middle East	58.5	58.4	44.6	41.0	36.7	40.5	42.7	0.4	4.6
Western Hemisphere	32.8	40.5	26.2	24.6	33.3	45.9	61.7	11.0	97.7

Source: International Monetary Fund, *International Financial Statistics*, 1992 Yearbook, February 1983, and May 1993; data exclude Taiwan.

Table 5 Total Reserves of the Developing Countries Measured in Weeks of Imports

Country Group	Regional Aggregates		Regional Averages ^a	
	1981	1990	1981	1991
Africa	7.0	11.6	9.4	15.7
Asia	11.1	19.9	13.1	17.3
Middle East	25.7	22.9	21.9	24.0
Western Hemisphere	16.1	21.8	17.5	26.2
Low Income	—	—	11.1	18.1
Lower Middle Income	—	—	14.9	21.8
Upper Middle and High Income	—	—	17.3	19.8

Source: Table A-1 and International Monetary Fund, *International Financial Statistics*, 1992 Yearbook.

^a Unweighted averages for individual countries listed in Table A-1; some countries' figures for 1991 pertain instead to 1989 or 1990.

A number of developing countries are still short of reserves. Of the 24 African countries covered by the averages in Table 5, 12 had reserves smaller than three months of imports, and 11 other countries were in that same situation. The numbers were much higher in 1981, however, when 19 African countries

and 16 other countries had reserves smaller than three months of imports. Therefore, I find it somewhat hard to argue that there is an acute shortage of reserves or that the global stock is very badly distributed.¹⁴

A case can still be made for SDR creation, along lines set out above. It would be a way to give the low-income countries the extra degree of freedom they presently lack because they cannot borrow freely. I would be surprised, however, if the low-income countries held onto the SDRs, and they should not be made to do so by reinstating the reconstitution requirement, as Williamson suggested a decade ago.¹⁵ That would do them little good and would reduce the usefulness of the SDR itself, and it is not apt to win the support of those who dogmatically oppose SDR creation because they fear inflation, even when aggregate demand is deficient in the whole world economy.

A stronger case can be made, however, for taking rather different steps to help the developing countries. Although reserves and reserve credit are not perfect substitutes, it may be more fruitful to focus primarily on making reserve credit more readily available than raising the stock of reserves. Two reforms would do that.

First, the International Monetary Fund should reverse the silly decision taken several years ago, which attached full-fledged conditionality to the use of the Compensatory and Contingency Financing Facility (CCFF). That facility was established in 1963 to help commodity-producing countries offset temporary fluctuations in their export earnings due to fluctuations in commodity prices. It was known at the time as the Compensatory Financing Facility (CFF) but was extended in 1988 to deal with balance-of-payments problems caused by other adverse shocks (e.g., an increase in debt-service payments resulting from an increase in world interest rates). The decision to create the CFF reflected in part the desire of the developed countries to forestall a proliferation of commodity agreements, which ran the risk of

14 When the FONDAD conference discussed the first version of this paper, critics raised two objections (1) computing the ratio of reserves to imports may not be the best way to measure the adequacy of reserves; (2) increases in the ratios for some low-income countries are the result of severe import compression due in turn to low export earnings and high debt-service payments. Both points are valid. The first, indeed, restates a point made early in this paper, that a country's need for reserves depends on the variability of the flows across the foreign-exchange market, not on the level of imports, and I made the same point years ago; see Peter B. Kenen and Elinor B. Yudin, "The Demand for International Reserves," In: *Review of Economics and Statistics*, 47, 1965. The second point amounts to warning that the apparent improvement in the reserve positions of the low-income countries, measured by their ratios of reserves to imports may be a statistical illusion; checking the numbers again, I have found cases of this sort, but they do not account fully for the general result reported in the text.

15 John Williamson, "A New SDR Allocation?" *Policy Analyses in International Economics* 7, Institute for International Economics, Washington, 1984.

propping up commodity prices at unsustainable levels. To substitute effectively for those agreements, however, the CFF was designed to provide financing automatically, whenever a commodity-producing country experienced a temporary shortfall in its export earnings. By making access to the CFF strictly conditional, like access to ordinary drawings on the Fund, the Fund made the facility virtually redundant and broke an implicit contract with the developing countries, which gave up their quest for commodity agreements in exchange for liberal access to the CFF. The decision was especially harmful to the poorest countries, which tend to depend most heavily on commodity exports and can least readily afford to cope with fluctuations in their export prices by holding large reserves.

Second, the Fund should encourage its members, especially those that experience large capital inflows, to build up their reserves by earmarking extra credit facilities for those countries' use. This scheme could be linked with one I proposed some years ago.¹⁶ The Fund might administer "shadow" conditionality in respect of member countries that look to be prospective users of Fund credit:

Under Article IV, sec 3(b) of the Fund agreement, the Fund engages in an annual consultation with each member. These consultations afford the Fund an opportunity to "exercise firm surveillance over the exchange rate policies of members," but they range widely over current problems and policies. In the course of these confidential consultations, and more frequently when necessary, the staff of the Fund should make known its views about the member's balance-of-payments situation and the policy changes, if any, that would be required to correct it. Its views should be offered to surplus countries as well as deficit countries.

But I carried the argument further. When a country is seen to be at risk of running a serious balance-of-payments problem, the staff of the Fund should solicit a "provisional" letter of intent, describing the policies the country would follow to deal with its balance-of-payments problem. The letter of intent would describe the policies that the country planned to follow in light of its current views about its balance-of-payments position, as well as those it would adopt if the situation began to deteriorate. The latter should be deemed to represent the policy commitments that the country would make when it sought to use Fund credit. If the staff of the Fund was not satisfied with the country's plans, it would ask the country to revise the provisional letter of intention. If the staff did not request revisions, the country would have the right to expect that the staff would recommend approval if the provisional letter of intent became a formal letter of intent, submitted with an

16 Kenen, "Financing, Adjustment, and the ... Fund", pp. 69-70.

application for a drawing. Provisional letters of intent might also be reviewed by the executive board of the Fund, and if it found fault with them, it could make representations to the countries submitting them. The countries would then know that they could not expect to draw on the Fund unless they revised their policy plans.

This process could be adapted and extended to meet the special needs of countries experiencing very large capital inflows. The staff of the Fund could recommend that such countries undertake to build up their reserves. The target could be formulated in flow or stock terms, as an annual rate of increase in reserves or a level to be reached by a specified date. Once such targets were agreed, the staff could recommend to the executive board that the countries meeting them be promised supplementary access to Fund credit, above and beyond their ordinary drawing rights. The amounts of supplementary credit would be geared to each country's reserve target. A dollar of extra reserve assets, for example, might "earn" access to an extra dollar of Fund credit, up to an agreed ceiling. The supplementary credit would be made available under the conditions normally applied to drawings in the first credit tranche, without imposing onerous policy conditions; it would be made available *pari passu* with the use of the countries' own reserves. Countries having access to this supplementary credit would be protected against a sudden reduction or cessation of capital inflows, due to conditions beyond their control, without having to build up their reserves by as much as would be prudent if they could not count on using extra reserve credit.

III. CONCLUSION

The three proposals made in this paper – an SDR allocation, liberalising access to the CCFF, and the earning of extra reserve credit by building up reserves – hardly amount to a full-fledged reform of the international monetary system. More must be done – and now. The International Monetary Fund must seek and receive a larger role in the policy consultations of the G-7 countries, and the framework for those consultations must be broadened to take explicit account of the powerful ways in which the G-7 countries affect the entire world economy. The G-7 constitute a "steering committee" for the world economy; they must accept that challenge and the corresponding need for accountability. At some point soon, moreover, the G-7 countries must make a fundamental choice; they have either to lapse back into freely floating exchange rates or move on to a more structured exchange-rate regime. They have tried to defer this choice, hoping to conserve their credibility by avoiding ambitious commitments; their caution, however, runs

the risk of eroding their credibility.¹⁷ Finally, it is time for the Fund and its members to re-examine the ways in which the Fund obtains and uses resources. If the Fund were based fully on the SDR, in the spirit of Keynes rather than White, there would be no need to add to its resources periodically, and it could start to serve as an important supplier of reserves, not merely a custodian of reserve credit.¹⁸

The developing countries, however, must not be made to wait until the world is ready to deal with these issues, nor should they be told to wait until it has found ways to deal with the problems of Central and Eastern Europe. Some steps can be taken now, including the three proposed in this paper. Those three should, in fact, be treated as a package, because they address different needs. The low-income countries would be the main beneficiaries of SDR creation and of freer access to the CCFF. The middle-income countries would be the main beneficiaries of access to reserve-related supplementary credit.

17 See Peter B. Kenen, "Managing Exchange Rates", Council on Foreign Relations, New York, 1989.

18 See Jacques J. Polak, "Thoughts on an International Monetary Fund Based Fully on the SDR", IMF Pamphlet Series 28, Washington, 1979, and my "Financing, Adjustment, and the ... Fund", pp. 61-68.

STATISTICAL APPENDIX

Table A-1 Reserves and Per Capita Incomes in Developing Countries

Region and Country	Reserves Measured in Weeks of Imports		Income Per Capita in 1990 dollars
	1981	1991	
Africa			
Burkina Faso	10.9	42.9*	330
Burundi	19.8	29.7	210
Cameroon	3.1	0.8**	960
Central African Rep	38.0	39.1*	390
Cote d'Ivoire	0.4	0.4*	750
Ethiopia	18.8	1.0**	120
Ghana	6.8	14.2*	390
Kenya	6.2	3.4	370
Madagascar	2.5	33.0*	230
Malawi	7.1	11.3	200
Mali	2.5	12.0*	270
Morocco	2.7	23.5	950
Niger	10.7	15.3**	310
Nigeria	9.7	35.3**	290
Rwanda	31.8	18.7	310
Sierra Leone	2.5	3.1	240
South Africa	1.5	2.5	2530
Tanzania	0.8	9.1	110
Togo	18.2	31.4*	410
Tunisia	7.4	7.9	1440
Uganda	4.5	17.2	220
Zaire	11.8	13.4	220
Zambia	2.3	8.1**	420
Zimbabwe	5.2	3.7**	640
Asia			
Bangladesh	2.7	19.5	210
China	12.2	36.3	370
India	15.8	9.2	350
Indonesia	19.6	18.6	570
Korea	5.3	8.7	5400
Malaysia	18.4	15.4	2320
Nepal	28.5	27.2	170
Pakistan	6.7	3.2	380
Papua New Guinea	16.3	10.4	860
Philippines	12.7	13.2	730
Singapore	14.2	26.8	11020
Sri Lanka	9.2	11.7	470
Thailand	9.0	24.2	1420

Table A-1 (continued)

Middle East			
Egypt	4.2	33.7	600
Israel	18.0	19.8**	10920
Jordan	17.9	17.1	1240
Saudi Arabia	47.5	25.2**	7050
Western Hemisphere			
Argentina	18.0	58.6**	2370
Bolivia	5.3	5.9	630
Brazil	14.3	17.2**	2680
Chile	26.3	49.8	1940
Colombia	47.4	63.9	1260
Costa Rica	5.7	25.8	1900
Dominican Rep	7.0	11.6	830
Ecuador	14.6	20.0	980
El Salvador	3.8	10.6	1110
Guatemala	4.6	22.7	900
Haiti	2.7	2.4	370
Honduras	5.5	6.2	590
Mexico	8.8	17.1**	2490
Paraguay	69.9	41.4	1110
Peru	17.9	30.3	1160
Uruguay	13.6	11.1	2560
Venezuela	32.4	50.1	2560
Averages			
Africa	9.4	15.7	512
Asia	13.1	17.3	1867
Middle East	21.9	24.0	4952
Western Hemisphere	17.5	26.2	1496
Low Income	11.1	18.1	326
Lower Middle Income	14.9	21.8	1214
Upper Middle & High Income	17.3	19.8	5246

Source: International Monetary Fund, *International Financial Statistics*, Yearbook 1992 and May 1993, and World Bank, *World Development Report*, 1992.

The countries included in this table are those with populations larger than 2.5 million for which data on reserves and on incomes per capita were published in the sources listed above. (Reserve statistics were available for most IMF members, but not in weeks of imports, because of long lags in publication of the requisite import statistics.)

* Data for 1989.

** Data for 1990.

Table A-2 Regression Equations

**1991 Reserves (in weeks of imports) on 1990 Incomes Per Capita
(in thousands of dollars):**

(1) All Countries Except Four with Highest Incomes: ¹		
R Squared	0.056	
Number of observations (degrees of freedom)	54	(52)
Constant term	15.510	
Coefficient on income per capita	4.719	
Standard error (t statistic)	2.692	(1.753)
(2) Low Income Countries:		
R Squared	0.007	
Number of observations (degrees of freedom)	28	(26)
Constant term	15.412	
Coefficient on income per capita	8.187	
Standard error (t statistic)	18.964	(0.432)
(3) Other Countries Except Four with Highest Incomes:		
R Squared	0.084	
Number of observations (degrees of freedom)	26	(24)
Constant term	10.744	
Coefficient on income per capita	7.198	
Standard error (t statistic)	4.864	(1.480)
(4) Africa		
R Squared	0.091	
Number of observations (degrees of freedom)	24	(22)
Constant term	19.543	
Coefficient on income per capita	- 7.476	
Standard error (t statistic)	5.027	(1.487)
(5) Asia and Western Hemisphere Except Four with Highest Incomes:		
R Squared	0.122	
Number of observations (degrees of freedom)	30	(28)
Constant term	14.503	
Coefficient on income per capita	7.097	
Standard error (t statistic)	3.594	(1.975)

Table A-2 (continued)**Change in Reserves, 1981 to 1991, on Income Per Capita and 1981 Reserves:**

(6) All Countries Except Four with Highest Incomes:		
R Squared	0.105	
Number of observations (degrees of freedom)	54	(51)
Constant term	8.273	
Coefficient on income per capita	2.776	
Standard error (t statistic)	2.232	(1.244)
Coefficient on 1981 reserves	-0.306	
Standard error (t statistic)	0.134	(2.287)

1991 Reserves on 1981 Reserves:

(7) All Countries:		
R Squared	0.3402	
Number of observations (degrees of freedom)	58	(56)
Constant term	10.824	
Coefficient on 1991 reserves	0.658	
Standard error (t statistic)	0.123	(5.374)

Source: Data from Table A-1.

1 Israel, Korea, Saudi Arabia, and Singapore.