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THE BALANCE OF PAYMENTS, INTERNATIONAL MONETARY ASSISTANCE AND DEVELOPMENT

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Introduction

We have seen how the composition of trade of developing countries can lead to severe balance of payments difficulties, which can act as a constraint on growth, and how vulnerable many developing countries are to exogenous shocks that adversely affect their export earnings and import payments.

In this chapter we develop a simple model of balance of payments constrained growth, first of all without capital flows and then allowing current account deficits to be financed by capital inflows. It is shown that growth consistent with current account equilibrium depends on four major factors:

1. What is happening to the real terms of trade (or real exchange rate) and the price elasticities of demand for exports and imports.
2. The growth of world income.
3. The income elasticity of demand for a country's exports.
4. The income elasticity of demand for imports.

We show that if the real terms of trade are constant, a country's growth rate can be approximated by the ratio of export growth to the income elasticity of demand for imports.

The model has several policy implications relating to exchange rate policy, industrial policy to improve the income elasticity of demand for exports, and trade policy to reduce the income elasticity of demand for imports. Different types of exchange rate regimes are considered, from fixed pegs to free floating, and a cautionary tale is told from the East Asian financial crisis of 1997.

The model with capital flows shows how capital inflows can relax the constraint of current account equilibrium, but the extra growth is minimal because there are limits to the current account deficit to GDP ratio (and the international debt to GDP ratio).

The original purpose of the International Monetary Fund (IMF) was to provide short-term balance of payments support to countries and it does this through various facilities, such as Stand-By Arrangements, Extended Fund Facility, Extended Credit Facility, Standby Credit Facility, Poverty Reduction and Growth Facility and other special facilities. But the IMF imposes conditions on lending, and the more lending, the harsher the conditions. We examine the results of the IMF's programmes in developing countries and the criticisms of the policies imposed.

The chapter ends with a discussion of the potential of Special Drawing Rights (SDRs) to aid developing countries without them having to adjust to balance of payments difficulties by deflating their economies.

Balance of payments constrained growth

Poor countries are in balance of payments deficit most of the time, but the deficits fluctuate according to internal and external economic circumstances. In the 1970s, for example, owing to the oil shocks in 1973 and 1979 and the slowdown of world growth, the deficits grew considerably, despite a slowdown of internal growth that reduced the demand for non-oil imports. In the early 1980s, the deficits contracted because most developing countries were forced to adjust (that is, deflate their economies) in order to repay debt out of diminished export earnings. In the late 1980s, the deficits increased again, with some internal recovery and a greater willingness of the international capital markets to resume lending. By 1996, the deficits totalled \$98 billion, over half

of which was accounted for by Thailand, Indonesia, the Philippines, Malaysia and South Korea, which all experienced serious financial crises in 1997. These countries had to readjust, and since 2002, East Asia and the Pacific have been in big surplus. Today, China has a huge surplus, but many African countries have deficits in excess of 10% of GDP. The world as a whole is plagued with serious payments imbalances. For any country or continent, the observed deficit (*ex post*) measures the extent to which it has been able and willing to finance the difference between the value of import payments and the value of export receipts.

All countries have a growth rate that is consistent with balance of payments equilibrium on the current account, and with its overall balance on the current and capital account. What determines the growth rate that is consistent with current account balance on the one hand, and overall balance on the other? If we specify the equilibrium equations and the determinants of import and export demand, we can immediately see the major factors of importance, and we can, in turn, understand the various policy measures taken by individual countries and the international community to raise the growth rate of less developed countries consistent with balance of payments equilibrium. For the original development of this model, see Thirlwall (1979). For an overview of the literature, see McCombie and Thirlwall (1997, 2004), Thirlwall (2011) and Soukiazis and Cerqueira (2012).

The current account balance of payments of a country, measured in its own *domestic* currency, may be written as:

$$P_d X = P_f M E \quad (16.1)$$

where X measures the quantity of exports and P_d is the average price of exports, so $P_d X$ is the value of exports in domestic currency. M is the quantity of imports, P_f is the average (foreign) price of imports and E is the nominal exchange rate measured as the domestic price of foreign currency, which thus converts the value of imports measured in foreign currency ($P_f M$) into a domestic currency equivalent.

The condition for the balance of payments to remain in equilibrium in a *growing* economy through time is that the *rate of growth* of export earnings should equal the *rate of growth* of import payments, that is:

$$(p_d + x) = (p_f + m + e) \quad (16.2)$$

where the lower-case letters represent rates of change of the variables.

Now let us consider what the growth of export and import volume depends on. Export demand may be expected to depend primarily on the price of a country's exports relative to the foreign price of similar goods (expressed in a common currency) and on the level of 'world' income, which determines the purchasing power over a country's goods. Similarly, import demand may be expected to depend on the price of imports relative to domestic substitutes and on the level of domestic income. If the price and income elasticities of demand for exports and imports are assumed to be constant, we may write the export and import functions in the following (multiplicative) way:

$$X = A \left(\frac{P_d}{P_f E} \right)^\eta Z^\epsilon \quad (16.3)$$

and:

$$M = B \left(\frac{P_f E}{P_d} \right)^\psi Y^\pi \quad (16.4)$$

where Z measures 'world' income; Y measures domestic income; η is the price elasticity of demand for exports (< 0); ϵ is the income elasticity of demand for exports (> 0); ψ is the price elasticity of demand for imports (< 0); π is the income elasticity of demand for imports (> 0); and A and B are constants.

Taking small rates of change of the variables in equations (16.3) and (16.4), we can see what the growth of exports and imports depends on:

$$x = \eta(p_d - p_f - e) + \epsilon(z) \quad (16.5)$$

and:

$$m = \psi(p_f + e - p_d) + \pi(y) \quad (16.6)$$

In other words, **export growth** depends on:

1. How fast domestic prices are changing relative to foreign prices, taking into account variations in the exchange rate (e), multiplied by the price elasticity of demand for exports.
2. How fast world income is changing, together with the value of the income elasticity of demand for exports.

We rule out here the possibility that developing countries can sell any amount of their goods on world markets at the going price, which would mean that the income elasticity of demand, and what is happening to world purchasing power, does not matter, and that export growth is simply supply determined. This may be true in the case of *some* commodities from some *small* countries, but the proposition that demand conditions do not matter for export performance does not stand up to empirical scrutiny as a general rule. There are very few countries that are pure price-takers in international trade.

Likewise, **import growth** depends on:

1. How fast import prices are changing relative to domestic substitutes (taking account of exchange rate changes), multiplied by the price elasticity of demand for imports.
2. How fast domestic income (as a proxy for expenditure) is changing, together with the income elasticity of demand for imports.

Since the growth of imports depends on the growth of domestic income, if we substitute equations (16.5) and (16.6) into equation (16.2) (which gives the condition for a moving balance of payments equilibrium through time), we can derive an expression for a country's growth of income that is consistent with current account equilibrium, which depends on certain key variables and parameters. Substitution of (16.5) and (16.6) into (16.2) gives:

$$p_d + \eta(p_d - p_f - e) + \epsilon(z) = p_f + \psi(p_f + e - p_d) + \pi(y) + e \quad (16.7)$$

so that:

$$y = \frac{(1 + \eta + \psi)(p_d - p_f - e) + \epsilon(z)}{\pi} \quad (16.8)$$

Before embarking on discussion, let us identify in words what this growth rate depends on, which must be binding if current account deficits cannot be financed:

1. It depends on the rate at which the real terms of trade are changing ($p_d - p_f - e$). The real terms of trade are the ratio of export to import prices measured in a common currency ($P_d/P_f E$). A rise in this ratio, that is $(p_d - p_f - e) > 0$, raises real income growth consistent with current account equilibrium (other things being constant), and a fall in this ratio lowers the balance of payments equilibrium growth rate. This is the **pure terms of trade** effect on income growth.
2. If the real terms of trade are changing, the growth rate depends on the **price elasticities of demand** for exports (η) and imports (ψ), which determine the magnitude of the volume response of exports and imports to relative price changes. For surveys of estimating export and import demand functions, see Senhadji and Montenegro (1999) and Senhadji (1998).
3. One country's growth depends on the growth rates of other countries (z) – which neatly illustrates the **interdependence of the world economy** – but the rate at which one country grows relative to others depends crucially on the income elasticity of demand for its exports (ϵ), which depends on the tastes of foreign consumers, the characteristics of goods, and a whole host of **non-price factors** that determine the demand for goods in international trade. One of the main reasons why some countries have a healthier balance of payments and a higher growth rate than others is related to the characteristics of the goods they produce and export in world trade. What you export matters (Hausmann et al., 2007).
4. The growth rate depends on a country's **appetite for imports**, as measured by π , the income elasticity of demand for imports. The higher is π , the lower the growth rate that is consistent with balance of payments equilibrium on the current account.

These factors show the rationale for agreements to prevent the terms of trade deteriorating for developing countries, for exchange rate policy, for international Keynesianism to maintain the growth of world income, and for policies to induce structural change – through export promotion or import substitution – in order to raise the income elasticity of demand for exports and to reduce the income elasticity of demand for imports. Let us take up some of these issues in turn.

The terms of trade

The effect of terms of trade deterioration (import prices rising faster than export prices, other things remaining the same) is to worsen the balance of payments at a given rate of growth or, what amounts to the same thing, to reduce the rate of growth of income consistent with current account equilibrium. For example, if in equation (16.8), import prices were rising at 10% per annum while the price of exports was rising at only 5% per annum, this would mean a lower y than if the terms of trade were constant. In theory, this 'terms of trade effect' could be offset by a continual **appreciation** of the currency; that is, by a continual percentage fall in E ($e < 0$), but very few developing countries, if any, are in a position to appreciate their currencies even if they wanted to. Terms of trade stability in real terms must depend, or rely, on international commodity agreements to stabilize the prices of the exports of developing countries relative to the prices of the goods they import. Within this framework of analysis, the rationale for terms of trade agreements is apparent.

It is not clear, however, that terms of trade deterioration is always a bad thing, because what happens to export earnings and import payments, and hence to the balance of payments equilibrium growth rate, depends not only on changes in relative prices but also on the volume response of exports and imports to price changes. Since the price elasticities, η and ψ , are defined

as negative, it can be seen from equation (16.8) that if their sum exceeds -1 , $p_d < p_f$ will mean that y is higher than would be the case if $p_d > p_f$. In other words, the export and import volume response to domestic export prices rising more slowly than import prices is sufficient to offset the fact that more has to be paid for a given volume of imports relative to exports. If, however, the price elasticity of demand for the exports of a developing country is low because of the nature of the product in question (for example, a primary product), and the price elasticity of demand for imports is also low because the imports are necessities, the balance of payments will *worsen* if the terms of trade deteriorate, and growth will have to be constrained for the preservation of balance of payments equilibrium. In these circumstances, commodity agreements assume great importance and it would be beneficial if the ratio of export prices to import prices were to rise. In Chapter 15, we considered various commodity schemes aimed at stabilizing export prices, or changing the relative price of exports and imports. We also noted that this will not necessarily stabilize export earnings if there are fluctuations in export supply. The international response to this has been to devise schemes to compensate for loss of export earnings. In the past, the IMF operated a Compensatory and Contingency Financing Facility to cover shortfalls of export earnings, but now countries must use other emergency financing facilities (see below).

Another argument for stabilizing the export prices of developing countries and maintaining their incomes is that price and income instability tend to depress the world economy as a whole and the developing countries with it, given the interdependence between countries in the world economy. Falling prices and incomes in developing countries reduce the purchasing power over industrial goods, inducing recession, while rising commodity prices may also induce recession by raising the price of manufactured goods and inducing deflation in developed countries. For the smooth growth of the world economy, there is a lot to be said for attempting to stabilize the prices of primary products so that the purchasing power of the producers and exporters of these commodities grows in line with supply. One suggestion is that Special Drawing Rights (SDRs) (see below) might be used to purchase primary products in order to stabilize their price in times of glut, on the lines of Keynes' 'commod control' scheme (see Chapter 15).

The exchange rate and devaluation

Now suppose that export prices do rise more quickly than import prices, improving the terms of trade, but that the sum of the price elasticities of demand for exports and imports exceeds unity, what then? This will worsen the balance of payments and reduce the balance of payments equilibrium growth rate. It is in these circumstances that **exchange rate depreciation** may become relevant, and is often resorted to. It can be seen from equation (16.8) that if a country's rate of price increase is above that of other countries ($p_d > p_f$), this can, in principle, be compensated for by allowing the exchange rate to depreciate continually ($e > 0$) by the difference between p_d and p_f in order to hold 'competitiveness' steady. The conventional approach to balance of payments adjustment, and the policy pursued relentlessly by the IMF in countries experiencing balance of payments difficulties, is downward adjustment of the exchange rate. Note, however, that the rationale of such a policy presupposes a number of things:

- That the source of the difficulties is price uncompetitiveness.
- That the price elasticities are 'right' (that is, they sum to greater than unity) for a depreciation to reduce the imbalance.
- That the *real* terms of trade (or the *real* exchange rate) can be changed by devaluation.

A fall in the nominal exchange rate, however, that is, $e > 0$, may lead either to a fall in P_f ($p_f < 0$) or a rise in P_d ($p_d > 0$), both of which would nullify the effect of the devaluation (see equation (16.8)). A fall in P_f might come about if foreign suppliers desired to maintain their competitiveness as the devaluing country became more competitive. This is known as **pricing to market**; that is, foreign exporters reduce their markups in response to nominal exchange rate changes in order to remain competitive in world markets. A rise in P_d may come about as the domestic price of imports rises as a result of devaluation, which is then followed by a domestic wage–price spiral. Either way, within a short space of time, relative prices measured in a common currency may revert to their former level and devaluation will have been ineffective in this respect. Edwards (1989) has looked at the effectiveness of devaluation in reducing a country's *real* exchange rate. He studied 39 cases of devaluation in 25 developing countries in the period 1962–82, and found that, in most cases, devaluation had been eroded by domestic inflation within three years. Devaluation must be backed by restrictive monetary and fiscal policies if it is to be effective, but this can lead to unemployment. A detailed case study of Mexico by Kamin and Rogers (2000) shows that devaluation has nearly always been associated with high inflation and economic contraction.

Note also that a *one-shot* devaluation or depreciation of the currency cannot put a country on a *permanently higher growth path* that is consistent with balance of payments equilibrium. Currency depreciation would have to be continuous (that is, $e > 0$ permanently) for this to happen, unless devaluation can somehow induce favourable structural changes at the same time. Countries must look very carefully at the prevailing conditions before embracing currency devaluation as a panacea for the relief of balance of payments constrained growth. There are three major worries.

First, raising the domestic price of imported goods can be a highly inflationary policy for an open economy that is heavily dependent on imports, as many developing countries have discovered to their cost, particularly in Latin America, and some countries have had the courage to resist IMF support, which has been conditional on devaluation. In the eyes of some, the acronym IMF stands for (I)nflation, (M)isery and (F)amine.

Second, depreciation can be dangerous because it prematurely shifts resources into the tradable goods sector, where productivity may be lower than in the non-tradable goods sector. This is argued forcefully by Yotopoulos (1996), who believes that there is a tendency for the real exchange rate to be *undervalued* because of weakness on the capital account of the balance of payments, depressing the nominal exchange rate. In the early stages of development, developing countries should therefore protect the nominal exchange rate from depreciation through the use of controls and intervention in the foreign exchange market, and only start to liberalize once the foreign exchange market has become more fully developed and currencies are not regarded as 'soft' by the outside world. In the 33 countries studied by Yotopoulos (1996), there was a *negative* relation between changes in the real exchange rate and the growth of per capita income for most of the 1970s and 1980s (holding other factors constant).

Third, the effect of currency devaluation is to make countries more competitive in the range of goods that were the source of their balance of payments difficulties in the first place. A devalued currency might encourage export sales of new (manufactured) goods with a high price elasticity in world trade, but it might be inappropriate for the traditional range of goods produced and exported with a low price elasticity of demand. For example, if a country is a large supplier and a price-maker in world markets, currency devaluation coupled with low price elasticity will *reduce* export earnings. If the country is a price-taker, devaluation will raise the domestic price of the commodity and cause inflation. It is true that production for export will become more profitable

and might encourage a greater supply response, but there are other less inflationary ways to encourage supply than devaluation. The different types of exchange rate systems available in developing countries are discussed below.

The IMF supply-side approach to devaluation

Devaluation, as well as permitting a reduction in the foreign currency price of exports, may also increase the profitability of exporting, by raising the price of tradable goods relative to the price of non-tradables, and by providing exporters with more domestic currency per unit of foreign exchange earned. The IMF, having conceded that the price elasticity of demand for many of the goods exported and imported by developing countries (particularly as a group) is low, now increasingly uses this supply-side argument as a justification for devaluation. If output is stimulated, this will, to a certain extent, also mitigate the contraction of aggregate monetary demand that results from devaluation and any accompanying expenditure-reducing policies.

The IMF supply-side approach to devaluation was first articulated in print by Nashashibi (1980) with reference to the Sudan. The approach first requires the calculation of foreign exchange earnings per unit of domestic resources employed for a range of tradable goods. Export (and import substitute) activities can then be arranged on a profitability scale and, according to the supply-side argument, the appropriate devaluation is the one that goes down the scale far enough to ensure the profitability of traditional exports, as well as (perhaps) to encourage new activities. Thus, if the current exchange rate for the Sudan was, say, US\$2 to S£1 and foreign exchange earnings per unit of domestic resources were calculated to be less than this for most commodities, it would clearly be unprofitable to produce for export, and the exchange rate should be devalued to bring the production of tradables within the margin of profitability. Foreign exchange earnings per unit of domestic resources are measured as:

$$C = \frac{(P_x X - P_m M)r}{P_d D} \quad (16.9)$$

where X refers to exports, P_x is the world price of exports in domestic currency, M is the quantity of imported inputs, P_m is the price of imported inputs in domestic currency, D is the amount of domestic resources used in production, P_d is the price of domestic inputs and r is the exchange rate measured as the foreign price of domestic currency. If $C > r$, production is not profitable at the existing exchange rate.

It is clear from equation (16.9) that if devaluation is to improve profitability, the rise in $(P_x X - P_m M)/P_d D$ must be more than the reduction in r . Unfortunately, this cannot be taken for granted. It depends on the response of $P_x X$, $P_m M$, P_d and D to the change in r . The implicit assumptions underlying the approach are that developing countries are price-takers, so that P_x will rise in proportion to the devaluation, that X will increase, that M will decrease, and that these favourable effects will not be offset by rises in P_m and $P_d D$. In practice, there may not be a complete 'pass through' of devaluation to export prices (P_x), the elasticity of export supply may be very low because of structural rigidities and factor immobility, and the elasticity of import prices and domestic prices may be very high. The end result may be that the profitability of exporting remains largely unchanged. This was the conclusion of a detailed study of devaluations in the Sudan by Nureldin-Hussain and Thirlwall (1984), which looked at the profitability of cotton, groundnuts, sesame and gum arabic.

The Sudan and many other developing countries fall into the 'rigid country' classification distinguished by Branson (1983) in his useful taxonomic discussion of trade structures and devaluation. 'Rigid' countries are those that produce agricultural-based raw materials with low supply elasticities and whose demand for imports is very inelastic in the short run, particularly for imports used as intermediate inputs. In addition, the price elasticity of demand for exports may be high but not infinite, and real wages may be sticky. In these circumstances, devaluation may be a second best policy compared with 'structural' intervention to raise foreign exchange earnings per unit of domestic inputs.

The growth of world income and structural change

Now let us turn to the growth of world income: z in equation (16.8). There is nothing that individual poor countries can do about the growth of world income, but since all countries are linked through trade, the interdependence of countries and the importance of global prosperity is only too apparent. This should be the overriding function of supranational institutions and mechanisms: to keep world income and trade buoyant in the face of exogenous shocks and to avoid the beggar-thy-neighbour policies that characterized the 1930s, when the whole world economy slumped. The purpose of the IMF was to avoid a repetition of the 1930s – to help countries in balance of payments difficulties and to avoid recourse to widespread protectionism, which can export unemployment from one country to another in a downward spiral. This is the same purpose that underlies various schemes for the recycling of export surpluses and for managed trade; that is, to relieve the balance of payments constraint on growth in countries that tend to have a chronic deficit while other countries are in perpetual surplus. This was a major theme of the 1980 Brandt Report discussed in Chapter 1, and the major concern of countries during the financial and economic crisis that hit the world economy in 2008.

While individual countries have no control over the growth of world income, they do have some control over the income elasticity of demand for their exports, which determines how fast exports grow as a result of world income growth. Likewise, countries have some control over the income elasticity of demand for imports, because both these parameters are a function of the type and characteristics of the goods being produced for sale in international trade. Thus, they are a function of the industrial and trade strategy being pursued.

In Chapter 15, we discussed export promotion versus import substitution strategies. Import substitution is designed to lower the import elasticity, but there is a limit to import substitution, and the policy itself may lower the export elasticity at the same time by creating a rigid and inefficient industrial structure. A much more fruitful strategy, which has been pursued relentlessly and successfully by several Southeast Asian countries, is to concentrate on raising the export elasticity, which may, at the same time, reduce the import elasticity if the goods produced for export also compete with imports.

Application of the balance of payments constrained growth model

How well does the balance of payments constrained growth model outlined in equations (16.1)–(16.8) fit the growth experience of developing countries? Or, to put it another way, how well does equation (16.8) predict the growth performance of developing countries? To answer this question, it is convenient to simplify the model by assuming either that the sum of the price elasticities of

demand ($\eta + \psi$) does not differ significantly from unity, in which case equation (16.8) reduces to $y = \epsilon z/\pi$, and/or that relative prices in international trade do not change in the long run (or the real exchange rate remains constant), in which case equation (16.8) reduces to $y = \epsilon z/\pi = x/\pi$. This latter result is often referred to as the **dynamic Harrod trade multiplier result**, because it is the dynamic analogue of the static Harrod trade multiplier result $Y = X/m$, where Y is the *level* of income, X is the *level* of exports, m is the marginal propensity to import, and $1/m$ is the foreign trade multiplier (Harrod, 1933). *Prima facie* evidence that a country is balance of payments constrained in its growth performance would be to find that its actual growth is close to or just above its balance of payments equilibrium growth rate (financed by sustainable long-run capital inflows – see below), combined with unemployed domestic resources.

A number of studies have applied this simple model to individual or groups of developing countries, and most are supportive that GDP growth can be predicted from the ratio of export growth to the income elasticity of demand for imports. McCombie and Thirlwall (1994, 1997) give a survey of studies up to 1996, McCombie and Thirlwall (2004) reprint 18 studies with an introductory survey up to 2003, and Thirlwall (2011) lists over 40 studies in a history and overview of the balance of payments-constrained growth model. Recent country studies include Nell (2003) for South Africa, Razmi (2005) for India, Britto and McCombie (2009) for Brazil, and Felipe et al. (2010) for Pakistan. Recent studies for groups of countries include Perraton (2003) for 51 developing countries, Pacheco-López and Thirlwall (2006) for 17 Latin American countries, Gouvea and Lima (2010) for 4 Asian and 4 Latin American countries, and Gouvea and Lima (2013) for a panel of 90 countries. Case example 16.1 applies the model to Latin American countries.

Studies are supportive of the model for two main reasons:

1. It is shown overwhelmingly that real exchange rate changes are not an efficient balance of payments adjustment weapon; it is income that adjusts to preserve balance of payments equilibrium.
2. Capital flows make no substantial difference to the prediction of the current balance model because there is a limit to the current account deficit to GDP ratio that countries can sustain.

The results of these studies add weight to the idea and importance of export-led growth, discussed in Chapter 15.

Application of the balance of payments constrained growth model to 17 Latin American countries, 1977–2002

Case example 16.1

Countries	Actual GDP growth (y) (%)	Export growth (x) (%)	Income elasticity of demand for imports (π)	Predicted balance of payments constrained growth rate (x/π) (%)
Argentina	1.33	6.07	3.66	1.66
Bolivia	1.89	3.46	1.82	1.90
Brazil	2.70	8.07	1.59	5.08
Chile	5.50	8.62	2.03	4.24
Costa Rica	3.94	7.38	2.27	3.25
Dominican Rep	4.23	7.84	0.92	8.52
Ecuador	2.57	5.38	1.83	2.94
El Salvador	1.66	5.03	2.47	2.04

Case example 16.1

Application of the balance of payments constrained growth model to 17 Latin American countries, 1977–2002 – (continued)

Countries	Actual GDP growth (y) (%)	Export growth (x) (%)	Income elasticity of demand for imports (π)	Predicted balance of payments constrained growth rate (x/π) (%)
Guatemala	2.93	2.14	3.78	0.57
Honduras	3.41	2.44	1.41	1.73
Mexico	3.30	11.38	3.17	3.59
Nicaragua	0.45	1.40	0.97	1.44
Paraguay	3.73	7.01	2.48	2.83
Peru	1.93	5.25	1.56	3.37
Uruguay	1.43	4.05	2.13	1.90
Venezuela	1.13	1.74	3.76	0.46

Source: Pacheco-López and Thirlwall, 2006.

Capital flows

So far we have assumed growth to be constrained by the necessity to preserve current account equilibrium on the balance of payments. In practice, of course, countries are allowed to run deficits, sometimes for substantial periods of time, financed by capital inflows from abroad from a variety of sources. The extent to which the value of imports can exceed the value of exports to finance a correspondingly higher level of income is determined by the *net* level of capital inflows. Thus, we may write the equation for the overall balance of payments as:

$$P_d X + C = P_f M E \quad (16.10)$$

where C measures net capital inflows (including reductions in foreign exchange reserves) in domestic currency. Taking the rates of change of this identity gives:

$$\frac{E}{R}(p_d + x) + \frac{C}{R}(c) = p_f + m + e \quad (16.11)$$

where E/R and C/R represent the proportion of total receipts to finance the import bill that come from export earnings (E) and capital inflows (C), respectively. If we now substitute our expressions for x and m (equations (16.5) and (16.6)) into equation (16.11), we can solve for the growth rate associated with overall balance of payments equilibrium. This rate will depend on all the factors already mentioned, and on the rate of growth of *real* capital inflows ($c - p_d$). On substitution, we obtain:

$$y = \frac{(1 + \frac{E}{R}\eta + \psi)(p_d - p_f - e) + \frac{E}{R}(\epsilon[z]) + \frac{C}{R}(c - p_d)}{\pi} \quad (16.12)$$

This model is known as the **extended version of the dynamic Harrod trade multiplier result** (that is, extended to allow for capital flows). Apart from the weight, E/R , attached to the two export elasticities, η and ϵ , the only difference between equation (16.12) and our earlier result in equation (16.8) is the addition of the last term ($c - p_d$), which measures the growth of *real* capital inflows (the growth of the nominal flows, c , minus the rate of domestic inflation, p_d). A positive growth of capital inflows will allow a country to grow faster than would be the case if it was constrained to maintain balance of payments equilibrium on the current account. On the other hand, it must be said that a continually positive rate of growth of capital inflows implies an *ever-growing* burden of debt, which is not sustainable in the long run. Thus, running current account deficits to finance growth is not a feasible option in the long run, and other long-run strategies must be pursued that relate to the determinants of the growth rate consistent with current account equilibrium. For the original development of this model, see Thirlwall and Nureldin-Hussain (1982).

This model has been applied by Nureldin-Hussain (1999) to a sample of African and Asian countries over the period 1970–90, with interesting results (Table 16.1). Each country's growth rate (column 1) is disaggregated into three components according to equation (16.12). The first is the terms of trade effect, the second is the export volume effect, and the third is the effect on growth of real capital inflows. It can be seen that the model fits remarkably well for most countries, but the contribution of the different effects differs between countries, and between the two continents of Africa and Asia. Africa has grown much more slowly than Asia, on average, and over one-half of Africa's growth (excluding that arising from oil exports) has been financed by capital inflows. Movements in the terms of trade have also had an adverse effect on growth in Africa. In Asia, by contrast, a much higher proportion of growth has been permitted by the rapid growth of exports, and terms of trade movements have had a favourable effect on growth.

Table 16.1 Estimates of extended version of dynamic Harrod foreign trade multiplier, 1970–90 (annual percentage average)

	Actual growth rate	Terms of trade effect (A)	Export volume effect (B)	Real capital inflow effect (C)	Predicted growth rate = (A) + (B) + (C)
African countries					
Egypt	6.90	−2.37	4.36	7.31	9.30
Congo, Dem. Rep.	6.59	0.42	3.88	2.38	6.67
Kenya	6.24	−0.50	1.62	5.59	6.71
Mauritius	5.80	0.92	5.13	0.19	6.23
Tunisia	5.69	0.87	5.24	1.48	7.59
Burundi	5.60	1.69	3.21	−1.26	3.65
Cameroon	5.50	−1.12	7.08	0.00	5.97
Gabon	5.10	0.49	6.81	−0.04	7.33
Algeria	4.90	10.15	4.21	−8.72	5.64
Morocco	4.62	−1.34	2.83	3.47	4.96
Côte d'Ivoire	4.50	0.39	4.23	0.81	5.43
Lesotho	4.40	−3.43	6.62	1.55	4.74

Table 16.1 Estimates of extended version of dynamic Harrod foreign trade multiplier, 1970–90 (annual percentage average) – (continued)

	Actual growth rate	Terms of trade effect (A)	Export volume effect (B)	Real capital inflow effect (C)	Predicted growth rate = (A) + (B) + (C)
Burkina Faso	4.20	–5.17	3.03	5.63	3.50
Somalia	3.40	–1.10	0.18	5.00	4.07
Zimbabwe	3.23	–2.40	2.23	–1.24	–1.41
Sudan	3.10	0.14	1.13	1.92	3.20
Benin	2.90	1.44	0.96	1.35	3.75
Tanzania	2.90	0.33	–0.55	5.01	4.79
Togo	2.90	0.08	2.31	0.61	3.00
Senegal	2.67	0.23	1.56	1.05	2.83
Nigeria	2.50	2.37	1.28	–1.17	2.48
South Africa	2.42	–1.03	1.32	7.74	8.03
Mauritania	2.30	0.68	1.58	0.42	2.69
Ethiopia	2.20	–0.09	0.74	2.53	3.17
Sierra Leone	1.58	–0.23	–0.67	2.65	1.75
Zambia	1.40	–0.31	–1.29	0.58	–1.02
Ghana	1.40	–3.81	0.15	2.88	–0.79
Niger	0.81	–5.07	1.79	3.47	0.20
Madagascar	0.48	–0.10	0.06	0.95	0.91
Average	3.66	–0.27	2.45	1.80	3.98
Average excluding oil exporters	3.40	–0.84	1.99	2.49	3.64
Asian countries					
Korea, Rep. of	9.11	–0.81	13.47	–2.49	10.17
Hong Kong	9.07	–0.07	8.34	1.01	9.28
Indonesia	10.76	1.82	3.18	5.76	7.58
China	8.20	–0.02	6.43	0.26	6.67
Malaysia	7.08	–0.69	6.60	2.21	8.12
Thailand	6.80	0.96	5.45	2.61	9.02
Pakistan	5.04	–0.44	4.28	4.40	8.24
India	4.31	–0.85	3.16	1.96	4.27
Sri Lanka	4.30	–0.65	2.33	3.00	4.68
Japan	4.20	–1.42	9.73	–4.63	3.68
Philippines	3.70	0.22	2.00	0.26	2.48
Average	6.60	–0.18	5.91	1.31	6.74
Average excluding Japan and Korea	6.58	0.03	4.46	2.39	6.70

Source: Based on Nureldin-Hussain, 1999.

Exchange rate systems for developing countries

All countries have a wide choice of exchange rate systems, ranging from completely fixed to freely floating, with a number of options in between. Which system a developing country chooses must depend on its circumstances at the time, what exchange rate arrangements other countries are using, and the long-run goals of economic policy. For example, a country may wish to pursue exchange rate stability because of the instability and perceived disadvantages of floating rates, in which case it will wish to choose some form of fixed exchange rate regime. Alternatively, a country may wish to use its exchange rate to achieve various real objectives in the domestic economy, such as a faster rate of growth and full employment, and therefore sets a target for the *real* exchange rate. With changing domestic and foreign prices, a real exchange rate target will require frequent variations in the nominal exchange rate, in which case the country will wish to choose some form of flexible exchange rate regime. On the other hand, if inflation is the most serious problem within a country, currency depreciation to maintain a given real exchange rate may simply exacerbate inflation, and a country may wish to anchor its currency to that of another country or even adopt the currency of another country in order to gain monetary credibility. This would be an extreme form of exchange rate pegging.

There is also the question of capital flows. If a country has liberalized its capital markets and the capital account of the balance of payments, and capital is free to move in and out, it will be difficult, if not impossible, for a country to pursue an exchange rate target and operate an independent monetary policy at the same time. This is called the **impossible trinity**. Capital outflows, for example, will cause a currency to depreciate in value. The only effective way to stop this is to raise domestic interest rates, which depress the internal economy. The reverse dilemma occurs with capital inflows. The only way to reconcile internal and external equilibrium is either to control capital movements, or to allow the exchange rate to float. Theoretically, free floating allows a country to pursue a completely independent monetary policy geared to the goals of the domestic economy, but, in practice, no country is completely indifferent to the value of its exchange rate, particularly as it is a characteristic of the foreign exchange market that exchange rates may considerably overshoot their true 'equilibrium' value. These are just a few examples of the considerations and conditions that countries need to bear in mind in choosing an exchange rate regime. For useful surveys of exchange rate policy in developing countries, see Argy (1990), Frenkel (1999), Fischer (2001), Ghosh et al. (2002) and Ghosh and Ostey (2009). The spectrum of alternatives, from hard pegs to floating, is given in Table 16.2.

Each country must find its own solution, in the light of its own circumstances. The IMF generally respects a country's choice of exchange rate regime, and gives advice to support that choice. The different options are discussed below, but the historical experience of the past 30 years or so points to three broad policy conclusions (Fischer, 2001):

1. Intermediate positions between hard pegs and floating (what might be called 'soft' pegs) are not sustainable without capital controls.

Table 16.2 Types of exchange rate regime

Hard pegs	Intermediate regimes	Floating
Currency boards	Pegged exchange rates	Free float
Currency unions	Crawling peg	Managed float
Dollarization, or adopting the currency of another country	Exchange rate band Crawling band	

2. While countries have shifted from intermediate regimes to either end of the spectrum (more towards floating than hard pegs), a wide range of flexible rate arrangements still remains possible.
3. Countries are not indifferent to exchange rate movements, so independent floating is not an option and can be dangerous.

Let us now briefly consider the different types of exchange rate regime listed in Table 16.2, and their advantages and disadvantages.

A **currency board** is an extreme form of hard peg that requires each unit of a country's currency to be backed by an equal amount of a reserve currency, such as the US dollar. The currency board system was widely practised in Africa under British rule before independence. More recently, Argentina decided to anchor its currency to the US dollar in this way but went into serious recession with the appreciation of the US dollar in 2000–01, and the currency peg was eventually abandoned. Linking a weak currency to a stronger currency can be a useful anti-inflation device to gain monetary credibility. Indeed, the system is reminiscent of the old gold standard system, where the currency had to be backed up by gold, with the money supply expanding and contracting according to the balance of payments and changes in international reserves. The two major disadvantages of currency board systems are:

1. The credit for entrepreneurs to invest is not elastic to the needs of trade (because it depends on the availability of foreign exchange reserves),
2. If the reserve currency appreciates in value, so too does the currency that is linked to it. This can cause serious problems of competitiveness with other trading partners, and damage exports and the balance of payments.

Another extreme form of hard peg is a **currency union**, where countries decide to adopt a common currency, so that, by definition, exchange rates between member countries of the union disappear. Countries may decide to enter a currency union if they feel that multiple currencies, exchange rate volatility and uncertainty are seriously damaging trade, and that the overall benefits of surrendering monetary independence exceed the costs. The conditions for an **optimal currency area**, in which the benefits to the members exceed the costs, are that:

1. Economic cycles should be synchronized and economic shocks symmetrical so that a single monetary policy is suitable for all members.
2. Labour and capital are freely mobile.
3. Fiscal transfer mechanisms exist to help disadvantaged regions.
4. Multiple currencies are seriously damaging trade.

It is never easy for a country to know whether the benefits will exceed the costs, and decisions are often taken on political, as well as economic, grounds. It is important to stress, however, that the fact that a country has no exchange rate to defend vis-à-vis its partners does not mean that the country avoids balance of payments problems; they just show up in a different form (Thirlwall, 2007). If plans to import exceed plans to export, balance of payments difficulties will manifest themselves in falling output and rising unemployment, unless there are compensating capital transfers between the members of the currency union. The francophone countries of West Africa are part of a currency union that now uses the euro as the common currency, and the eurozone, the largest currency union in the world, comprises 19 (of the 28) countries of the EU with the euro as its common currency.

Another form of hard peg is to simply adopt the currency of another country, referred to as **dollarization** in the case of adopting the US dollar. As far as monetary and exchange rate policy is concerned, the country becomes an adjunct to the country issuing the currency. This is a last resort for countries unable to manage their own affairs. In recent years, Ecuador and El Salvador have dollarized.

Pegged exchange rates are fixed exchange rates, but adjustable. This was the system set up at Bretton Woods in 1944, by which each country's currency was pegged to the US dollar, so that all bilateral rates of exchange between countries were also pegged. The system was called the 'adjustable peg system', however, because if countries found themselves in fundamental balance of payments disequilibrium, with unsustainable deficits, they were allowed to adjust the rate of exchange with the dollar and therefore other currencies too. The system gave exchange rate stability, and avoided competitive devaluation by countries that characterized the beggar-thy-neighbour policies of the 1930s, but proved difficult to sustain in a world of increasing capital mobility. This is the problem for any country wishing to peg its exchange rate. If a currency is under pressure, the existence of a peg gives a one-way option for speculators. The currency markets anticipate that the peg can be adjusted only downwards, which then makes the currency vulnerable to speculative attacks. With large amounts of capital freely mobile, it is very difficult to maintain a pegged rate while attempting to pursue an independent monetary policy, because the interest rate has to be used to defend the currency. It was largely speculative capital flows, and the inability of the USA to meet the promise of exchanging dollars for gold, that caused the international monetary system established at Bretton Woods to break down in 1972. Since then, other countries that have tried to peg rates have met with a similar fate. To quote Fischer (2001): 'in recent years, fixed or pegged exchange rates have been a major factor in every major emerging market financial crisis – Mexico at the end of 1994; Thailand, Indonesia and Korea in 1997; Russia and Brazil in 1998; Argentina and Turkey in 2000 ... and 2001'.

If countries do decide to peg their exchange rate, there are three broad choices of peg:

1. Pegging to a single currency such as the dollar, pound or euro.
2. Pegging to an individually tailored basket of currencies reflecting the trade of the country concerned.
3. Pegging to a common basket of currencies such as the SDR (special drawing rights), which, since 2016, has been a weighted basket of the world's five major currencies – the dollar, the yen, the euro, the pound and the Chinese yuan (renminbi).

The question is: Which peg to choose? This will depend on what the country is trying to achieve. If it is macroeconomic stability, pegging against just one currency is unlikely to be optimal since movements in a country's exchange rate may bear no relation to its own balance of payments, but instead will move according to the balance of payments of the country that the currency is pegged to. Ideally, the pegged rate needs to balance out the effect of individual *bilateral* exchange rate changes over the economy as a whole. This requires pegging to a basket of currencies, where the weights should reflect the direction and elasticity of total trade (exports and imports) between the country and its trading partners. Pegging to a common basket of currencies, such as the SDR, is likely to be superior to pegging to just one currency, but inferior to an individually tailored basket of currencies.

To preserve the advantages of a fixed exchange rate, but to minimize the speculative pressures that can build up with the prospect of currency depreciation, there are various, more flexible, intermediate exchange rate regimes.

One possibility is a **crawling peg**. Under a crawling peg, a country maintains its pegged exchange rate within agreed margins at a level equal to the moving average of the market exchange rate over a previously agreed time period. This allows a country's currency to drift gradually lower if circumstances warrant, but avoids the upheaval of devaluation under an adjustable peg system and the possibility of excessive depreciation under free floating. To avoid speculation against the currency, the interest rate can be raised by a margin equal to the permitted rate of depreciation.

A variant of the crawling peg is an **exchange rate band**, whereby the country allows the exchange rate to vary within a specified range. A **crawling band** allows the exchange rate band itself to move over time.

The furthest extreme of flexibility is to allow a currency to float completely independently without any intervention at all. This implies that the country is completely indifferent to its exchange rate. In practice, no country can be indifferent if it is concerned with macroeconomic stability. Exchange rates can overshoot wildly, which can be very disruptive, and a rapidly depreciating currency can be a serious source of inflation by raising the domestic price of imports. It also needs to be stressed that although free floating, by definition, guarantees equilibrium in the foreign exchange market (because the exchange rate is the price that equilibrates the supply and demand for foreign exchange), it does *not* guarantee equilibrium on the current account of the balance of payments because the demand elasticities for imports and exports may not be of the right order of magnitude. This may then involve the unsustainable build-up of debt if deficits are financed by foreign borrowing.

Although many countries claim to have moved towards greater exchange rate flexibility in recent years, in practice, they intervene. This is called **managed floating**. Countries have no target rate of exchange, no peg, no official band, but they intervene on a daily basis according to circumstances. Managing the exchange rate is easier when there are controls on capital flows. Capital controls insulated China from the exchange rate turmoil that hit many countries in Southeast Asia in 1997 (see Case example 16.2). In 1998, Malaysia imposed capital controls in order to manage its exchange rate more effectively (see Athukorala, 2001). For a short time, Chile imposed a tax on capital inflows so that it could operate a policy of monetary contraction to control inflation without leading to destabilizing capital inflows.

Case example 16.2

The 1997 East Asian financial crisis: a cautionary tale

The financial crisis in East Asia erupted in July 1997 when pressure on the Thai baht became so severe that the government was compelled to cease defending the fixed exchange rate and to allow the currency to float, in order to avoid defaulting on its international obligations. There was rapid contagion throughout the region, leading to a collapse of the currencies of Thailand, Indonesia, Malaysia, the Philippines and Korea (the Asia-5) within a matter of weeks. Accompanying the currency collapse were steep falls in these countries' stock markets, which spread to other economies such as Singapore and Hong Kong, whose currencies remained relatively stable. The turmoil rapidly turned into a major world financial crisis and not only had dramatic effects on the region's growth performance, but also substantially reduced world economic growth. What happened in East Asia in 1997 provides an illuminating case study, and cautionary tale, of the danger to countries of attempting to run large balance of payments deficits financed by short-term capital inflows, while trying to maintain a fixed exchange rate.

continued overleaf

Case example 16.2

The 1997 East Asian financial crisis: a cautionary tale – *continued*

The question is: Why did this region, previously described by economists and commentators as representing a 'growth miracle', plunge into one of the world's most serious postwar recessions? The answer is that, for some time, there had been a major imbalance in the external accounts of the Asia-5 countries, but no one warned of the danger, not even the IMF, who did not see the crisis coming. The deficits of 5% and more of GDP were being financed by shorter term volatile capital inflows. Volatile flows constituted over 60% of external financing in the years prior to 1997. The massive capital inflows led to imprudent lending by the domestic banks, and a rapid expansion of credit, leading to asset and property bubbles. The latter encouraged even further capital inflows. It became clear to investors that the exchange rate could not be maintained, and once market sentiment changed, a self-fulfilling prophecy developed, leading to a vicious circle of capital flight, falling exchange rates and a collapse in the regional stock exchanges. Once capital begins to move out of a region and the exchange rate begins to fall, no one wants to be caught holding assets valued in domestic currency. The capital loss caused by a depreciating currency can far outweigh any possible gains in higher returns or in higher interest rates that are imposed to try to restore confidence.

The East Asian financial crisis exposed some fundamental weaknesses in the Asian growth process, although not the underlying factors that gave rise to rapid growth rates in the first place. Particularly, it showed the danger (and this is a warning to other countries) of the rapid liberalization of international capital flows before the domestic banking system has developed sufficient regulatory control, and of financing ever-growing balance of payments deficits relative to GDP by increasingly short-term capital flows. The balance of payments becomes the ultimate constraint on the growth performance of nations.

Source: Based on McCombie and Thirlwall, 1999.

Finally, it needs to be said that an optimal exchange rate strategy for a developing country ought to recognize the **dual structure** of most countries and that a single exchange rate for all commodities may not be appropriate. Either a **dual exchange rate** is required, or some system of taxes and subsidies to achieve the same effect. A classic early reference arguing the case for dual exchange rates is Kaldor (1964). Under a dual exchange rate system, a fixed (official) rate could apply to primary commodity exports (and to essential imports to keep their domestic price low) and a free (devalued) rate could apply to manufactured exports with a high price elasticity of demand (and to inessential imports). With a foreign exchange shortage, the free rate would produce a domestic price of foreign exchange well above the official rate. The higher the free rate, or the greater the degree of devaluation, the greater the stimulation of manufactured exports and the greater the discouragement of inessential imports.

The main administrative problem with dual exchange rates is to separate the two markets, to ensure that export proceeds from primary commodity exports are surrendered at the official rate and that foreign exchange bought at the official rate is used for essential imports. The former can be achieved through state marketing boards, the latter through strict licensing. Currency auctions – selling foreign exchange for non-essential purposes to the highest

bidder – is another form of dual (or multiple) exchange rate policy. In the early days of the IMF, dual and multiple exchange rates were discouraged and frowned upon as interfering with free trade and exchange, but in more recent years, greater tolerance has been shown.

Recent research on the relation between the exchange rate regime adopted by countries and the functioning of the real economy shows the following:

- Under pegged regimes, inflation is lower, the growth of output is not affected, but output volatility is higher than under flexible exchange rate regimes (Ghosh et al. 2002).
- Pegged regimes are more prone to currency crises than floating exchange rate regimes, particularly in countries more integrated with international financial markets, but intermediate regimes are even more prone to crisis than the bipolar extremes of hard pegs or free floating (Bubula and Otker-Robe, 2004).
- Countries with flexible exchange rate regimes absorb terms of trade shocks more easily than countries with fixed exchange rate regimes, so that output is less volatile (Broda, 2004).

So, trade-offs are involved. Pegged exchange rates are best for controlling inflation, but they constrain the use of other macroeconomic policies such as scope for countercyclical fiscal policy because agents fear that countries will intervene to control expected currency depreciation. Pegs also impede timely external adjustment so payments imbalances build up. Intermediate regimes deliver faster growth of output of about 0.5% per annum, but inflation is higher (Ghosh and Ostry, 2009). The countries currently pursuing different types of exchange rate regime are shown in Table 16.3. It can be seen that there is quite a variety of exchange rate systems in operation. Forty three countries still peg their currency to the US dollar in one form or another and 26 countries peg to the euro. At the other end of the spectrum, 36 countries operate a managed float and 29 countries have free floating. Neither free floating nor managed floating mean that countries are indifferent to the exchange rate; merely that there is no formal peg to which the currencies are anchored.

Table 16.3 Countries classified by exchange rate regime, 2014

Exchange rate arrangement	Exchange rate anchor					
	US dollar (43)		Euro (26)		Composite (12)	Other (9)
No separate legal tender	Ecuador	Palau	Kosovo	San Marino		Kiribati Tuvalu
	El Salvador	Panama	Montenegro			
	Marshall Islands	Timor-Leste				
	Micronesia	Zimbabwe				
Currency board	Djibouti	St. Kitts and Nevis	Bosnia and Herzegovina	Lithuania		Brunei Darussalam
	Hong Kong SAR	St. Lucia	Bulgaria			
	ECCU	St. Vincent and the Grenadines				
	Antigua and Barbuda					
	Dominica					
Grenada						

continued

Table 16.3 Countries classified by exchange rate regime, 2014 – *continued*

Exchange rate arrangement	Exchange rate anchor					
	US dollar (43)		Euro (26)		Composite (12)	Other (9)
Conventional peg	Aruba The Bahamas Bahrain Barbados Belize Curaçao and Sint Maarten Eritrea	Jordan Oman Qatar Saudi Arabia South Sudan Turkmenistan United Arab Emirates Venezuela	Cabo Verde Comoros Denmark Sao Tome: and Principe WAEMU Benin Burkina Faso Cote d'Ivoire Guinea-Bissau Mali Niger	Senegal Togo CEMAC Cameroon Central African Rep. Chad Rep. of Congo Equatorial Guinea Gabon	Fiji Kuwait Libya Morocco Samoa	Bhutan Lesotho Namibia Nepal Swaziland
Stabilized arrangement	Guyana Iraq Kazakhstan Lebanon	Maldives Suriname Trinidad and Tobago	FYR Macedonia		Singapore Vietnam	
Crawling peg	Nicaragua				Botswana	
Crawl-like arrangement	Honduras Jamaica		Croatia			
Pegged exchange rate within horizontal bands					Tonga	
Other managed arrangement	Cambodia Liberia				Algeria Iran Syria	
Managed Floating	Afghanistan Kenya Madagascar Malawi Mozambique Papua New Guinea Seychelles Siena Leone Tanzania Ukraine Uruguay	Albania Brazil Colombia Georgia Ghana Hungary Iceland Indonesia Israel Korea Moldova New Zealand Paraguay Peru Philippines Romania Serbia South Africa	India Mauritius Mongolia Zambia			

Table 16.3 Countries classified by exchange rate regime, 2014 – *continued*

Exchange rate arrangement	Exchange rate anchor			
	US dollar (43)	Euro (26)	Composite (12)	Other (9)
Free floating	Thailand Turkey Uganda			
	Australia Canada Chile Japan Mexico Norway Poland Sweden United Kingdom	Somalia United States EMU Austria Belgium Cyprus Estonia Finland France Germany Greece Ireland Italy Latvia Luxembourg Malta Netherlands Portugal Slovak Rep. Slovenia Spain		

Source: IMF, 2014.

The international monetary system and developing countries

The world's international monetary system is governed largely by the **International Monetary Fund (IMF)**, which was established at Bretton Woods in 1944 in the aftermath of the Great Depression of the 1920s and 1930s and in preparation for the postwar peace. There was a fear that the protectionism and beggar-thy-neighbour policies that characterized the interwar period would rear their ugly heads again, to the detriment of the world economy at large, if not all the individual countries within it. Thus, the IMF was originally conceived as an institution for stabilizing the world economy, rather than as an agency for development, providing short-term loans to member countries in temporary balance of payments difficulties. Responsibility for development was given to the IMF's sister institution, the **World Bank**, established at the same time. Because the IMF was not allowed to create money, John Maynard Keynes (one of the architects of the IMF) used to complain (and joke) that his proposal for a bank had become a fund, and what was, in fact, a fund had been called a bank.

Over the years, however, and particularly in recent years, the role of the IMF has changed. It has increasingly become the bank manager of poor countries, and much more of a development agency, advancing longer term loans to cover what are now perceived as longer term structural balance of payments difficulties. The role of the World Bank has also been changing, and now it too provides loans as a means of balance of payments support (the traditional preserve of the IMF), for programmes of structural adjustment (see Chapter 14). In turn, the IMF instituted a Structural

Adjustment Facility in 1986, and an Enhanced Structural Adjustment Facility in 1987 (see below). The roles of the IMF and the World Bank have almost merged, reflecting the fact that the balance of payments is the principal long-run constraint on the growth of output in developing countries.

The IMF and the World Bank also roughly agree on the same policies and reforms that should be applied in developing countries – often referred to as the **Washington Consensus**. The term ‘Washington Consensus’ was originally coined by John Williamson of the Institute for International Economics in 1989 to refer to an agenda for reform in Latin America, which he believed the IMF and the World Bank would endorse (see Williamson 1990, 1993). The reforms quickly came to be seen as a model for the wider developing world. The package of reforms suggested by Williamson comprised the following:

- Fiscal discipline
- Redirection of public expenditure towards education, health and infrastructure investment
- Tax reform – broadening the tax base and cutting marginal tax rates
- Interest rates that are market determined and positive (but moderate) in real terms
- Competitive exchange rates
- Trade liberalization – replacement of quantitative restrictions with low and uniform tariffs
- Openness to foreign direct investment
- Privatization of state enterprises
- Deregulation – abolition of regulations that impede entry or restrict competition, except for those justified on safety, environmental and consumer protection grounds, and prudential oversight of financial institutions
- Legal security for property rights.

The Washington Consensus extols the virtues of the free market and free trade for the achievement of more rapid economic progress (see Taylor, 1997), but Williamson objects to the interpretation of it as ‘neoliberal’, because neoliberalism also embraces a political ideology relating to minimal state interference in economic and social affairs, low tax rates, individualism, and a general indifference to the income distribution produced by market forces.

The wisdom of the Washington Consensus was always a matter of dispute among economists, but its initial appeal did not last long because, in the 1990s, several developing countries that adopted the package of reforms, under pressure from the IMF and the World Bank, suffered severe financial and economic crises, which toppled governments, reduced living standards, and left millions of people worse off. Free-market forces turned out to be as disruptive and destructive as government regulations and controls. Economists now question the pace and sequencing of the deregulation and liberalization of markets, and call for stronger domestic institutions and policies to be put in place before countries open up to floods of imports and capital inflows. The need to mix institution-building with the freeing of markets is sometimes called the **post-Washington Consensus**. However, the ideology and practical policy-making of the IMF and the World Bank have hardly changed.

One country that has resisted the pressure of the Washington Consensus is China. It has forged its own development strategy, the **Beijing Consensus**, which does not allow the economy to be buffeted by the unfettered forces of free-market capitalism, either domestic or international. It is becoming increasingly attractive to other (large) developing countries (e.g. Brazil) looking for an alternative approach to economic policy-making, which puts the needs of people first, not the interests of bankers and international speculators. China’s declared goal is to achieve fast, sustainable growth, combined with equity and poverty reduction. China recognizes that to achieve this requires a degree of economic independence to insulate it from turbulence in the world economy. This makes it cautious about free trade and the free movement of international capital, although not about attracting long-term foreign direct investment. China is fortunate to

be large enough (and stable enough) to go its own way. Many developing countries are either too small, too vulnerable or too unstable to resist the orthodoxy because they are dependent on loan support from the IMF and the World Bank.

How the IMF works

The IMF has three main roles:

1. It oversees the international monetary system and monitors the economic and financial policies of its 189 member countries. As part of this surveillance process, which takes place at the global level and in individual countries, the IMF highlights possible risks to stability and advises on needed policy adjustments.
2. It helps its member countries design economic policies and manage their financial affairs more effectively by strengthening their human and institutional capacity through expert advice and training, which it calls 'capacity development'.
3. It provides loans to member countries experiencing actual or potential balance of payments problems to help them rebuild their international reserves, stabilize their currencies, continue paying for imports, and restore conditions for strong economic growth, while correcting underlying problems.

The IMF is a source of four main forms of financial assistance, or liquidity, to developing countries:

- Drawings from the ordinary facilities provided by the IMF
- Drawings made under special facilities
- Facilities for low-income countries
- The periodic issue of Special Drawing Rights (SDRs).

Members' drawing rights, their share of SDR allocations, and indeed their subscription to the IMF and voting power are all based on **quotas**. Every member must subscribe to the IMF an amount equal to its quota – 25% in the form of reserve assets and the remainder in local currency. Initial quotas are based on a formula relating to the economic circumstances of individual countries, such as living standards, importance in world trade and so on, which are then modified in various ways in the light of the conditions and quotas of other countries. The USA has the largest quota, amounting at present to 83 billion SDRs out of the total value of quota subscriptions of 471 billion SDRs. When countries draw on the IMF, they buy the currency they need with their own currency, and when they repay, they repurchase their own currency with foreign currency acceptable to the IMF. The size of the quotas comes under continual review. The 14th General Review of Quotas took place in 2015.

The IMF may supplement its quota resources by borrowing any country's currency. This was institutionalized by the **General Arrangements to Borrow (GAB)** in January 1962, which was a four-year arrangement concluded with ten industrialized countries. Since then, the GAB has been extended several times. The IMF also borrows from the private capital market and makes bilateral deals with countries.

The IMF also borrows to finance special facilities as a means of recycling the balance of payments surpluses of some member countries. The IMF argues that while it has no desire to supplant ordinary commercial banks in the recycling process, its ability to advocate adjustment policies effectively and convincingly in deficit countries is enhanced by the capacity to make substantial financial resources available to member countries. Thus, while the IMF continues to place reliance on quota subscriptions as the main source of its finance, it is also in the market to borrow. Now that the IMF sees its role as providing larger amounts of finance over longer and longer periods

for countries with chronically weak balance of payments in relation to their growth objectives, it has an ever-growing need for resources.

A country making use of the IMF's resources is generally required to carry out a programme of balance of payments adjustment as a condition of support. This requirement is known as **conditionality** and reflects the IMF principle that financing and adjustment must go hand in hand. What constitutes balance of payments equilibrium is not rigidly defined. It need not mean current account equilibrium, but the measure must be defined free of restrictions on trade and payments, in keeping with the underlying liberal free trade philosophy of the IMF. The enforced programmes of balance of payments adjustment typically consist of currency devaluation and restrictions on government expenditure and the money supply, coupled with the liberalization of trade and capital movements.

These conditionality practices, which were developed during the 1950s and 1960s under pressure from the USA, have been severely criticized (see below) and have undergone continual review. They are harsh, but perhaps less harsh than they were. Countries are encouraged to approach the IMF early before payments problems become acute, and it recognizes the need for a longer adjustment period. When helping countries to design adjustment programmes, the IMF is supposed to have due regard to the socioeconomic and political characteristics of the country concerned (although there is still not much evidence of this). The IMF now recognizes that balance of payments difficulties associated with an acceptable growth of output may have as much to do with the structural characteristics of a country as with relative price distortions and excessive government expenditure. The emphasis has also shifted from demand contraction to supply-side policies to increase the efficiency of resource allocation and supply potential. For a comprehensive review of the evolution of the conditionality practices of the IMF, see Guitian (1982) and Dell (1981).

IMF lending

Table 16.4 shows the IMF's major non-concessional lending facilities, and Table 16.5 shows the IMF's concessional lending facilities for low-income countries. Currently, there are five major non-concessional facilities. First, there is the **Stand-By Arrangement (SBA)**, created in 1952 to provide short- to medium-term assistance to countries with short-term balance of payments difficulties. Normally, certain performance criteria relating to money supply targets and government expenditure must be met before resources are released. A strong programme is required to rectify balance of payments disequilibria, which almost always consists of deflation and depreciation of the exchange rate. Typically, an SBA covers a 12- to 18-month period, and repayments must be made within 3–5 years of each drawing. Countries may draw up to 200% of quota annually and 600% cumulatively.

Second, there is the **Extended Fund Facility (EFF)**, created in 1974 to provide longer term assistance to support countries' structural reforms to address long-term balance of payments difficulties. The repayment schedule is longer, 4–10 years, but the conditions are stringent. The country must provide a detailed statement of policies and measures every 12 months. The resources are provided in instalments, with performance criteria attached. Nonetheless, the introduction of the EFF represented an important and significant shift in emphasis from viewing the balance of payments as a stabilization problem, to recognizing the balance of payments as a fundamental long-term constraint on growth that cannot be rectified in a short period of time by conventional means. Structural change is required.

In the wake of the 2007–09 global financial crisis, the IMF strengthened its lending policies through the creation of three new facilities: the **Flexible Credit Line (FCL)**, the **Precautionary and Liquidity Line (PLL)** and the **Rapid Financing Instrument (RFI)** (see Table 16.4 for details).

Table 16.4 IMF's non-concessional lending facilities

Credit facility (year adopted)	Purpose	Conditions	Access limits	Repayment schedule (years)
CREDIT TRANCHES AND EXTEND FUND FACILITY				
Stand-By Arrangement (SBA) (1952)	Short- to medium-term assistance for countries with short-term balance of payments difficulties	Adopt policies that provide confidence that the member's balance of payments difficulties will be resolved within a reasonable period	Annual: 200% of quota; cumulative: 600% of quota	3½–5
Extended Fund Facility (EFF) (1974) (Extended Arrangements)	Longer term assistance to support members' structural reforms to address long-term balance of payments difficulties	Adopt up to 4-year program, with structural agenda and annual detailed statement of policies for the next 12 months	Annual: 200% of quota; cumulative: 600% of quota	4½–10
Flexible Credit Line (FCL) (2009)	Flexible instrument in the credit tranches to address all balance of payments needs, potential or actual	Very strong ex ante macroeconomic fundamentals, economic policy framework, and policy track record	No preset limit	3½–5
Precautionary and Liquidity Line (PLL) (2011)	Instrument for countries with sound economic fundamentals and policies	Sound policy frameworks, external position, and market access, including financial sector soundness	250% of quota for 6 months; 500% of quota available upon approval of 1- to 2-year arrangements; total of 1,000% of quota after 12 months of satisfactory progress	3½–5
SPECIAL FACILITIES				
Rapid Financing Instrument (RFI) (2011)	Rapid financial assistance to all member countries facing an urgent balance of payments need	Efforts to solve balance of payments difficulties (may include prior actions)	Annual: 50% of quota; cumulative: 100% of quota	3½–5

Source: IMF, 2014.

In addition to the IMF's ordinary lending facilities, there are three special lending facilities for low-income countries: the **Extended Credit Facility (ECF)**, the **Standby Credit Facility (SCF)**, and the **Rapid Credit Facility (RCF)**, all related to protracted balance of payments difficulties (see Table 16.5 for details). Note that the ECF supersedes the Poverty Reduction and Growth Facility, which was set up in 1999 to assist poor countries facing persistent balance of payments problems, and was designed to work alongside the IMF and World Bank's Heavily Indebted Poor Country Initiative (see Chapter 14) for debt relief for poor countries, and requires the preparation of a Poverty Reduction Strategy Paper. This is still a requirement under the EFF.

Total IMF credit outstanding for all 189 IMF members in March 2016 was nearly 55 billion SDRs, having fallen from a peak of 96 billion SDRs in December 2012 in the wake of the world financial crisis.

Table 16.5 IMF concessional lending facilities to low-income countries

	Extended Credit Facility (ECF)	Standby Credit Facility (SCF)	Rapid Credit Facility (RCF)
Objective	Help low-income countries achieve and maintain a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth	Very strong ex ante macroeconomic fundamentals, economic policy framework, and policy track record	Approved access available up front throughout the arrangement period, subject to a midterm review after 1 year
Purpose	Address protracted balance of payments problems	Resolve short-term balance of payments needs	Low-access financing to meet urgent balance of payments needs
Eligibility	Countries eligible under the Poverty Reduction and Growth Trust (PRG1)	Efforts to solve balance of payments difficulties (may include prior actions)	Outright purchases without the need for full-fledged program or reviews
Qualification	Protracted balance of payments problem; actual financing need over the course of the arrangement, though not necessarily when lending is approved or disbursed	Potential (precautionary use) or actual short-term balance of payments need at the time of approval; actual need required for each disbursement	Urgent balance of payments need when upper- credit-tranche (UC1) program is either not feasible or not needed
Poverty Reduction and Growth Strategy	IMF-supported program should be aligned with country-owned poverty-reduction and growth objectives and should aim to support policies that safeguard social and other priority spending		
	Submission of Poverty Reduction Strategy (PRS) document by second review	Submission of PRS document not required; If financing need persists, SCF user would request an ECF with associated PRS documentation requirements	Submission of PRS document not required; move to ECF facilitated in cases of repeated use by preparation of a Poverty Reduction Strategy Paper (PRSP)
Conditionality	UCT; flexibility on adjustment path and timing	UCT; aim to resolve balance of payments need in the short term	No UCT and no conditionality based on ex post review; track record used to qualify for repeat use (except under shocks window)
Access policies	Annual limit of 100% of quota; cumulative limit (net of scheduled repayments) of 300% of quota. Exceptional access: annual limit of 150% of quota; cumulative limit (net of scheduled repayments) of 450% of quota		
	Norms: access declines with total outstanding credit; 120% of quota if outstanding credit is less than 100% of quota; 75%	Sublimits (given lack of UCT conditionality): annual 25% of quota, 100% of quota cumulative (net of	

Table 16.5 IMF concessional lending facilities to low-income countries – *continued*

	Extended Credit Facility (ECF)	Standby Credit Facility (SCF)	Rapid Credit Facility (RCF)
Objective	of quota if outstanding credit is greater than or equal to 100% of quota; SCFs treated as precautionary annual access limit 75% of quota, average annual access limit 50% of quota	scheduled repayments); under the shocks window: 50% annual and 125% cumulative (net of scheduled repayments)	
Financing terms	Interest rate: Zero Repayment terms: 5 ^{1/2} –10 years	Interest rate: 0.25% Repayment terms: 4–8 years Availability fee: 0.15% on available but undrawn amounts under precautionary arrangement	Interest rate: Zero Repayment terms: 5 ^{1/2} –10 years

Source: IMF, 2014.

Other IMF activities

As well as providing finance and loans to member countries, the IMF has a number of other responsibilities connected with the smooth functioning of the world economy, including the surveillance of exchange rates and promoting the health of the world financial system. One of the mandates of the IMF is to monitor the exchange rate policies of countries. Article IV, Section I of the original (1947) IMF Charter states that member countries should ‘avoid manipulating exchange rates ... to prevent effective balance of payments adjustment or to gain an unfair advantage over other members’. By manipulating the exchange rate, the IMF means countries indulging in practices that keep an exchange rate undervalued in order to maintain large balance of payments surpluses. The assessment of exchange rate levels, however, is not easy because an ‘equilibrium’ rate depends on how the internal balance of a country is defined, and what is regarded as the optimal level of international reserves. There are different ‘equilibrium’ exchange rates for different levels of employment and unemployment, different growth rates, and reserves to import ratios. But, the IMF lacks any power to influence the exchange rate policy of countries, except persuasion. The sanction of fining countries in persistent surpluses, which Keynes proposed at Bretton Woods, was never adopted.

Criticisms of the IMF

The policy prescriptions of the IMF in developing countries have been, and still are, based on a blend of finance and adjustment. Few would dispute the need for international institutions to provide finance to ease the burden of balance of payments adjustment. In its adjustment policies, however, the IMF has come in for severe criticism; so much so that it has been described as **anti-developmental**. In its approach to adjustment, the IMF is conditioned by the beliefs and philosophy of the organization itself and the prevailing orthodoxy of neoclassical economic theory. The IMF denies that it has a rigid doctrinaire approach to economic policy, but it

clearly has a particular philosophy based on the Washington Consensus. It is a major bastion of support of an international economic system that prefers capitalism to socialism, favours private investment over public investment, extols the virtues of free trade and the operation of the price mechanism, and encourages the free flow of private capital to and from developing countries. Gore (2000) argues that this consensus that emerged within the IMF (and World Bank) was more than just a paradigm shift from the idea of state-led development to market-oriented policies. There was a deeper shift in the way development problems were perceived in an increasingly globalized world, and the IMF's policies have been a response to these changes in the world economy. The fact remains, however, that a particular orthodoxy has been applied to the vast majority of developing countries as if they were one homogeneous mass and can be properly treated in exactly the same way.

Joseph Stiglitz (2002), formerly a chief economist of the World Bank, has severely criticized the IMF for serving the needs of global finance, rather than the needs of global stability, by encouraging premature internal and external financial liberalization. He has satirized the methods of the IMF by describing what he calls a four-step programme for every country, regardless of circumstances and already 'pre-drafted' by IMF officials before they reach the country, for 'voluntary' signature by the country concerned. No signature, no help. The four core elements of each programme are privatization of state industries, capital market liberalization, market-based pricing, and free trade.

Capital market liberalization has been disastrous for many countries not ready and able to cope with volatile capital inflows and outflows. The IMF has, in fact, admitted that opening economies prematurely to free flows of capital constituted 'an accident waiting to happen', and now concedes that capital controls are justified in some circumstances. The IMF was undoubtedly shaken by the 1997 East Asian crisis, which it did not foresee even though there was a massive build-up of current account deficits and capital had started to flow out of Southeast Asia long before the crisis hit.

Market-based pricing has also been disastrous in many instances, leading to civil unrest. When food and fuel subsidies for the poor were lifted in Indonesia in 1998, the country exploded into riots.

Free trade, we saw in Chapter 15, is not optimal from a development point of view. If imports grow faster than exports, the balance of payments worsens.

The neoliberal, neoclassical approach to economic thinking and policy-making colours, to a large extent, the IMF's diagnosis of balance of payments problems and their appropriate solution. Deficits are invariably seen as related to, or caused by, price uncompetitiveness and excess monetary demand, to be 'cured' by devaluation and demand contraction. But, the IMF still lacks a comprehensive theoretical apparatus to deal with two basic questions regarding devaluation: How is the degree of *overvaluation* of a currency determined? How is the optimal pace of adjustment from the overvalued to the equilibrium rate of exchange decided? In keeping with the IMF's philosophy, devaluation and retrenchment are coupled with other measures that, from a balance of payments point of view, work in the opposite direction – namely the relaxation of foreign exchange controls, the removal of import restrictions, and the dismantling of subsidies and price controls.

Critics of the IMF argue with some justification that there is one law for the poor and another for the rich. While poor countries must remove controls over foreign exchange and imports as a condition of assistance, rich countries continue to impose restrictions on imports from developing countries. To support the liberalization programme, the country then has to depress aggregate demand sufficiently to accommodate devaluation in the attempt to achieve balance of payments

equilibrium, which leads to slow growth and unemployment. The symptoms of balance of payments disequilibrium are tackled, but not the root causes of the perpetual tendency towards disequilibrium. As we argued in Chapter 15, the balance of payments problems of most developing countries must be regarded as primarily *structural* in nature, relating to the characteristics of the goods produced and traded. This implies a very different approach to balance of payments adjustment than one of continual devaluation, demand contraction and dismantling of the public sector. At the very least, it calls for policies – using a judicious mix of subsidies and controls – to alter the *structure* of production.

Another criticism of the IMF is that it ignores 'structural' *surpluses* on the balance of payments – the counterpart of 'structural' deficits – and critics argue that the burden of adjustment ought to be shared more equitably between deficit and surplus countries, instead of the major part of the burden being shouldered by debtor developing countries, as at present. If surplus countries do not attempt to adjust by expanding their own economies, or by appreciating their currencies, they should be penalized, and deficit countries ought to be allowed to discriminate against the goods of these countries. This would be a revival of the idea of 'scarce currencies', and of the right of countries to control imports from 'scarce currency' countries, that is, from those with surpluses.

Critics would also argue that if the IMF is genuinely concerned with development as well as providing balance of payments support, it could distribute all new issues of SDRs to developing countries to spend in developed countries. After all, if the developed countries were not able to earn their reserves by selling goods to developing countries in exchange for SDRs, they would have to earn them in some other way. We shall return to this matter below.

The IMF has become sensitive to some of these criticisms in recent years, particularly to the charge that it is 'anti-developmental'. Along with the World Bank, the IMF now declares itself committed to poverty reduction and allowing countries to 'own' their own policies through the formulation of Poverty Reduction Strategy Papers. Instead of countries having to fulfil a mass of individual conditions for loan support, governments can now specify just a few broad outcomes relating to poverty reduction, health and education. To what extent it will change its attitude to balance of payments difficulties and the need for devaluation and deflation, however, is still an open question.

The IMF also now has an **Independent Evaluation Office (IEO)**, established in 2001, to monitor its lending activities and research the effects of its lending policies. The IEO chose three subjects for its first studies:

- fiscal adjustment in IMF-supported programmes
- the role of the IMF in three capital account crises (Indonesia and Korea, 1997–98 and Brazil, 1998–99)
- prolonged use of IMF resources.

Kenen (2004) surveys the results of the studies so far. On fiscal policy, the IEO criticizes IMF programmes for not paying enough attention to raising income and property taxes, and combating tax evasion, and for focusing too heavily on cutting public employment or capping wages in periods of fiscal crisis. In general, fiscal policy has not been 'too tight', although the fiscal outcome has normally been tighter than forecast. In Korea and Indonesia, however, in 1997–98, there was too much fiscal stringency because the IMF did not foresee the collapse of investment and output, so that IMF policies made the situation worse. The prolonged use of IMF resources has increased in recent years because, as Keynes once said: 'if you owe a bank a little, the bank owns you, but if you owe the bank a lot you own the bank'. The IMF has been reluctant to pull out

of countries in case it doesn't get repaid at all. The evaluation reaches some interesting findings, which have general lessons:

- Excessively detailed conditionality does not appear to be effective.
- Conditionality that is focused on policy rules or procedures, rather than on discretionary one-time actions, seems to be most effective.

The International Financial Institution Advisory Commission, known as the **Meltzer Commission**, appointed by the US Congress, which reported in 2000, recommended that the IMF should withdraw from the development field entirely and concentrate on the role of 'lender of last resort' to emerging economies facing financial crisis. This would be a return to its original function of lending to countries in short-term balance of payments difficulties. Likewise, the World Bank should pare down its activities, lending only to really poor countries, and not to countries able to attract private capital. In line with the focus on poverty reduction, lending should be confined to countries with an income of less than \$4,000 per head with low credit ratings. For the poorest countries, there should be grants not loans. Lending to Asia and Latin America could largely be left to the regional development banks in those regions. In general, there should be a much clearer distinction between the activities of the IMF and the World Bank. This would be a return to the original conception at Bretton Woods that the World Bank would act as the development agency and the IMF would be like a bank to be used in emergencies only, but not get involved in detailed policy-making itself in the countries concerned. A move in this direction would disarm many of the IMF's critics.

The results of IMF programmes

The effects of the IMF's programmes on countries' economic performance have been very mixed. In an early study, Reichmann and Stillson (1978) examined the effects of IMF programmes in developed and developing countries in the period 1963–72, comparing the two years after the implementation of the programme with the two years before. Taking the balance of payments as a whole (current plus capital account), of the 75 cases examined, only 18 showed a statistically significant improvement and 4 showed an actual worsening. In the 29 cases where the inflation rate had exceeded 5% before the programme, it had worsened in 6 cases and in 16 cases there was no significant change. As far as GDP growth is concerned, of the 70 cases examined, the performance had improved in 33 but deteriorated in 28. A study by Donovan (1982) of the non-oil-developing countries for the period 1971–80 revealed a similar pattern: some improvement in the balance of payments, mixed effects on growth and some tendency towards inflation.

Following a major analysis of over 30 IMF stabilization programmes supported by upper-tranche credits between 1964 and 1979, Killick (1984a, 1984b) advocated what he called a 'real economy approach to balance of payments' or 'adjustment with growth', which would be a more flexible supply-oriented approach with demand management subservient.

One of the purposes of the Extended Fund Facility and the (now defunct) Structural Adjustment Facility was to permit the IMF to deal with structural disequilibrium, but as far as the EFF is concerned, the programmes were no different from conventional demand management programmes built around monetary and fiscal contraction coupled with trade liberalization and some production incentives.

In a follow-up study of IMF programmes in developing countries, Killick (1995) criticized the IMF's overreliance on conditionality and performance criteria, which invariably leads to the

breakdown of IMF programmes. To avoid breakdowns and pressure on IMF resources, he calls for the relaxation of standardized reform packages and a greater emphasis on locally initiated programmes of stabilization and reform. Above all, the programmes should set a growth target of at least 1% above population growth, and sufficient financing for this should be mobilized. Killick finds that the main victim of IMF programmes is investment, and that there is no evidence that IMF financing acts as a catalyst for private investment.

Taylor (1988) reports the results of studies of 18 countries, conducted under the auspices of the World Institute for Development Economics Research (WIDER) in Helsinki. The principal finding of the authors of the country studies is that 'past policies could have been designed to better effect, and that programmes of the Fund/Bank type are optimal for neither stabilization nor growth and income redistribution in the Third World'. This is a serious indictment of policy from some of the world's leading development economists. There are alternative programmes to those implemented by the IMF, but they would be more interventionist and more directly concerned with the targets than with the precise instruments. There is a role for selective import controls, export subsidies, multiple exchange rates, low interest rates and so on, but these are all frowned on by the IMF. The IMF conducts its own in-house studies of programmes and is naturally more sanguine, but is conscious that the design of programmes can be improved. In a study of 45 IMF lending arrangements approved between mid-1988 and mid-1991, Schadler (1996) reports striking gains on the external accounts, but virtually no improvement in inflation, investment and growth. Four explanations are given:

- Countries coming to the IMF too late
- Too much emphasis on the external objective of balance of payments equilibrium rather than domestic objectives
- The breaking of monetary targets
- Not enough emphasis on raising domestic saving.

Research on the effect of IMF programmes on the growth of per capita income by Przeworski and Vreeland (2000) and Dreher (2006) shows a negative effect. Dreher's (2006) study examines data for 98 countries over the period 1970–2000 and, overall, finds a negative effect of 1.7 percentage points per annum (on average), although the compliance with conditionality mitigated the negative effect. Dreher's conjecture is that 'the short-term effect of demand compression takes place very quickly, while the compliance measures pick up later adherence to the more structural aspects of policy conditions'.

Special Drawing Rights (SDRs) and developing countries

One possibility for increasing the flow of resources to developing countries is to distribute to them most, if not all, of the saving accruing to developed countries from the issue of costless SDRs as a means of international payment. The IMF established SDRs in July 1969. To date, there have been only four allocations of SDRs: 9.3 billion between 1970 and 1972; 12.1 billion between 1979 and 1981; 161.2 billion in 2009, and a one-off injection of 21.5 billion in the wake of the financial crisis and world economic recession in 2008–09, allocated mainly to low-income countries.

The normal basis of allocation of SDRs between countries is the member countries' quota subscriptions to the IMF. This means that approximately 70% of the new international money created has been distributed to the world's richest countries, while the poorest countries have

received only 30%. If the SDRs had been distributed on a per capita basis, the distribution would have been almost exactly the reverse.

There can be no doubt about the potential benefits of international money, such as SDRs, for the world as a whole, but there are several objections to the present distribution, and reasons to believe that a redistribution of SDRs in favour of developing countries could increase world welfare. First, the balance of payments adjustment costs of developing countries are generally higher than those of developed countries, and this in itself constitutes an economic argument for revising the present allocation rules. But second, SDRs represent a social saving because they are costless to produce (unlike gold), and do not have to be earned by exporting (unlike dollars). The view that the social saving to SDRs should be distributed to the developing countries has spawned several proposals for a so-called **link between development assistance and SDRs**, which would have several advantages:

1. If there was a regular expansion of SDRs a link would provide a useful mechanism by which total development aid could be guaranteed to rise with the long-term growth of world trade and production. At present, there is no guarantee that aid will rise in proportion to world income. Aid programmes are chopped and changed according to the balance of payments situation of donor countries.
2. A link scheme would increase the proportion of total international aid that is untied, and this would not impose any reserve losses on the donor, as when a country unties its aid unilaterally. All donor countries would gain reserves in exchange for the exports they provide to the developing countries.
3. If the link scheme operated through such international financial institutions as the World Bank or one of its affiliates, these multilateral institutions would be provided with a regular flow of resources without the necessity of entering into time-consuming negotiations with national governments.

The historical origin of the link idea can be traced back to Keynes' plan, proposed at Bretton Woods in 1944, for an International Clearing Union (ICU) with the power to issue international money for collectively agreed purposes. The function of the ICU was not only to be a world central bank but also to lend to international organizations pursuing internationally agreed objectives, in particular, at that time, for postwar relief work and the management of international commodities.

The variety of link proposals that have been put forward can be classified into three types: a direct link, an organic link and an inorganic (or indirect, voluntary) link.

As far as a **direct link** is concerned, the simplest method would be to allocate more SDRs directly to developing countries, as was done in 2009. Alternatively, the IMF quotas to developing countries could be increased.

An **organic link** refers to the possibility of channelling SDRs to developing countries via developed countries, development agencies, or both. The direct allocation of SDRs to development agencies probably has the most advantages and the least drawbacks among the organic link proposals. Development agencies would have accounts with the IMF to which SDRs would be credited. The development agencies would then lend in the normal way. When goods were purchased from exporters by developing countries, the IMF would then transfer the SDRs from the account of the development agencies to the account of the exporting country. The country would then pay its exporters in its domestic currency. The scheme has the advantage of being simple and could be introduced with minimal amendments to the IMF Articles of Agreement.

A tied version of the organic link was Scitovsky's (1966) original plan for a new international currency to be issued to deficit countries with unemployed resources, which would relinquish domestic currency in exchange. This could then be lent to developing countries, but could only be spent in the issuing country. This would serve several purposes. It would provide developing countries with unrequited imports at no opportunity cost to developed countries and remedy developed countries' deficits at the same time. This is also a way of eliminating deflationary bias in the world economy.

An **inorganic link** would involve developed countries agreeing to make voluntary contributions to the multilateral aid-giving agencies whenever new SDRs were allocated. The contributions would be in national currencies but would represent a uniform proportion of each contributor's SDR allocation. The drawback of the proposal is its voluntary nature – one or two major countries might not contribute or might make their contribution dependent on their balance of payments. This would introduce a great deal of uncertainty into the scheme. Also, national governments would have to agree appropriations and this would create the same difficulties as regular foreign aid appropriations. There do not seem to be many advantages in an inorganic link.

Several objections have been raised against the link proposals but none is very convincing. Some have argued against the link on the grounds that the creation of reserves should be kept separate from the transfer of real resources. But this has never been the case historically. Resource transfers have always been involved in the acquisition of gold and dollars. Since SDRs save real resources, it is entirely appropriate that, in the process of reserve creation, the saving should be distributed to developing countries.

A second objection to the link is that it would mean the loss of control over the granting and distribution of assistance by national governments. Under the link scheme, the distribution of the burden of assistance would depend on where the SDRs were spent, which, it is argued, could not be accurately forecast. This is a weak argument for two reasons. The same objection may be levelled against *all* forms of untied bilateral aid. There is never an automatic correspondence between the financial burden of aid and the real resource burden of aid. It all depends on whether the national governments that grant aid allow the resources to be transferred, which depends primarily on their policy towards the balance of payments.

A further objection is that the link is likely to be inflationary. It is true that developing countries will tend to spend new international money rather than add to their reserves, but whether or not the resulting claims on developed countries are inflationary will depend on whether developed countries are willing to release resources to the extent of the claims on them. In practice, SDRs could be less inflationary than the dollar standard by instituting multilateral control over international liquidity rather than unilateral control by the USA, which, because of the need for dollars, has not been subject to the anti-inflationary discipline that is normally present in other countries.

A final objection is that development assistance is not likely to increase under the link because governments will cut down on their normal budgetary aid appropriations. Critics argue that it is highly unlikely that developed countries would be willing to give extra aid through the link but not in other forms. This objection can also be challenged. First, the reserve effects of the two forms of assistance are not the same. Conventional aid worsens the donor's balance of payments, whereas the link scheme would improve the balance of payments of countries where SDRs were spent and thus improve the reserve position. Second, governments often wish to provide aid for specific purposes and this desire would not be undermined by a link. Moreover, since it is difficult

for a country to know how much aid it is providing through the link, it would be difficult for a country to offset it. The link deserves much more consideration in international monetary circles than it has received to date. To paraphrase Pirandello, if ever there were an instrument in search of a policy, it is SDRs.

Summary

- A major constraint on the growth of output in many developing countries is a deficit on the current account of the balance of payments, or, in other words, a shortage of foreign exchange to pay for imports.
- The International Monetary Fund (IMF) was established at the Bretton Woods conference in 1944 to give financial support to countries in temporary balance of payments difficulties, but the deficits of developing countries are structural and long term, relating to the nature of the goods they export and import.
- A country's growth rate consistent with balance of payments equilibrium on current account depends on changes in the real exchange rate, the price elasticities of demand for exports and imports, the growth of world income, and the income elasticity of demand for exports and imports.
- If the real exchange rate is constant over time, the long-run growth of GDP can be approximated by the ratio of the growth of export volume and the income elasticity of demand for imports.
- Capital inflows can lift a balance of payments constraint on growth, but only by a small amount for realistic values of the sustainable ratio of deficits (or international debt) to GDP.
- Currency depreciation needs to be continuous to raise a country's growth rate permanently consistent with balance of payments equilibrium, but currency depreciation can be very inflationary.
- No single exchange rate regime can be prescribed for all developing countries. Each country needs to choose its own regime consistent with other economic objectives.
- The IMF has many lending facilities, but access is mainly related to the size of a country's quota with the IMF, not to the scale of difficulties confronting the country.
- IMF conditionality has been severely criticized as deflationary, and insensitive to the circumstances and needs of countries. The results of IMF policies have been disappointing.
- Special Drawing Rights (SDRs) could be distributed to developing countries as a means of financial support, to be spent in developed countries. This would increase developed countries' reserves and transfer resources to developing countries.

Chapter 16

Discussion questions

1. What factors determine the demand for a country's exports and imports?
2. Can the devaluation of a country's currency guarantee balance of payments equilibrium on the current account?
3. What factors determine the income elasticity of demand for a country's exports?
4. Why are developing countries more prone to balance of payments disequilibrium than developed countries?

Chapter 16**Discussion questions – continued**

5. What do you understand by the IMF's 'supply-side approach to devaluation' in developing countries?
6. What factors need to be taken into account in choosing a country's exchange rate regime?
7. What are the lessons of the financial crisis in Southeast Asia in 1997?
8. How do the ordinary and special facilities of the IMF work? What do you understand by 'conditionality'?
9. What criticisms have been levelled against the IMF in its policies of support to developing countries?
10. What have been the effects of IMF policies in developing countries?
11. How could SDRs be used simultaneously as an instrument of aid to developing countries and as a means of employment creation in developed countries?

Websites on balance of payments and IMF

International Monetary Fund www.imf.org

UNCTAD Handbook of Statistics <http://unctad.org/en/Pages/Publications/Handbook-of-Statistics.aspx>

UN Comtrade comtrade.un.org