Escola de Economia de São Paulo

FGV EESP

Levy Economics Institute of Bard College

International Financial System Reform and Developing countries

Jan Kregel

Director of Research, Levy Economics Institute of Bard College,
Professor of Development Finance,
Ragnar Nurkse School of Innovation and Governance,
Tallinn Technological University, Estonia

Graduate Programs in Economic Theory and Policy
Levy Economics Institute of Bard College

Ragnar Nurkse Department of Innovation and Governance

The Seventh Latin American Advanced Programme on Rethinking Macro and Development Economics,
LAPORDE
Hosted by São Paulo School of Economics - Fundação Getulio Vargas
São Paulo, Brazil, 8 – 12 January 2018

International Financial Reconstruction and Development

- **Crib Notes**

- Bretton Woods Post-War Financial Architecture Presumes
  - External Equilibrium in balance on average over time for all countries
  - Single Exchange Rates
  - US dollar as Peg or Settlement currency for current account and capital account
- All Three Contradict the Needs of Developing Countries
- Can we formulate a Development Friendly, Stable International Payments System?

International Financial Reconstruction and Development

- Conflicting Objectives:
- Bretton Woods and Exchange rate Stability
- Mainstream Development policy, net transfers of resources and Aid flows

Bretton Woods and Financial Stability

- The main objective of the post-war architecture governing trade and finance was to carve out a system in which exchange rates would not impact relative international competitiveness and trade flows
- But, stability of exchange rates implied current account positions amongst members of the system, in the absence of autonomous capital flows, would be roughly in balance over time.
- **The Bretton Woods system could just as easily been represented as one in which external balances were in equilibrium over time as one in which exchange rates were stable**.

Keeping External Balance and Exchange Stability

- To ensure stability a deficit country would generate an external surplus via domestic policies to:
- Reduce “absorption” – that is a reduce income and employment to reduce imports,
- Produce “expenditure switching” via adjustment of domestic wages and prices.
- If this failed a “structural disequilibrium” required an exchange rate adjustment
- Access to IMF funding to support the new rate came with policy “conditionality”, to ensure that the loan could be repaid.
- The corollary of the stable exchange rate and external equilibrium over time was thus a broad similarity in the relative growth rates of all members of the system.

Mainstream Policy Inconsistent with Bretton Woods Architecture !

- Bretton Woods based on exchange rate stability, negligible capital flows and absence of permanent external disequilibrium, i.e. on average external accounts in balance
- But External finance approach required developed country capital outflows to developing countries
- And developing countries balance of payments deficits corresponding to the industrial imports from developed countries.
- If international financial stability required stable exchange rates, imbalances would be limited by conditions of developed country financial stability, not the development needs of developing countries.
- Indeed, the adjustment policies required to preserve exchange stability were designed to constrain developing countries expansion because of asymmetric adjustment.

Exchange rate Stability and External Balances

- The presumption of external equilibrium was not the only component of cognitive dissonance between development policies and international financial stability.
- When internal adjustment policies to restrict domestic expansion required by IMF conditionality were unable to produce a reversal of external disequilibrium, countries were required to introduce a currency realignment.
- The efficacy of devaluation to produce external balance was already known to require very precise elasticity conditions summarised in the Marshall-Lerner conditions.
  - **(NB: these were derived from a departure from an initial state of external balance: NOT DISEQUILIBRIUM!)**
- It was not obvious that these conditions applied to developed countries' export structure
- Whether they would be satisfied in developing countries was never explicitly considered.
- There was no guarantee that that they would be met,
- much of Prebisch's discussion of negative impact of the declining terms of trade are couched in terms of the impossibility for developing countries to meet those elasticity conditions.

International Financial Stability v. Economic Development

- The Bretton Woods financial system was thus designed on the presumption of external equilibrium prevailing on average across member states,
- Persistent deficit countries were responsible for external adjustment through internal fiscal policies (reduce absorption),
- When insufficient to restore equilibrium, exchange rate depreciation reinforced contractionary fiscal policies (expenditure switching).
- At the same time, international development policy was formulated on the assumption of sustained surpluses (0.7% of GDP) and deficits between developed and developing countries
- And skepticism concerning exchange rate adjustment as a measure to influence external balances.

External Accounts and Aid Flows

- The Bretton Woods system appears a perfectly rational solution for relatively equally developed countries starting from a position of equilibrium.
- What was not noticed at the time was the impact of this system on the developing countries.
- The solution to what was considered to be the fundamental obstacle to their successful development: the generation of sufficient domestic saving required to finance their own development.
- The obvious solution was the high savings rates in developed countries, and the international transfers of these savings from developed to developing countries.

Foreign Aid Flows = External Disequilibrium

- But, not only did this approach to assistance for developing countries produce a contradiction in the approach to capital flows implicit in the definition of international financial stability, it also applied to official development assistance.
- Whether in the form of capital flows or ODA, developing countries would have persistent current account deficits, which was also counter to the implicit framework of Bretton Woods.
- But, when the development financing flows were on a non-concessional or private market basis, developing countries would face accumulating debt service burdens in foreign currency, and this would add to their accumulating external imbalances, driving them farther from the accepted Bretton Woods equilibrium

Post-Bretton Woods Equilibrium: Debt Sustainability Replaces Stable Exchange Rates

- The decision to abandon currency stability should have eliminated the hold of the external equilibrium assumption on national development strategies (and indeed it eliminated the very raison d'être of the IMF).
- Paradoxically, however, it was at this point that the multilateral financial institutions emerged from the dead and managed to expand their influence to developing countries, the developed countries no longer having any need for balance of payments support.

Conditionality Survives Death of Stable Rates

- The persistence of influence of macro conditionality contained in MFI support for developing countries arose from the increase in unsustainable debt accumulations in both middle income and the least developed economies.
- For the first, the problem resulted from the reliance on external capital flows to finance external imbalances.
- For the second, it arose from official assistance flows
- When these flows collapsed in financial crisis the IMF was called in, not so much to provide financial support, as to provide a good housekeeping seal of approval in the form of a structural adjustment program based on the traditional conditionalities meant to encourage the return of private finance to the country in difficulty.

Private Market Capital Flows = Debt

- The rapid increase of private flows following the collapse of stable exchange rates allowed imbalances to increase without limit as long as foreign lenders were happy to continue investing.
- **Thus rise of international capital flows allowed the IMF to return as the break on development strategies even in the absence of the imposed equilibrium of external accounts.**
- This suggests limited private capital market intermediation of international capital flows was a more important element of the Bretton Woods system than the imposition of external equilibrium to ensure exchange rate stability.

HIPC, PRGF, PRSP

- As part of an attempt to maintain relevance after the demise of its mandate to maintain exchange rate stability the MFIs moved to provide increasing support to developing countries.
- Traditional conditionality macro policies had not provided support for the development process;
- This led to a change in policy emphasis,
  - “Get prices right” by recommending reduction in the role of the state and more market-based activities
  - Introduce market “institutions” remedy the failure of “good governance” believed a major cause of the failure of these policies.
- Thus the IMF created the PRGF's to provide funding for the least developed countries, as well as initiating the Highly Indebted Poor Country (HIPC) initiative to provide debt relief.

More Good Housekeeping Conditionality

- But just as the IMF had provided conditionality to exchange rate programs to ensure repayment of bridge loans under Bretton Woods, it now sought to insure that debt relief funds were directed to poverty reduction and were motivated by domestic ownership through the inclusion of Poverty Reduction Strategy Papers (PRSP) that were meant to involve domestic stakeholders in the design of the specific country programs that would be implemented to promote economic growth and reduce poverty.

Making Austerity Development Friendly

- Thus, the HIPC initiative was created to provide debt relief, but also to ensure that debt stability was maintained, and this was insured through policy conditionality.
- While the degree of stakeholder participation in this process has been sharply criticized,:
- "The IMF appears to believe that participation will not challenge programme content, i.e. it will not lead to radically different programmes being formulated, it will simply give civil society a better understanding of why "IMF-style" reforms are necessary and thus ownership of them.
- The ABC of the PRSP 14 June 2000 | Briefing An introduction to the new Bank and Fund Poverty Reduction Strategy Papers by Angela Wood April 2000 http://www.brettonwoodsproject.org/2000/06/art-15882/#13

Macro Conditionality Survived in PRSPs

- “the macro-economic and structural reform policy contents of the 30 completed PRSPs … [which] reveals that there is no fundamental departure from the kind of policy advice provided under earlier structural adjustment programmes.
- Current policies contain all the elements of the first generation of policy reforms designed to promote the role of the market and ‘get the prices right’, and share a similar format and content involving all of the following: reforms: financial and trade liberalisation; privatisation; public sector reform; sectoral policies (e.g., infrastructure, energy and manufacturing); and social sector reform.
- With regards to fiscal and monetary matters, the emphasis is still on maintaining ‘current-account and fiscal balances consistent with low and declining debt levels; inflation in the low single digits; and rising per capita GDP’ … .
- Tight monetary and fiscal policies to control inflation and budget deficits are proposed, along with tax and custom reforms to increase revenues, and a flexible exchange rate or movement towards one (unless part of a monetary union).”
  - QEH Working Paper Series QEHWPS108 Working Paper Number 108 Do PRSPs empower poor countries and disempower the World Bank, or is it the other way round? Frances Stewart and Michael Wang

Macro Policy Conditionality and Control of Development Assistance

- What was not initially recognized was the impact of these macro policies on targeted development assistance directed to specific development objectives such as those represented in the UN Millennium Development Goals and many developed country official development agencies.
- Millennium Project Report notes "IMF program design has paid almost no systematic attention to the [Millennium Development] goals when considering a country's budget or macroeconomic framework.
- In the vast number of country programmes supported by the IMF since the adoption of the goals, there has been almost no discussion about whether the plans are consistent with achieving them …
- In its country-level advisory work, the UN Millennium Project has found that multilateral and bilateral institutions have not encouraged countries to take the Millennium Development Goals seriously as operational objectives.
- Many low income countries have already designed plans to scale-up their sector strategies, but due to [overall national] budget constraints could not implement them. In other cases, countries are advised to not even consider such scaled-up plans." (Rowden, 178)
  - Rick Rowden. The Deadly Ideas of Neoliberalism: How the IMF has Undermined Public Health and the Fight Against AIDS, Zed Books, 2009

Conditions on Debt Relief Limit Aid Flows

- Stephen Lewis, former UN Special Envoy for HIV / AIDS in Africa, was especially incensed about the budget cutbacks demanded of Zambia by the IMF as a precondition for benefiting from a partial debt-relief programme, and issued a statement following the July 2004 G8 summit.
- Lewis noted that in Zambia the debt relief deal was conditioned on its compliance with strict fiscal and monetary policy targets, and 'the imposed [IMF] macroeconomic policy means that the Ministry of Health can hire no more staff, and fully twenty per cent of the municipal districts have no doctors and no nurses'.
- Lewis explained, 'The Government urgently wants to confront the pandemic, but it cannot do so with its financial policy and planning in a straitjacket … The Board of the IMF must come to realize that rigid macroeconomic conditionality is putting Zambia at risk … I have argued before in cases involving the IMF, and I argue again that it has failed to grasp the demonic force of the human and economic carnage caused by HIV and AIDS' (Lewis 2004).

Development Assistance versus Good Macro Stability

- In summary, any financial transfer to finance a particular development objective will run counter to fiscal targets, money supply targets, inflation targets or government employment targets imposed by macro conditionality. This problem persists even when aid flows are made in terms of generic budgetary transfers which are then deliberated by national parliamentary or congressional budget decisions since those decisions are subject to the conditions set in MFI support programs for debt reduction or financial and economic stability.

External Adjustment and External Debt

- That the visions of the post war financial system and development financing were inconsistent does not appear to have occurred to either the IMF or the IBRD or the UN, responsible respectively for exchange rate stability and economic development.
- Prebisch’s centre-periphery concerns can be seen as a recognition of this inconsistency
- The emergence of the Washington Consensus can be seen as a resolution of this cognitive dissonance in official policy by rejecting the need for any special conditions and policies for developing countries.
- This internal inconsistency masked another major problem for developing countries: the impact of international debt on external balances.
- Over time capital flows generate debt service flows that increase the factor services balances and aggravate current account imbalances, which is incompatible with the stability of the international system conceived at Bretton Woods.
- See DOMAR Condition

Exchange rates, external adjustment and External debt

- The “Traditional” Approach to Exchange Rates and Exchange Rate adjustment
- The Analysis of the impact of rising external debt due to external financing of development on the external balance

Exchange rates and Early Development Policy

- Development Pioneers recognised the conflict between the exchange rate appropriate to support of the export of manufactures and that determined by the exports of the primary sector.
- For Prebisch the problem was to create manufacturing exports that could compete in foreign markets, whether or not developed countries were willing to expand their purchases of developing country manufactures.
- To “earn their way to development” not “borrow their way to development”
- Today the question is to defend existing domestic industry and to attempt to expand it.

Diamand on Exchange Rates Development

Diamand: an "unbalanced productive structure" (UPS) results from industrialisation strategy.

- The developing industrial sector: lower productivity than in traditional primary production
- And lower productivity than in developed countries.

- Manufacturing exports will have higher prices than prevail in international export markets.
- Since exchange rates are primarily determined by exports of the more productive primary sector, manufactured exports will be doubly disadvantaged as the overvaluation of the exchange rate reinforces the international divergence in domestic productivity.
- The result is an UPS in which two sectors with very different productivities co-exist: a "less dynamic primary sector which works at international prices and exports, and the protected and more dynamic industrial sector which works at prices higher than international ones and, unless it is given special industrial exchange rates for export, produces only for domestic consumption." (Diamand, 1978, 25)

Kaldor on Exchange Rates for Development

- Kaldor adopted a similar approach to industrialization. Also for Kaldor the basic problem was an inability to produce manufactured goods at levels of costs and productivity that would allow them to be competitive in international markets.
- “When import requirements exceed the capacity to export on account of high domestic costs, … [t] his is because the exchange rate which would make it possible for an under-developed country to develop export markets in manufactured products would mean a considerable under-valuation of its currency in terms of primary commodities.”

Exchange rates and Industrialisation

- Since foreign savings are not the problem, Diamand argues: “countries whose primary production is faced with limitations by world demand should ... concentrate upon industrial exports. ... they must take into account that obstacles to these exports are ... in the pattern of exchange rates habitually used by them.”(Ibid., 30)
- Diamand offers an additional explanation to the lack of foreign demand for exports for the failure of rising industrial productivity to pass through to higher demand and domestic wages: the failure of the exchange rate to offset the high costs of production of the industrial sector.

Exchange Rate Policy for Industrialising Development

- Instead of operating on the overall exchange rate, “The first measure should thus consist in restructuring the industrial exchange rates for exports. …
- we would **have two basic exchange rates**. The nominal rate {representing a more expensive dollar} ... for financial transactions, industrial exports and, with the corresponding import duties (much lower than in the conventional system), also for imports.
- On the other hand, we would have the primary exchange rate for {primary goods} exports, determined by the nominal rate less export duties. This reform would bring the nominal exchange rate substantially closer to the structure of industrial costs and would improve the possibility to export manufactured goods.
- Another alternative or complementary procedure is **to build up a de facto exchange system for exports with tax reimbursements and other fiscal stimuli.** ” (Ibid., 31)
- IMF forbids the former, the WTO forbids the latter

Exchange Rate Policy for Industrial Development

- Kaldor reaches the same conclusion, that "there is no single rate of exchange which is capable... of securing equilibrium between domestic costs of production and the prices, or the level of costs, in foreign markets"

- Similar to Diamand "There is no way out of this dilemma except by **some system of dual exchange rates, or some system of combined taxes and subsidies which produce the same effect as dual exchange rates.**" (p. 188)

Why Exchange Depreciation doesn't Work

- Kaldor notes that while a developing countries “shortfall of exports is generally taken as evidence of over-valuation of the currency. ... it is essential to understand that that it is not the kind of over-valuation that could be ‘cured’ by any uniform adjustment of the exchange rate.”
- Since primary commodities form the great bulk of its exports ”the rise in export proceeds in the primary sector which follows a devaluation tends to generate an inflation in domestic costs and prices that soon neutralises any initially beneficial effects on the export costs of manufacturers. ... the rise in the domestic price of export crops is bound, sooner or later, to lead to a corresponding rise in the local prices of food.
- And since, at the levels of income characteristic of under-developed countries, money wages in industry will be closely correlated to the price of food, a rise in earnings from primary exports will tend to bring about a corresponding advance in the level of money costs in manufacturing production.” (1964, p. 186-7)

IMF exchange rate policy

- Kaldor notes, “the periodic efforts of ... the I.M.F. to secure an alleviation of the balance of payments problems of particular under-developed countries by the introduction of more “realistic” exchange rates, ... have proved so misguided.
- In most of these cases ... devaluation has been followed by a new wave of inflation which has swallowed up the stimulus to exports afforded by the devaluation, within a relative short period.
- The diagnosis that has led to such recommendations has been based **on the false analogy from the situation of industrialised countries** whose export prices are cost-determined to that of primary producers whose export costs are price-determined.”

IMF and Alternative Exchange Rate Policy (Diamand)

- The implementation of similar policies in some developing countries has been "ad hoc and improvised" "arrived at under the pressure of circumstances, not within the framework of an integrating paradigm...adopted without conviction, badly quantified and incoherent, these measures do not suffice to counteract the basic trend towards foreign deficit and indebtedness, that leads to the necessity of a continuing foreign aid, either as a refinancing operation or as new loans."
- As a result countries have been for forced to appeal for financing to the IMF which conditions "assistance to the adoption of…well-known IMF-type stabilization plans: devaluation,…monetary restriction,… the elimination of the budget deficits financed by monetary issue. …wage-freeze,… rebates in tariff protection, removal of exchange controls, the dismantling of multiple exchange rates, etc."

IMF single Exchange rate policy

- The result is the imposition of exchange rate policy that prevents a country from earning its way out of the payments imbalance and imposes “the return to a single exchange rate aim[ed] at stimulating efficiency; finally, exchange freedom is aimed at restoring confidence and at promoting loans and investments from abroad.”
- From the point of view of Diamand’s “corrected conceptual prism, devaluation means greater incentives for the traditional primary exporting sector to the detriment of wages and other urban incomes. Monetary restriction is aimed at inducing recession.
- The plan is called a ‘stabilization’ plan but its first visible effect is a heavy inflationary impact as a result of devaluation with which the word ‘stabilization’ gets a somewhat ironic undertone. … On the other hand, the ‘efficientist’ measures, consisting of lower tariff protection and a unified exchange structure, not only block the way for all the rational solutions outlined before but also contribute to increase the proportion of imports in the GNP and to discourage even those industrial exports which could have opened their way to foreign markets, The result is a further aggravation of the external bottleneck.”

How do we get out of this mess?

"in the education and training of macro-economists there is an implicit assumption either of a balance of payments equilibrium, or of a temporary disequilibrium, which can easily be solved by the adequate management of exchange rates." (Diamand, 49)

- Thus recommendations of Diamand, Kaldor and others for the problem of competitive exports of manufactures from developing countries have never been implemented, aside from the hesitant and half-hearted attempts driven by emergency conditions noted by DIamand.
- European countries practiced capital controls and/or dual exchange rates until the late 1980s with relative success.

It has been argued that exchange rate differentiation would be too difficult to implement, similar arguments are made about financial transactions taxes: If the technical capacity to impose effective financial transactions taxes exists, then it should also make possible dual exchange rate regimes.

- The impact on developing countries would be appreciably more positive that any transfer of resources generated by the transactions tax. And more importantly, it would allow developing countries to "earn" their development finance, rather than being dependent on external finance or charity.

Reforming the International Financial System

- Exchange Rates and Capital Flows in Keynes's *Treatise on Money*

Keynes's Treatise on Money

- In *A Treatise on Money* Volume II – the *Applied Theory of Money* Keynes makes a detailed analysis of financial globalization (what we now call financialization)
- Open International Financial Markets implied:
  - Uniform rates of interest in all countries
  - Loss of "national policy autonomy" to counter volatility of domestic investment and support full employment

Globalisation Reduces National Policy Autonomy

- Chapter 36 of the *Treatise* is called “**National Policy Autonomy**”
- He notes the conflict between free international investment flows and policy to offset the impact on the economy of the cyclical behaviour of domestic investment decisions.
- Today the United Nations talks about national “**policy space**” for developing countries

Keynes had already warned about the false illusion of externally borrowed National Policy Space

- A single international monetary standard requires the Central Bank to relinquish control over domestic interest rates
- This implies a uniform rate of interest across countries.
- Any attempt to use interest rates to offset domestic fluctuations in investment would then create interest rate differentials and international capital flows that would eventually undermine the country’s commitment to the international standard.
- To resolve this policy conflict Keynes suggests the **control of net capital flows** -- the foreign capital balance.

Long-term Capital Flow Controls

- Keynes recommends formal controls over long term capital flows.
- He notes that most countries have always had registration requirements for capital issues in their own markets and that these could be expanded internationally.
- He also suggests a tax on purchase of foreign securities not listed in the UK market of 10 per cent.

Short-term Capital Flow Controls

- To influence short-term flows
  - he recommends a dual rate structure that differentiates between financial flows and trade finance, given preference to the later.
  - He also recommends a more flexible exchange rate structure through variation in the rates at which the Central Bank's bid and offer rates within the gold points
  - He also recommends the active use of intervention in the forward market, a suggestion that was first made in the Tract, to set short-term interest rates on short term capital transactions.
- **Keynes concludes that Central Banks should use bank rate, the forward rate and flexibility in its bid and offer rates to influence short-term flows.**

The Ideal International Financial System

- However, he notes that an ideal system would have **flexible exchange rates**
- From the time of the *Tract on Monetary Reform* Keynes argued that a flexible exchange rate system was preferable to a fixed rate system as long as there was a **forward foreign exchange market** in which traders could cover their exchange risks.
- This is basically the same position that was incorporated in the proposal for the Clearing Union and the position that he took to the Bretton Woods Negotiations in 1944.

Implications of Keynes' Analysis for "National Policy Space"

- The most important point of Keynes's analysis of these issues for current conditions is his implicit acceptance of the position that dominated pre-war thinking on these issues –

External capital flows determine domestic conditions and trade flows, rather than the other way around

Again Keynes in the *Treatise*

- The belief in an extreme mobility of international lending and a policy of unmitigated laissez-faire towards foreign loans … has been based, … on too simple a view of the causal relations between foreign lending and foreign investment.
- Because … net foreign lending and net foreign investment must always exactly balance, it is been assumed that no serious problem presents itself.
- Since lending and investment must be equal, an increase of lending must cause an increase of investment … and a decrease of lending must cause a decrease of investment; …
- Indeed, the argument sometimes goes further, and -- instead of being limited to net foreign lending -- even maintains that the making of an individual foreign loan has in itself the effect of increasing our exports.
- **All this, however, neglects the painful, and perhaps violent, reactions of the mechanism which has to be brought into play in order to force net foreign lending and net foreign investment into equality.**

More Keynes

- “I do not know why this should not be considered obvious.
- If English investors, not liking the outlook at home, fearing labor disputes or nervous about a change of government, begin to buy more American securities than before, why should it be supposed that this will be naturally balanced by increased British exports? For, of course, it will not. It will, in the first instance, set up a serious instability of the domestic credit system -- the ultimate working out of which it is difficult or impossible to predict.
- Or, if American investors take a fancy to British ordinary shares, is this going, in any direct way, to decrease British exports?”

Keynes's Alternative

- The solution is not a replacement for the $
  - SDR will not change this – it just replaces gold, or the dollar
- Solution: No international currency
  - Clearing Union: Unit of Account for clearing balances
  - Automatic financing of deficits by surplus countries
  - Managed External Adjustment – not market, not financial crisis
- The Developing Countries could introduce a Regional Clearing Union

Graduate Programs in
Economic Theory and Policy

Levy Economics Institute
of Bard College

www.levyinstitute.org