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The LDCs in the 1982 International Economy: Two Comments

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The following comments were made at two conferences sponsored by the Institute for International Economics of Washington D.C. The first conference dealt with the topic of IMF conditionality, and was held on March 24-26, 1982. The second discussed issues raised by the GATT Ministerial meeting scheduled for October 1982, and was held on June 23-25, 1982. While the comments make references to papers which will eventually be published by the Institute for International Economics, they are reasonably self-contained, and may be of some interest to those following the 1982 turbulence in the International economy.

I. The LDCs and the IMF

Two strands are running through our discussions which should be kept distinct. One refers to the "correct" macroeconomics one should use when giving policy advice to different species of economies. Another is the proper role for the IMF, and the optimum conditionality for its lending. Perhaps the following mental experiment will help to delineate the two strands: would one's view of the proper role for the Fund change depending on whether its Managing Director were Arnold Harberger or Lance Taylor? Mine would not. Others may prefer a more or less interventionist (paternalistic) IMF depending on whether they like the prevailing macroeconomics at that Institution. So before commenting briefly on the Western Hemisphere papers, I would like to discuss possible Fund roles, and argue for a modest one which would be, on the whole, independent of fashions in macroeconomics.

The purposes of the IMF could include:

A. Overseer of International macroeconomic stability, warning countries of threats of slump and inflation, of excessive or insufficient national and International liquidity, and engaging in countercyclical lending;
B. Promoter of trade 1iberalization;
C. Overseer of international financial markets, a role which could be limited to encouraging freer capital flows and harmonizing Central Bank regulations over them, or extend to the "planning", jointly with private and public banks, of international capital movements;
D. Supplier of short-term credit, at financial charge more favourable than going market rates, to countries with temporary balance of payments difficulties;
E. Dispenser of advice on banking organization, central bank regulation, debt management, and other economic policies;
F. Overseer of exchange rates.

Both International economic conditions and the "clients" of the Fund have changed considerably since the 1940s, influencing both the demand for and supply of its Services. The international capital market of the 1970s and 1980s, to give the most dramatic example of changed circumstances, has provided an environment not contemplated by those meeting in Bretton Woods in 1944. And it is a safe bet that the name Zaire meant nothing to at least 90 percent of those delegates.

A first group of today's IMF members, more patrons than clients, include the economically healthier industrial countries, such as France, Germany, Japan and United States. These and other industrialized countries have a number of favourite for a pre-empting possible Funds roles listed above. Thus, the OECD, summit meetings, and other *ad hoc* arrangements, excluding Third World and Socialist countries, handle the major tasks listed under item A. The more international GATT is in charge of item B, and one has to strain to argue that item B should be a major responsibility of the IMF. The founding fathers of the Fund did perceive that international financial turbulence contributed to the decline of international trade during the 1930s, so the maintenance of financial and exchange rate orderliness was deemed to promote trade liberalization. But to argue that Keynes, White, *et.al.*, charged the IMF with the task of seeking Free Trade is silly. There are many things wrong with the GATT today, but they will not be corrected by making the IMF its militant vanguard.

The Bank for International Settlements handles for the industrialized countries the more modest tasks listed under item C. The stronger industrialized countries do not see themselves on the demand side for possible Fund Services listed under items D and E, leaving F as their major interest for an IMF presence, beyond their creditor interest in the more ambitious tasks listed under item C.

The economically weaker industrial democracies remain potential clients for IMF Services listed under items D and E. Their use of the Fund as not just a provider of short-term credit but also as a specialized consultant is due not to their lack of technical expertise, but to the hope that an outside consultant may play a catalytic role in reaching a consensus among conflicting domestic groups. Apparently the IMF has been successful in playing this role in countries such as Italy and Britain, suggesting that for the catalyst to work one needs a home-country chemistry involving a good deal of free discussion and open political debate, removing the mists of suspicion around the presence of an outside consultant (a point suggested to me by Winston Fritsch). If this conjecture is correct, the IMF catalytic role could also be useful for another rather small group of clients, i.e., less developed countries with relatively open political systems. Costa Rica and India come to mind in this context.

Semi-industrialized countries whose past relations with the Fund have been sticky and which may be attempting a transition toward a more open polity under authoritarian tutelage are unlikely to want the IMF's Services under either D or E. As policy autonomy for those countries is enhanced by an unregulated international capital market, they will be suspicious of a possible Fund role as described by item C. Brazil is the archetype of such reluctant clients.

Under the circumstances of the 1980s, and given past history, the steadiest and largest group of Fund clients for Services under items B, D, E and F is likely to be drawn from the economically weakest and most authoritarian developing countries. Little wonder, then, that during 1979-80 efforts were made by the Fund to broaden its appeal to other types of potential clients, such as India.

Finally, among the list of potential clients, one has OPEC nations with persistent surpluses, and some socialist countries. The former, together with other major creditors, have an interest in Services under item C and also under item F. The latter appear to view IMF membership mainly as a stepping-stone toward World Bank membership and also, in ironic contrast with much of the Third World, as a symbol of independence.

The Fund is a supplier of short-term credit at financial charge more favourable than those of loans available from private lenders, who are concerned about sovereign and other risks relevant for private agents. In distributing the limited pool of such credit, it is allocating the real resources from the rest of the world. This provides the fundamental justification for some form of non-price rationing, and therefore conditionality. The international community represented by the IMF has the right to expect when the loan is made that the chances of repayment on time are high. In general equilibrium everything depends on everything else, but how much do prices for public utilities, food subsidies or agricultural credit have to do with expected balance of payments deficits or surpluses? It is the expected balance of payments situation that will determine the chance of repayment of the IMF loan, and balance of payments targets may be achieved using a large number of instruments, which one may regard as more or less efficacious or efficient. It is the business of the Fund to insist on balance of payments targets consistent with loan repayments, to closely monitor performance in this area, and to suspend credit to countries which do not repay promptly without good reason, such as unexpected exogenous shocks. It is *not* the business of the IMF to make loans conditional on policies whose connection to the balance of payments in the short or even medium run is tenuous. It was a brilliant administrative stroke for the IMF staff to develop “the monetary approach to the balance of payments” during the 1950s, allowing the translation of balance of payments targets into those involving domestic credit, but the assumptions needed for such a translation cannot be sustained for all countries at all times.

Given the present lack of consensus on “correct” macroeconomics, not just among academics but also among major Fund patrons (contrast macroeconomic policy in France and the United States), the case for IMF conditionality focused narrowly on balance of payments targets is strengthened. It is true that observed performance in the balance of payments is the result both of domestic policies and factors beyond the country’s control. Yet a number of indicators, such as staple prices and market shares, could be used to evaluate performance, and failures to meet agreed targets. Note that the compensatory facilities of the IMF have accumulated experience in this area.

Focusing on balance of payments targets would remove IMF conditionality from the more political aspects of short run macroeconomic policy making. Countries which feel that they want to use Fund Services under item E could of course request such help, and under those circumstances the IMF staff could give full expression to its views on inflation, optimal trade regulations, food subsides, etc. If the Fund were to adopt this modest role, the composition of its active clientele may decline, but only those with a bureaucratic vested interest will want to argue that work must be found to maintain full employment at the IMF.

What about the more ambitious role listed under item C? Is not the Fund a natural overseer of International capital markets full of imperfections and prone to instability? Those of us sceptical of the accuracy and fruitfulness of conceptualizing international markets of any kind as pure and perfect have no trouble admitting that financial markets are far from textbook ideals, and cannot help but to be amused that, nearly ten years after the first call for a New International Economic Order, so many Northern observers are discovering imperfections and dilemmas in international financial markets, some arguing that banks lend too little and others that banks lend too much. Both, of course, could be right for different countries and at different times, perhaps in a cyclical pattern. But let us remind newcomers of an old neoclassical point: in the process of correcting one imperfection there is the danger that we may introduce a bigger one. To make the IMF a kind of central committee of an international credit cartel would be a remedy worse than the disease, at least from the viewpoint of many LDCs and perhaps from a more cosmopolitan viewpoint (this complex matter is discussed in more detail by Edmar Bacha and myself in *International Financial Intermediation: A Long and Tropical View*, Princeton Essays in International Finance, Nº 147, May 1982).

Given my viewpoint on the proper IMF role, not to mention space limitations, my comments on the papers on Argentina, Brazil, Chile, Jamaica and Peru will focus on points related to the previous discussion. Marshall *et.al.*, in their thorough paper, trace the decline of IMF influence in Argentina, Brazil and Chile, from the 1950s to the present. The expansion of international capital markets plus import substitution of economists contributed to such a trend. Whether one likes their brand of macroeconomics or not, it would be difficult to argue that the technocrats in those three countries have much to learn from the Fund staff regarding how to run their own economies. Under the often paranoid political circumstances of those countries, the catalytic role played by the IMF in Italy and the United Kingdom is unlikely to be reproduced; rather, the Fund’s presence is bound to acquire, whether unfairly or not, mysterious and somewhat sinister overtones. The paper by Marshall *et.al.*, also reminds us how much and how often views on optimum exchange rate policy have changed, both inside and outside the Fund. Fixed exchange rates, come hell or high water, were associated with structuralists in the 1950s, who argued that “devaluation does not work and is simply inflationary”. Similar conclusions have been preached by the Chilean authorities during 1979-82, and it would be interesting to know the Fund's position on this matter. Someday, if IMF archives are opened to researchers, it would also be interesting to trace the evolution from support of fixed rates with periodic large and abrupt devaluations, to tolerance of crawling pegs. From research on the Colombian experience, my impression is that the Fund staff was unsympathetic to crawling pegs in the late 1950s and early 1960s, regarding sporadic and massive devaluations of fixed pegs as the only method of exchange rate adjustment compatible with the IMF Articles.

Bacha carefully estimates the high price Brazilian authorities are willing to pay to keep the Fund at arms length. One imagines that the gifted technocrats in Brasilia must have done similar calculations; the resulting high cost is not a measure of their irrationality but an appalling indictment of the Fund's record over the past 35 years in dealing with Brazil. The Fund during 1979-80 seemed to be on the way toward a more sensible approach to conditionality. Had those trends continued, a Brazilian use of Fund resources over the next few years could have been foreseen, perhaps after a more open political situation developed allowing a freer discussion of economic alternatives within Brazil. The outlook, after all, is for Brazilian macroeconomic policies which are fairly austere. But during 1981 the Fund had second thoughts regarding the flexibility promised during 1979-80; just like the Supreme Court and the Federal Reserve of the United States, the IMF may not be totally insensitive to election results. While Brazilian borrowing now appears less likely, perhaps, Bacha could extend his calculations to different scenarios with longer horizons, some involving eventual Brazilian use of Fund credit. Another topic for further research is the determinants of the "spread" charged to Brazil; how much do Brazilian macroeconomic policies influence it, independently of the Fund's explicit seal of approval? During 1981 and early 1982 the "spreads" have been singularly unresponsive to the new Brazilian austerity, signalling perhaps a lack of credibility.

Peruvian generals were as reluctant as those in Brazil to submit to the Fund's conditionality until private credit dried up. In a curious contrast with Southern Cone experience of the 1970s, the incompetence of military governments in macroeconomic management eventually led to a civilian administration. Diz emphasis the difficulties in evaluating the post-1977 stabilization plans; more discussion of the exogenous shocks suffered by the Peruvian economy during the 1970s should help to delineate the role of policy in aggravating or improving economic conditions both before and after 1977.

Finally, the Jamaican paper documents a case where the Fund appears to have been more flexible than usual in its dealings with a populist government, although it remains unclear the extent to which this was due to the then prevailing political winds in the United Kingdom, Europe and the United States. But for someone used to Ibero-american circumstances the most intriguing aspect of the Jamaican story is the dog that did not bark. Suffering from crippling external shocks and apparently from gross macroeconomics mismanagement, Jamaicans settled their differences at the ballot box. Where were the Jamaican generals?

II. The LDCs and the International Trading System

These are times when repetition of tried and true points may be preferable to garish originality. In this spirit I will focus on the extravagant demands being made during 1982 by industrialized countries on some LDCs, especially the NICs, commenting along the way on issues raised by Dr. Finger. The demands, particularly as articulated by the Reagan administration, may be summarized as follows: the NICs cannot expect to continue selling, much less expand their sales, in the markets of industrialized countries unless the NICs reduce their own barriers to imports of commodities, services and direct foreign investment, and unless they bring their export-promotion practices in line with *whatever* is the fashion along the Potomac. Voodoo economics needs its hocus-pocus: “reciprocity” and a narrow interpretation of “graduation” are some of its magical incantations.

International trade theory emphasizes that the gains from trade to a country do not depend on “reciprocity”, defined in the GATT sense, from its trade partners. The founding fathers of GATT were, of course, well aware that national gains could be achieved by unilateral reduction of trade barriers. The mumbo-jumbo on “reciprocity” was a (then) politically clever device to enlist within each country the support of mercantilists wanting to export more against the protectionists wanting to import less. A terms-of-trade argument can be made for a reciprocal reduction of trade barriers, and for the “binding” of remaining barriers, to avoid the temptation of nationally “optimal tariffs” which could lead to trade wars. But it is doubtful that this is what the shouting about lack of NIC reciprocity is all about.

Since around the mid-1960s several important LDCs started to reorient their trade and payments policies so as to give sales abroad incentives which were closer to those given to domestic sales. This trend toward neutrality between "import-substitution" and export-expansion typically started from situations of gross discrimination against selling abroad. The process counted with the enthusiastic endorsement of the World Bank, aid agencies of industrialized countries, and many Northern academics.

The elimination of the bias against exports could have been achieved by the rapid abolishment of import barriers and the unification of exchange rates. Most of the now-NICs, plagued by macroeconomic and balance of payments disequilibria, wisely opted instead for a package of measures including export subsidies and guidelines of various sorts, steadier and more realistic real exchange rates, plus an elimination of the most outlandish import restrictions. Foreign investors who during earlier years had received direct and indirect subsidies in their sales to the domestic market were nudged into exporting, often receiving further subsidies. It is worth recalling that when foreign investors sold mainly within LDCs the prevailing Northern advice was that a good investment climate called for generous LDC subsidies to transactional enterprises. As the new policies succeeded in expanding foreign earnings, imports grew, dramatically in many cases, and barriers were further relaxed, in what appeared to be a virtuous circle.

It his moot how far import liberalization would have proceeded in the NICs had the world economy behaved in the 1970s as it did during the 1960s. What is clear is that in many NICs balance of payments difficulties caused by post-1973 exogenous shocks halted the virtuous circle, freezing complex foreign trade systems combining import restrictions and export subsidies. The variance of incentives is large and probably those systems are far from optimal from the national view-point, but it is doubtful that in many NICs average incentives to export now exceed those given for domestic sales. It is also clear that few, if any, NICs have been recently piling up foreign exchange reserves, or growing faster than their record for the last twenty years. Most NICs today have long shopping lists for Northern goods, plans which must be shelved due to a lack of foreign exchange. It is well known that the servicing of the NICs external debt, especially after the unexpected increase in interest rates since 1980, takes up a large share of their foreign exchange earnings, which during 1982 appear to be experiencing an alarming decline. One may also note that LDCs which have drastically liberalized their import regimes, such Chile since 1973, do not appear to have been spared Northern protectionism.

In his paper Dr. Finger proposes as one of the objectives for the 1980s that the NICs open their markets to international competition, an opening, he argues, which would provide the NICs access to the world’s most rapidly growing markets – their own. The NICs could in this fashion reproduce the post-World War II boom he believes was parked by OECD trade liberalization, complete with trickling down benefits for other LDCs, just as the NICs benefitted from the OECD-led post war boom. The idea is intriguing, but is presented in such a general way that one can imagine implementation specifics which could make it more or less desirable, even for one like myself who believes that gains from trade remain to be reaped both in North-South and South-South trade.

A crucial question is whether the proposed NIC trade openings will be done in a discriminatory fashion. A non-discriminatory dismantling of import barriers by the NIC could aggravate macroeconomic and balance of payments problems in those countries. At the margin NICs will want to use a large share of their foreign exchange earnings to buy Northern goods and, of course, to service their debt held in the North. Perhaps what Dr. Finger has in mind, given his analogy with post World War II, is some kind of transitional EPU for NICs. This could make a lot of sense, although much still depends on the specific nature of the arrangements, which could generate different degrees of trade creation and diversion, as well as various “trickles” for other LDCs. And all subject to the important proviso that Northern countries would not use growing South-South trade as another excuse to shut out Southern goods from their markets. Bizarre notions are appearing, especially in Europe, that international trade is only desirable among countries with similar economic, political and social conditions, arguments which turn some Southern “de-linkers” on their heads.

Dr. Finger’s paper reflects the doubts our profession feels about the quantitative dimensions of the gains from trade. Little triangles and intra-industry trade suggest that tariff changes involve “nearly zero-sum transfer decisions”. But as already noted he also regards trade liberalization as the spark behind the massive post-World-War II accumulation of capital and technological breakthroughs. Ironically, some heterodox notions such as economies of scale, Chenery-like foreign exchange gaps, and various dynamic effects can generate more persuasive arguments in favour of large gains from trade than orthodox trade approaches. One may note that some of these notion is gradually being incorporated into rigorous models, and that not all of them result lead to our favourite result that “everyone will be potentially better-off”. Paul Krugman, for example, has shown that in some plausible models where technological progress drives international trade, “catch-up” by follower countries may hurt the leader by eliminating the gains from trade. These new theories substantially improve on the Heckscher- Ohlin-Samuelson constructions, but one trembles to think of the abuses and mischief to which they may be put by meretricious lobbyists and the new European nationalists.

Returning to the extravagant demands being made on the NICs during 1982, a few points may be made on the push by the Reagan administration to open doors for services and direct foreign investments, already yielding tangible fruit in new bilateral and discriminatory treaties signed between the United States and some LDCs with weak bargaining positions. It could be argued that if the NICs are so short of foreign exchange, they should be eager to welcome direct foreign investment and associated services. One may note, first of all, that direct foreign investment seldom yields in the short run substantial amounts of freely usable foreign exchange. It may bring technology, marketing networks and even sector-specific capital goods, which may be productive in the long-term, but hardly the means to Service debt or pay for oil imported this year. More fundamentally, the linking of open markets for commodities with open doors for Services and direct investment challenges post war understandings regarding international economic relations.

Trade theory has focused traditionally on commodities rather than services, broadly defined to include labour and capital services. The gains from trade were demonstrated for exchanges of wine for cloth and apples for blankets, rather than for exchanges involving interest payments or workers’ remittances. If reduced to algebraic symbols, one can conceive of demonstrations of the gains from trade which would obliterate the difference between apples and workers’ remittances. But differences remain between commodity trade and service flows, at least those generated by foreign labour and capital. In the case of goods, transactions can be once-and-for-all affairs, involving few commitments about the future and minimizing intrusiveness between countries which like exchange but not intimacy with foreigners. Factor payments are generated by stocks of machines and people living among foreigners, a process which historically has been accompanied by asymmetrical intrusiveness and non-economic side effects, not all desirable either from a national or a cosmopolitan perspective. Little wonder, then, that most nations have abstained from committing themselves to free flows of capital, labour and services, even at the height of enthusiasm for freer trade in commodities as during the time when the GATT was created.

Reopening these issues in 1982 seems singularly bizarre and dangerous, particularly when done in an imperial style which appears to regard other countries' sovereignty and culture as non-tariff barriers. Explosive issues are opened up: if Tokyo is to be made just like home for U.S. lawyers and bankers, why not have Texas give "national treatment" to Mexican maids? Will New York city be opened up to Indian doctors and South Korean construction crews? Which services and factor flows, in short, are to be "opened up", and what principles are to be followed in those decisions? De-linkers, North and South, would receive fresh ammunition if countries were to be given an all-or-nothing choice between a closed economy and one open not just to commodity trade, but to all services and factor movements. Many countries would choose to pass up the gains from commodity trade rather than to allow foreigners to run their banking, shipping and insurance sectors, as during pre-World War II days.

A more immediate danger exists as a consequence of the mercantilist spasm seizing industrialized countries during 1982. A heavily indebted country like Brazil, to give a concrete example, is being denied the means for a smooth servicing of its external liabilities. Not only are its steel and shoes exports challenged as artificial, but also those of sun-intensive orange juice and chickens are viewed as resulting from unfair subsidies. Even sugar, which Brazil has been exporting for about four centuries, is shut out by quotas in the United States and driven out of traditional markets by (in this case) truly dumped European sugar. Eurocurrency spreads and credit availability are closely linked to the export outlook, and external recession and protectionism are not helping Brazilian efforts to roll-over its debt, not to mention its search for additional finance at a reasonable cost. If both recession and Northern protectionism persist, no one should be scandalized if Brazilian voices and those from other NICs call for some form of recontracting of external obligations. Financial rules of the game should be no less flexible than those regarding trade.

In conclusion, one may emphasize that there are gaps and flaws in international arrangements on trade and finance as they exist since 1982. The GATT has never overcome its birth defects, and Keynes' "lusty twins" are undergoing a difficult menopause. No "central committee" appears to be worrying about the interactions of trade and finance, as noted in the previous paragraph. The U.S. 1982 proposals to extend the GATT into some services are misguided in timing, style and substance, but at least they highlight the long run need to reform the GATT-Bretton Woods system more along the lines of the Havana charter, an issue raised by the LDCs almost ten years ago.

A broad reform should, *inter alia*, tackle the issue of how NICs and other relatively advanced LDCs should gradually be expected to accept rules applicable to the industrialized countries, including the granting of preferences to the least developed countries in an unconditional most favoured nation fashion (Brazilian preferences just to Paraguay embody the same dangers than French preferences to Chad, or those of the United States to Jamaica). Viewed in this broad and long-term perspective, "graduation" becomes a legitimate and important issue, both for the system as a whole and for the possible graduates. For reasons of their national welfare, NICs will eventually want to liberalize their import regimes further, nationalize their export incentives and also become dues-paying members of the inner club in which trade rules get written and interpreted. Other LDCs, with smaller domestic markets and weaker bargaining power, may also seek international rules yielding greater transparency and predictability in access to external markets. These smaller countries have much to gain from resisting the lure of discriminatory special trading relationships, which typically are sold to them by larger countries as being aimed at other "exotic and unfair" trading blocs, but which historically have frequently ended up limiting both the economic and political development of the smaller countries. Systemically, the gradual but complete incorporation of new Germanys and new Japans into the trading order, and the provision of a minimum of economic security for truly sovereign small countries, seem like necessary conditions for international stability. World War One and Two suggest that the rationale for such conditions is more political than economic.