A Critical Review of Proposals for Financial Co-operation Among Developing Countries *

Introduction

Pressure has been growing in the last 18 months to launch an initiative in the field of southern financial reform. At meetings in Tunis (September 1983), New York (April 1984) and Caracas (September 1984), the various arms of the Group of 77 have argued the need for a 'South Bank'.[1] This Bank would have the responsibility of providing financial assistance in three main areas. Its primary function would be to lend funds long term for development projects, joint ventures and the rediscounting of export credit. Its second role would be to provide balance of payments support expecially for the poorest LDCs who have neither access to private capital markets nor the leverage to force rescheduling and moratoria on the commercial banks. Thirdly, the Bank would open special lending windows for commodity stabilisation schemes and for sub-regional payments and credit associations. The Bank's proposers suggest that $22 billion is the minimum viable capital subscription, of which $4b is to be paid-up capital; of that figure a quarter would be in fully convertible currencies. The South Bank is modeled very consciously on the World Bank in terms of bond placement in the euro-currency markets, lending practices to member countries and a prudent 1:1 gearing ratio. Some versions of the proposal would also have the Bank creating a Third World dollar or Southern currency.

The object of this article is to review the scope for useful south-south co-operation within the financial area. It examines three main issues

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[1] For a presentation of the various proposals see *Economic and Technical Co-operation Among Developing Countries: The Group of 77 in Action*, Volumes 1 and 2, New York, 1984.

whose resolution will be critical to the success of any exclusively Southern financial body: the pre-requisites for effective cooperation, the objectives, and finally the institutional forms of financial co-operation. The general conclusion reached is that the proposals to date raise more questions than they answer. Not only is the need for any such institution debatable, given the lack of any systematic economic trends during the 1970s and early 1980s, but more importantly it is also unclear whether the mutuality of economic interests among the Group of 77 is as pronounced as the proposals normally assume. In the absence of an almost complete consensus within the Group of 77 on the responsibilities, priorities, mix between commercial and subsidised operations and/or the organisational structure of a South Bank, the probability that the idea will ever leave the drawing board is extremely low.

The Pre-requisites for Effective Co-operation

Plans for closer financial co-operation amongst developing countries have to deal with a number of problems. First they have to identify those deficiencies of the existing arrangements that they are setting out to remedy. Part of the problem here is that some deficiencies may be more transitory than others, and even those that are not transitory may still change in certain ways through time. Policy responses therefore need to be flexible.

Second, plans need to carry the appropriate degree of financial and political backing. There is little point in proposing schemes that require levels of funding and an extent of political co-operation which will simply not be forthcoming. Given that there are fundamental differences between developing countries, not least in terms of their status and interests within the existing set of international financial arrangements, a critical issue is whether it is possible to isolate areas where co-operative action can produce an acceptable distribution of benefits.

These problems are nicely illustrated by the OPEC phenomenon. Not only did the rise in the price of oil generate the extra clout for LDCs to push for a new international economic order, but it was also seen as providing the finance for schemes based exclusively in the Third World. However, in practice, the OPEC surplus proved to lack durability and, in any case, questions were legitimately raised concerning the degree to which OPEC countries would use their new found wealth to support Third World ventures rather than simply placing their excess revenues on the Eurocurrency market where the uses of this money depended on the credit policies of the private (and industrial country dominated) international banks.

A third problem associated with plans for financial co-operation amongst developing countries relates to the efficiency of reform. If pursuit of one type of reform involves an opportunity cost in failing to pursue another type, governments have to give considerable thought to where their main effort should be made. It is not just a matter of what countries stand to gain from intra-South co-operation but also what they stand to lose from it. Many LDCs have an important stake in Northern based arrangements and will be reluctant to risk these in the pursuit of the uncertain benefits that they may derive from Southern based reforms. This again suggests that the degree of aggregation is important. Developing countries do not have homogeneous interests in the area of international financial policy. Dissimilar interests will not evaporate under the banner of Third World solidarity. What is needed therefore is a more painstaking approach which sets out to identify which developing countries have mutual and complementary interests, and which do not. The need is for a disaggregated approach to Southern financial reform.

The Objectives of Co-operation

The objectives of greater financial co-operation amongst developing countries are very diverse incorporating both economic and political elements. From a long list of factors, the desire to overcome two related deficiencies of the existing international financial framework may be seen as being paramount to any discussion of South-South solutions.

The first is the inadequacy of LDCs' international reserves and their impaired access to commercial credit. The development of their economies is viewed as being constrained by a shortage of foreign exchange, and by the size of the current account deficit that they can finance. However the issue is not clear cut. There are inconsistencies in the theory of reserve adequacy as applied to developing countries as well as there being significant variations amongst developing countries themselves. While the intrinsic instability of the balance of payments and the high costs of adjustment raise the demand for reserves, the high opportunity cost of holding reserves reduces it. In any case to argue that theory supports the claim that the demand for reserves in LDC's is proportionately higher than in industrial countries presupposes that their export receipts are more unstable and their costs of adjustment higher, and there is some debate over these issues.[2] Furthermore care has to be exercised not to confuse the demand for reserves to hold, which may be related to the above factors, with the demand for reserves to spend which may be more appropriately related to the level of development.

What is perhaps more relevant from the point of view of Southern financial co-operation is that the degree of liquidity inadequacy varies *between* developing countries. Again a more disaggregated approach is appropriate.

The second supposed deficiency is that existing institutions have a pro North-South trade bias which encourages an international division of labour under which LDCs export unprocessed primary commodities and import manufactured goods which may not be fully appropriate to their needs. This structure of trade has implications for both the trend and the stability of LDCs' balance of payments as their terms of trade decline and are exposed to variations emanating from the business cycle in industrial countries. Intra South trade is seen as a way of breaking out of these traditional patterns and of encouraging export diversification. Differences in comparative costs amongst developing countries are seen as implying that much of the South would benefit from increased intra South trade. Yet an increase in such trade is constrained by a lack of finance. Therefore trade measures need to be accompanied by financial reform.

It is then the claim of those advocating Southern solutions that such reforms would overcome the principal deficiencies of the existing system.

[2] For a fuller review of the theory of the demand for international reserves as applied to developing countries see BIRD, GRAHAM, *The International Monetary System and the Less Developed Countries*, Macmillan, Second Edition, 1982.

Forms of Financial Co-operation

Financial co-operation within the South is often encapsulated in proposals for setting up a Southern IMF (although this is really a contradiction in terms) or a Third World or South Bank. Although summarised in this way the activities of the institution would comprise a number of elements. These normally include, first, some form of clearing union to economise on the use of reserves; second, pooling arrangements to achieve the same basic objective; third, a payments or credit union which would offer short or medium term balance of payments assistance; and, fourth, a Southern currency or Third World dollar. The details of different schemes vary but these principal purposes are common to most. It is these general aspects that are examined here rather than any specific proposal.[3]

i. *A Clearing Union*

This is the least ambitious aspect of co-operation. Trade amongst developing countries would be recorded by the union and at frequent intervals would be netted out. Countries would then settle their net balances in convertible currencies. Depending on how frequent the multilateral settlements were, the scheme would involve a small element of intra South trade credit. The implication of the scheme is that scarce hard currencies would only be needed to finance net imbalances rather than total imports.

ii. *Reserve pooling arrangements*

These are significantly more ambitious since they are a step in the direction of the joint management of reserves with participating countries depositing a proportion of their reserves with a central reserve pool.

The theoretical attractions of the scheme derive from the assumed shortage of reserves in developing economies, their limited access to

[3] A useful and concise review of the various financing schemes may be found in STEWART, FRANCES, and SENGUPTA, ARJUN, *International Financial Co-operation, A Framework for Change*, Pinter, 1982.

private capital markets, and the problems associated with using flexible exchange rates. Given these characteristics, which more nearly describe the least developed countries than the better off LDCs, reserve pooling offers a way of using scarce reserves more efficiently.

Any specific level of trade instability can be supported by a smaller pool of reserves than would be necessary if countries held their reserves individually. Since the export base of the South as a whole is more diversified than that for any one Southern country instabilities are more likely to cancel out at the more aggregated level. By reducing the need for reserves the opportunity cost of holding the excess reserves is avoided. The benefit from reserve pooling therefore depends on the value of this opportunity cost, which may be seen as the difference between the internal social rate of return on resources and the rate of interest on reserves.

Although attractive for this general reason, reserve pooling schemes are subject to a number of difficulties. Countries may be reluctant to give up their independent management of reserves, and may have differing views about the optimum size of the reserve pool. Distributional issues cannot therefore be avoided since countries which choose to hold relatively large reserves because of the benefits they see from them (perhaps in terms of enhanced credit worthiness), or because they estimate that the opportunity cost of reserve holding is relatively low may not be anxious to pool their reserves with other countries which have different attitudes. Associated with such differences in reserve management policy will be differences in attitudes to macroeconomic management. Again countries acquiring reserves by pursuing 'conservative' macroeconomic policies may not wish to pool their reserves with countries whose policies are more expansionary and more inclined to generate deficits and therefore cause reserves to be used. This implies the need for quite a high degree of fiscal and monetary harmonisation amongst the participants, to an extent that may be difficult to arrange.

Aside from these broad issues there are many practical questions. What will determine the size of contributions? What will contributions be denominated in? What will determine the extent to which participants can draw from the pool and how much credit will be extended, at what price and under what conditions? How should any income associated with the management of the pool be distributed? It is more than probable that individual countries within the South will have different views about the appropriate answers to each of these questions.

iii. *A Payments or Credit Union*

Although there are similarities between the notion of a reserve pool and a payments union in terms of the range of functions they perform, the latter emphasises more strongly the provision of short to medium term balance of payments assistance. In summary the advantages of such provision stem from the welfare gains associated with countries being able to select the optimum combination of adjustment and financing when faced with payments deficits; the assumption being that a shortage of finance constrains them from reaching this optimum. In principle a Southern payments union could operate along similar lines to the IMF with countries making subscriptions but being able to draw on a short term basis beyond the value of these in certain circumstances.

In practice there are a host of problems to overcome. What will determine the size of subscriptions and their denomination? What will be the size and nature of the credit extended? Will conditionality be attached to drawings and how will this differ from IMF conditionality? In what circumstances will low conditionality finance be made available? Although such questions are familiar in the context of discussion of the IMF the proposal for a Southern payments union generates other more specific questions as well. Not least, because of its discriminatory basis it will induce a change in the size and pattern of LDC trade with there being both trade creating and trade diverting effects. The relative sizes of these effects are clearly significant.

Furthermore there is the question of whether the clash of interests between surplus and deficit countries, as well as between other factions, is likely to be any less within the context of an exclusively Southern monetary fund. There must be severe doubts about this. In addition there is the question of to what extent the payments union will focus on countries payments positions within the South rather than overall? Again, will the payments union imply an exchange rate union? If not how will the payments problems associated with the so called 'third country phenomenon' be handled?

The mere length of this list of fundamental questions suggests that setting up a Southern payments union will not be straightforward. If a Southern solution exists it is certaintly not an easy solution.

iv. *A Southern Currency*[4]

Just as the IMF has a General Account which in the main distributes credit and a SDR Account which creates and allocates SDRs so it is sometimes argued that any exclusively Southern monetary fund should have the power to create its own currency.

The basic idea behind such schemes is straightforward. If developing countries are reserve constrained and are, at the same time, subjected to an anti-Southern trade bias the creation of a Southern currency, to be used in Southern trade, would simultaneously alleviate both problems.

Beyond the basics however, the proposal raises numerous problematical issues. Will the currency be backed or unbacked? If backed what will it be backed by? If unbacked will there be sufficient confidence in it? Will it carry an interest rate on net use and net acquisition and, if so, at what level should this be fixed? Without such an interest rate the incentive to spend the currency will be very great and this could be inflationary and could alter relative prices within the South given different income elasticities of demand for the products of different LDCs. Besides who will eventually hold the assets? Will some designation or reconstitution procedure be required under which countries will have to stand ready to acquire some additional amount of Southern Currency Units (SCUs) and to hold at least a proportion of their allocation in the long run? What factors will determine designation? In any case how will the assets be distributed amongst developing countries in the first place — what criteria will be used?

A further problem is that structural payments imbalances within the South will mean that surplus countries will continually acquire SCUs while deficit countries will be net users. Will surplus countries be prepared to accept this state of affairs? Even if interest were to be paid this will be in the form of SCUs. However while additional SCUs might be seen as being of little benefit to such countries the need to earn SCUs in order to pay interest will reduce the subsidy element to net users. In any case why should surplus countries sell real resources in exchange for SCUs when they might have sold them to industrial countries in exchange for hard currencies?

[4] For a detailed discussion of the idea of a Southern currency see STEWART, FRANCES, and STEWART, MICHAEL, 'A New Currency for Trade Among Developing Countries' in Al-Shaikly (ed.), *Development Financing: A Framework for International Financial Co-operation*, Pinter, 1982.

Another problem relates to the institutional relationship between the reserve creating part of the Southern monetary fund's activities and its credit granting part and the correct balance between reserve and credit provision. Yet another relates to the valuation of SCUs. Will this be linked to the dollar, the SDR, or some other bundle of convertible currencies? Moreover what will be the implications of the valuation method for individual LDCs?

It is not that these problems apply only to a Southern currency. Many of them are quite familiar in the debate over SDRs. The important point is that there is no reason to believe that a Southern currency will *avoid* such problems. If new assets are to be created and allocated to the poorest countries of the world it would seem better to provide them with general purpose SDRs rather than with limited purpose SCUs. Agreement on some form of SDR link seems no more unlikely from a practical point of view, and the poor country recipients would gain more.

In principle, modifications to the SDR and the introduction of a Southern currency are, of course, not mutually exclusive. But given the administrative constraints it would seem likely that a choice is involved in terms of where the emphasis is placed. Furthermore it needs to be recognised that opting for a Southern solution will reduce still further the chances of developed countries agreeing to a more genuinely international one. However opting for reforms within the SDR framework does not mean that developing countries will fail to benefit from an extension of trade credit which serves to facilitate the expansion of intra South trade. The sum of benefits from a series of modest reforms may well exceed those from a few grand schemes which, because of their size and nature, may be difficult if not impossible to implement.

General Constraints on Financial Co-operation

Apart from the detailed questions relating to the various forms of co-operation which would have to be resolved, there are some rather more general constraints that severely limit the scope for significant evolution in the direction of an exclusively Southern alternative.

First, although some LDCs are, without doubt, short of reserves and have little access to commercial markets, others are not. There are then major distributional issues within the South which proposals for Southern solutions tend to de-emphasise. It is in the low income countries that the shortage of international liquidity has been most constraining. If the problem is one that is limited to LICs it is far from clear that the best method of solving it is to establish a Southern institution in which their interests are likely to be dominated by richer LDCs. In any case what the latter want are measures that serve to protect and extend their access to the capital markets of the North. They might not wish to be associated with proposals that they may feel would be seen as reducing their creditworthiness. Assistance to the LICs, with the concessionary component that this requires, is better handled at the international level.

Second, the presumption that intra South trade has been discriminated against is open to some debate. Havrylyshyn and Wolf[5] provide evidence that for 1963-77 there was no obvious bias against such trade. Indeed they argue that once the weight of LDCs in the world economy, their comparative advantage (which is often competing), their restrictive trade regimes and the liberalising trends in OECD tariff structures are taken into account, the proportion of intra-LDC trade is, in fact, greater than might have been expected. Moreover they reject the view that, given the slowdown in the growth rate of OECD economies, the West can no longer be an engine for LDC growth. They are unable to find any strong relationship between the growth of developed countries and exports by developing countries, especially since many of the developed countries are themselves important sources of primary products. The correct policy prescription, so they argue, is to optimise the gains from international trade through specialisation and exchange irrespective of the destination of exports or the source of imports. If developing countries want to expand intra-LDC trade, perhaps the first step should be to reduce tariff barriers.

Indeed, given the level of government intervention in the economies of many LDCs, it is extremely difficult to say whether one pattern of international trade is more likely than any other to allow a country to reach its production possibility frontier. Governments intervene both in domestic factor markets and in international final product markets. The consequence of a tangled web of taxes and subsidies, few of which are explicitly directed at correcting "distortions" which have resulted through market failures or imperfections, is that it is almost impossible to unravel what actually is the domestic resource cost of any particular economic activity. In light of this informational vacuum, it is hard to make unambiguous predictions about the gains which might result from another level of political activism.

Third, if one stops to think about the question of the appropriate institutional structure then the problems of a southern IMF are further compounded. Not only will the protracted negotiations over the precise details of the organisation be politically costly and financially expensive but it is also important to realise that, aside from specific differences over precise arrangements, there are also broad divergences in economic interests, political concerns and ideological perspectives among a group as heterogeneous as "The Third World", or the "South". One cannot fail to be aware of the inertia and political deadlocks which characterise the activities of the EEC whose membership is relatively homogeneous and which seems to share a communality of interests much more pronounced than that which "unites" the south.

Concluding Remarks

Proposals for extensive financial cooperation amongst developing countries rest on a number of extremely contentious premises. The advocates of a South Bank or similar institution need to argue that LDCs face a set of financially related problems which either have similar structural components or permit the exploitation of possible complementarities between the different sub-groups. They must be sure that the resources of a Southern institution will augment rather than merely substitute for financial flows currently available to the member nations. They need to assert with some confidence that the poorest LICs will not merely exchange one set of dependent financial relations for another which may be no more sympathetic but less able to help. The poorest, especially sub Saharan African, LISs have reached a stage where the only palliative for structural balance of payments problems are explicit international income transfers. It is not easy to imagine that the South Bank will have sufficient financial reserves and ideological commitment to sustain a strongly redistributive stance over the long term.

[5] WOLF, MARTIN, and HAVRYLYSHYN, OLI, "What Have We Learned About South-South Trade?' a paper presented to a conference on *South-South versus South-North Trade - Does the Direction of Developing Countries Exports Matter?* sponsored by the World Bank under the Research Project, The Direction of Developing Countries Trade, and held at the Free University of Brussels, Belgium, 28 February - 1 March 1983. For a rather different view, however, see STEWART, FRANCES, 'Recent Theories of International Trade: Some Implications for the South,' a paper presented to the Development Studies Association Conference, Dublin, 1982.

Clearly the proposers of the South Bank have given serious consideration to these issues. They believe that the Bank would help all LDCs through the export credit and commodity stabilisation facilities, thereby expanding intra-South trade. They accept that the Bank would have only a limited role in the area of balance of payments support, perhaps providing temporary financing for the poorest countries. They also accept the proposition that the acceptability of the institution both to its potential members (the NICs and OPEC) and to the wider international community demands that lending take place on a largely commercial basis. They rightly argue for caution in the allocation of resources to the areas of commodity stabilisation and sub-regional payments associations. However the institutional structure of the organisation, where voting rights will be linked only loosely to the level of financial contribution, seems to fly in the face of political realities. Finally they acknowledge the need to work with the existing commercial banks and international financial institutions and stress that the South Bank would be an appropriate vehicle for joint ventures.

The real issue however is whether LDC energies would be better directed in alternative channels. There is considerable scope for marginal reforms within the current international financial system which would significantly benefit the LICs.[6] The area of intra-south trade promotion is likely to be enlarged more by the reduction of discriminatory and distortionary tariff structures than by the creation of a bureaucratic apparatus to rediscount export credit instruments. In any event, the concern of LDCs should be to maximise welfare without any *a priori* assumptions about the appropriateness of trading partners. There is undoubtedly a potential role for a Third World Secretariat, or perhaps a revamped UNCTAD, whose function would be to provide information about international economic and financial trends and whose expertise would help LDCs to deal better with the uncertainties implicit in participation in the current global trading system. However the primary duty of LDC governments should be to address domestically generated economic problems and to push for efficient financial reform within the context of the existing framework rather than engage in institution building.

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[6] For an evaluation of some of these see Bird, Graham, *International Financial Policy and Economic Development: A Disaggregated Approach*, Macmillan, London, forthcoming.