

The Case Against the Link

Introduction

For quite some time academic economists as well as some bankers and economists in Government and international organizations have been proposing that the creation of international reserves by the IMF be linked with development assistance to less developed countries (ldc's). Since the Rio de Janeiro meeting of the IMF in 1967 where it was decided to go ahead with the creation of *Special Drawing Rights* (SDR's) and the activation and first allocation of the new reserve assets in 1970 the demand for a Link has become more and more insistent.¹

The primary and basic purpose of the Link is to increase the flow of development aid to Less Developed Countries (ldc's) from More Developed Countries (mdc's). It is true that other objectives have been mentioned, one of which, improvement of the international monetary system, will be noted later. But it is safe to say that, if it could be shown that the basic objective cannot be achieved or only to a small and uncertain extent, the enthusiasm for the Link would quickly evaporate.

The present paper does not question the desirability of the basic objective. In fact the writer finds it wholly laudable. But it is argued that a sizable increase in the flow of aid cannot be achieved through the Link and that the Link would be an inefficient method to provide aid.

¹ The earliest and most ardent protagonists of the Link have been Maxwell Stamp and Robert Triffin. Emilio Colombo has been the strongest supporter of the Link among the leaders of the industrial countries. For a brief review of the Link movement and bibliography see JOHN R. KARLIK, "On Linking Reserve Creation and Development Assistance", a Staff Study prepared for use of the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Washington, D.C., April 1969.

The "Link" complicates reserve creation

As Harry Johnson² and others have pointed out, the SDR's will have enough trouble to get firmly established and properly managed even without the additional formidable complications created by the link to aid. These additional difficulties will not only arise at the beginning when the Link is introduced, but will continue to complicate the management of the SDR's indefinitely. Once the link exists there is bound to be continuous pressure from the ldc's to increase the volume of SDR's and to raise the portion channelled through IDA. Pressure from the ldc's will inevitably induce counter-pressure from the mdc's.

The sponsors of the Link have tried to allay these fears by pointing out that 16 per cent of the voting power in the IMF can block any increase in SDR allocation. True enough, but they have overlooked the possibility that the method of a minority veto can be applied also on the other side. An inkling of what can be expected was provided by news reports (*The New York Times*, Sept. 29, 1970, and *The Economist*, London, Sept. 26, 1970, p. 72) that a movement was under way to organize the ldc's in the Fund for the purpose of voting against any change in the Articles of Agreement such as the proposal to widen the margin of permissible deviations of exchange rates from the par value ("band proposal") unless such a reform was coupled with the Link — in other words to link the Link with the "band" (or with the "crawl").

At this point another argument used by some proponents of the Link might be mentioned. It is sometimes said that SDR's constitute aid already in their present form, with the U.S. being the greatest beneficiary because it has the largest quota in the Fund. The suggestion is that since SDR's are aid anyway, the distribution should be made a little more equitable by allocating SDR's to ldc's.

This argument again mixes reserves and aid. It should be clear that a rational allocation of reserves has to be governed by entirely different principles than allocation of aid—volume of trade, variability of trade and international payments and similar criteria, while the

² See "Linking Reserve Creation and Development Assistance", Hearing before the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Congress of the United States, May 28, 1969.

allocation of aid should be governed by comparative levels of real income and wealth or some other index of economic welfare.

Whether the comparative size of the country quotas in the Fund is "correct" or "rational" can, of course, be questioned. To call the quota structure "inequitable" (even the word "scandalous" has been used) on the ground that the rich countries have the largest quotas makes little sense in view of the fact that the rich countries collectively have, over the years, not only held on to their reserves but have added to them. If there are *individual* rich countries that have run through their reserves, it would have been at the "expense" of other rich countries who could complain about inflation being imposed on them. To make the large Fund quota and SDR allocation of the U.S. a target of criticism makes no sense either because the U.S. has made no (or only infinitesimal) use of these facilities. The related complaint that under present international monetary arrangements the "special position" of the dollar — the world's foremost reserve, intervention and transactions currency — confers special privileges on the U.S. is not convincing on at least two grounds. First, it is by no means clear that the U.S. derives *net* benefits from being the "world's banker". Second, even if there was a net benefit it could be adjudged to be "equitable" or "inequitable" in some sense only in the context of the whole international investment position of the U.S., its contribution to the development of other countries through foreign aid, capital exports etc. But it would lead too far to pursue this matter any further.

The "Link" is Inflationary

Harry Johnson and others have also pointed out that the "link" is essentially a proposal for inflationary financing of development aid. Fritz Machlup³ has shown that an increase in international liquidity through a rise in the price of gold is more inflationary than an equal increase in liquidity brought about by the creation of SDR's. For largely the same reasons the Link must be said to be a more inflationary method of liquidity creation than the present procedure of SDR allocation, although the Link method is less inflationary

³ *Remaking the International Monetary System. The Rio Agreement and Beyond*, Baltimore, 1968.

than an increase in the gold price would be. The production of gold requires the expense of real resources, SDR creation is costless. But if SDR's are allocated through the Link to ldc's for the purpose of providing real aid, the ldc's will spend the SDR's. Under the present procedure only a country in deficit is supposed to use its SDR's. Under the Link their prompt expenditure is the purpose.

With moderate allocations of SDR's and only a small portion subject to the Link the inflationary effect may quantitatively be small at least at first. But it is bound to increase steadily and using an essentially inflationary method of liquidity creation is bad in principle.

Thoughtful advocates of the Link have acknowledged the inflationary danger, but have tried to get around it by giving reasons why some inflationary effect may be welcome and by proposing a special kind of link that is supposed to be non-inflationary.

Good examples are John R. Karlik and Tibor Scitovsky.⁴

Karlik recognized the danger of inflation and he concedes that in principle the critics of the Link are right when they object to linking two entirely separate issues — reserve creation and development assistance. But he argues that occasionally it is easier and more effective to tackle two separable problems jointly than to deal with them separately; liquidity creation and development assistance are said to be such a case.

Karlik tries to show that the voting procedure in the IMF is such that there is a "strong probability that globally the SDR distribution will be inadequate" (p. 6). He also expresses the usual doubts concerning a further expansion of the use of the dollar as a reserve medium. The consequence will be a general inadequacy of reserves, deflation and trade restrictions.

All that seems to me very dubious and exaggerated. There is no sign anywhere in the world of deflation produced by a scarcity of international liquidity. Attempts to curb inflation cause, of course, slack and unemployment in the U.S. and elsewhere. But that surely has nothing to do with a lack of international liquidity. It is difficult to think of any country in the present day world that would be

⁴ J. R. KARLIK, *op. cit.*

For Tibor Scitovsky's see the Hearing volume quoted above, esp. his prepared statement pp. 32-34.

willing to permit, for the purpose of acquiring additional international reserves, substantially more unemployment than may be necessary on purely domestic grounds to curb inflation.

Also the statement that the role of the dollar as a provider of international reserves is finished or cannot be further expanded is no longer tenable. On the contrary the successful replacement of the gold pool by the two-tier gold market has fortified the stability of the dollar exchange standard. Dr. E. Stopper, President of the Swiss National Bank spoke of "the progressing acceptance of a *de facto* dollar standard" after the introduction of the two-tier system.⁵

The danger of the use of trade and payments restrictions on balance of payments grounds is greater than the danger of deflation and unemployment. But it is increasingly recognized that exchange rate changes, flexible rates or frequent changes of par values, are the proper method of dealing with serious (fundamental) disequilibria and that when this method is used unemployment and trade restrictions are unnecessary.

But let us waive all these doubts and assume that international liquidity needs to be increased to prevent some countries from deflating or restricting trade. Why can the present method of general SDR allocation not cope with that problem? Why is the Link method superior?

Both Karlik and Tibor Scitovsky face the problem squarely. I now follow Scitovsky's exposition which is a little more explicit than Karlik's. He says that a general distribution of SDR's may not be acceptable for the presumptive surplus countries. He also acknowledges that: "If the IMF were empowered to lend to the IBRD or to IDA part of the national currencies it held against SDR's; or if surplus countries were required so to lend part of their excess surpluses; or if any countries were so to lend in connection with their acquisition of SDR's this would almost certainly add to the surplus countries' surpluses and to the inflationary pressures these may create. The reason is that proceeds of all project loans the IBRD and its subsidiaries make available to developing countries must be spent on goods produced by the lowest bidder in an interna-

⁵ Monetary Conference of the American Bankers Association, Hot Springs, West-Virginia, May 18, 1970 (mimeographed paper). For further discussions of the role of the dollar in the international monetary system see G. HABERLER and T. WILLET, *A Strategy for U.S. Balance of Payments Policy*, American Enterprise Institute, Washington D.C., 1971.

tional competition; and the lowest bidder is likely to be, for obvious reasons, a firm in one of the surplus countries. Such a link therefore would be likely to add to the surplus countries' surpluses and potentially also to the inflationary pressures weighing on them.

Such a link, I believe, is undesirable. It would aggravate the very problems that opponents of reserve creation are afraid of".

It will be noted that this inflationary undesirable kind of link comprises both the so-called "organic" link (SDR's allocated through the IMF to IDA or ldc's) and the "unorganic" link (voluntary contributions of SDR's by ldc's). However, the so-called "organic" link could be administered in such a way as not to be inflationary. Neither Karlik's nor Scitovsky's exposition is quite clear. But they seem to propose the following scheme: Only "industrial countries in need of additional reserves", which are characterized as "deficit countries", would be asked to acquire ("buy back") SDR's from ldc's by making loans or still better grants "tied to their own exports" (*italics in the original Scitovsky paper loc. cit., p. 33*). So the surplus countries would not be affected at all and would have no reason to object.⁶ It will be asked whether this scheme will not mean additional inflationary pressure in the deficit countries. Scitovsky and Karlik recognize this possibility. But they say that if this is the case the countries in question will not use their options to acquire SDR's from ldc's. To quote Scitovsky: "It (the scheme) imposes a real cost and may create inflationary pressures on the deficit countries, which can act as a deterrent and limit the creation of SDR's and the consequent inflationary pressures on surplus countries" (p. 34) Scitovsky calls this "an important and valuable function of such a link and, to my mind, its economic justification" (p. 34).

I find it very difficult, I must confess, to visualize the working of the Karlik-Scitovsky kind of link. The details have not been presented and I shall not try to spell them out. But whatever they are, I do not believe that the Karlik-Scitovsky scheme could produce much additional aid for the ldc's. The ideal candidate for the scheme would be a deficit country which suffers from unemployment.

⁶ Scitovsky realizes that the deficit countries' exports are likely to be non-competitive — or else these countries would not be in deficit. That is why he recommends grants or low cost loans to overcome the low competitiveness.

He does not consider the possibility that surplus countries could object to this kind of competition, especially since the deficit countries will acquire SDR's which presumably could be used later to finance purchases in surplus countries.

That kind of country is hard to find nowadays. Most deficit countries suffer from inflation and over-full employment and will therefore not be disposed to shoulder an additional burden which would add to their inflation troubles. Even if a country suffers from inflation *and* unemployment at the same time — not a rare combination anymore — it will hardly make it much more eager to use the new facility, because there are more attractive and efficient options available than the Karlik-Scitovsky type of Link. Countries in serious deficit with inflation should try to disinflate; if they have unemployment they should reflate and depreciate; if they suffer from "stagflation" (stagnation *and* inflation) they might try monetary expansion plus an incomes policy plus currency depreciation. The foreign aid they are willing and able to make available they should provide via the budget.

This brings me to the next issue.

Aid through the "Link" vs. aid through the budget

In principle most economists would agree, I believe, that the aid which a country is supposed to provide, or wishes to give, should be voted by Parliament and appropriated through the regular budgetary process and not be determined as a by-product of international money creation.⁷ For one thing when aid goes through the government budget no extraneous inflationary elements are introduced. For another thing Parliament should legislate and appropriate the sums it wishes to devote to foreign aid; the decision should not be left to international officials and the forces of the market, that is to say the burden of aid should not fall on those countries where the SDR's may lodge eventually (see below).

It might be objected that parliamentary approval will be required anyway for the activation of the SDR's that are to be linked to aid. But this does not invalidate or weaken the case against the Link.

In the first place when debating whether the proposed additional allocation of SDR's is of the proper or optimal size Parliaments should not be influenced, as they inevitably would be in case the SDR's are linked with aid, by extraneous considerations. In the second place if it is realized that aid given by channelling SDR's via the Link through IDA represents no less of a burden than aid

⁷ Scitovsky is quite explicit on that point. See *loc. cit.*

extended through the budget, it is not clear why it should be easier to persuade Parliaments to agree to the Link than to appropriate aid through the budget. The fact of the matter is that the proponents of the Link hope through the Link to increase the flow of aid, a laudable objective to be sure. But the success of this strategy depends essentially on spreading the erroneous notion that for the donor countries the cost of aid via the Link with SDR's is nil or at least less than the cost of aid via the budget.

It will not do to say that in case of general unemployment the real cost would be virtually zero. In the second half of the 20th century such situations rarely exist and if they did a policy of monetary expansion plus a depreciation of the currency, if necessary, would achieve the same result which the Link is supposed to accomplish.

One encounters frequently, however, the statement that aid through the Link, or through the "organic" link, "would indeed be painless."⁸ This is a very misleading statement. (In some places e.g. p. 8 the author does qualify the expression "painlessness" by the phrase "from the standpoint of taxpayers"). In reality there is, of course, no such thing as "painless" aid. To express it differently, aid could be painless only in the same sense in which inflation can be said to be a "painless" method of providing real resources — an idea which carries little conviction in an era of inflation.

The Distribution of the Burden of aid among the donor countries

It should be clear that for the industrial donor countries collectively the method of providing aid through the Link implies the same burden as the method of giving aid via the budget. The economic burden or real cost of aid consists, of course, of the export surplus, the transfer of real resources from the donor to the recipient. But the distribution of the total burden among the industrial donor countries may well be different under the two methods.

Under the traditional method of aid via the budget an attempt is being made to approach a roughly equal, if not equitable, distribution of the burden by striving for a uniform GNP percentage of aid

⁸ See for example HARRY H. BELL, "Institutional Aspects of Linking Development Finance with Reserve Creation under the Rio Agreement", United Nations Conference on Trade and Development, January 6, 1970.

contribution from all industrial countries, the famous 1% or 0.75% target proclaimed by the Pearson Committee and other bodies. True the goal has not yet been reached and it is by no means clear whether a uniform GNP percentage is the ideal formula. But the postulate of an equitable distribution is at least explicitly acknowledged and deviations from the postulated ideal are measurable.

Under the Link system the real distribution of the burden of aid, in other words the real contribution of different donors, is practically impossible to foresee. It will depend partly on the size of the quotas in the IMF of the various countries, partly on the pattern of balance of payments surpluses of the donor countries which the infinitely complex system of world market forces and national policies of scores of countries will produce.

With little exaggeration the difference between the two systems of aid can be compared with the difference between two national tax systems: (a) a system that distributes the national tax burden among taxpayers somehow, according to individual income and wealth and (b) a tax system that distributes the burden by means of a lottery.

Karlik and Scitovsky have recognized the inequity of the ordinary ("unorganic") Link which would make it unacceptable to the presumptive surplus countries.⁹ The awkward distinction between "organic" and "unorganic" Link probably stems at least partly from the vague feeling of the unpredictability and inequity of the burden sharing under the "unorganic" Link. The trouble with the "organic" Link is that it leaves it to the international agencies and officials, without giving them precise instructions, to determine somehow which countries will carry the burden. Karlik and Scitovsky have recognized the problem and have tried to indicate (rather vaguely) the principles that should be followed in the administration of the "organic" Link to make it acceptable. But their scheme would, as I tried earlier to show, fail to achieve the basic purpose of the Link: it would produce very little additional development assistance to the ldc's.

It has been claimed that "perhaps the clearest argument for linking receipts of SDR's to the provision of foreign aid rests on

⁹ Both authors are a little too sure, in my opinion, that they can identify from past experience who the surplus countries will be. The pattern of surpluses and deficits may well change from time to time.

this chain of reasoning: "... SDR's are a substitute for gold. Being cost-free they will make possible a substantial saving in real resources for the international community. Rich countries could reasonably be asked to forgo their share of this saving and let it accrue to the benefit of poor countries. They could do this by earning paper gold in the same way they formerly earned commodity gold that was added to world reserves".¹⁰ But it is by no means certain that the real alternative to SDR's is more gold. Many experts believe that the SDR's will replace dollars rather than gold in international reserves. Even with the SDR's a further expansion of the reserve function of the dollar is by no means excluded. The dollar may still turn out to be the far more attractive reserve asset. Surely the yield of dollar balances is much larger than the nominal interest on SDR's.

The decisive objection against the argument in question is, however, that the distribution of the burden of aid among the donor countries according to their GNP, or something like that, is surely much more equitable than the haphazard distribution that would be produced by the Link.

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¹⁰ EDWARD R. FRIED, "International Liquidity and Foreign Aid", *Foreign Affairs*, July 1970, pp. 142, 143.