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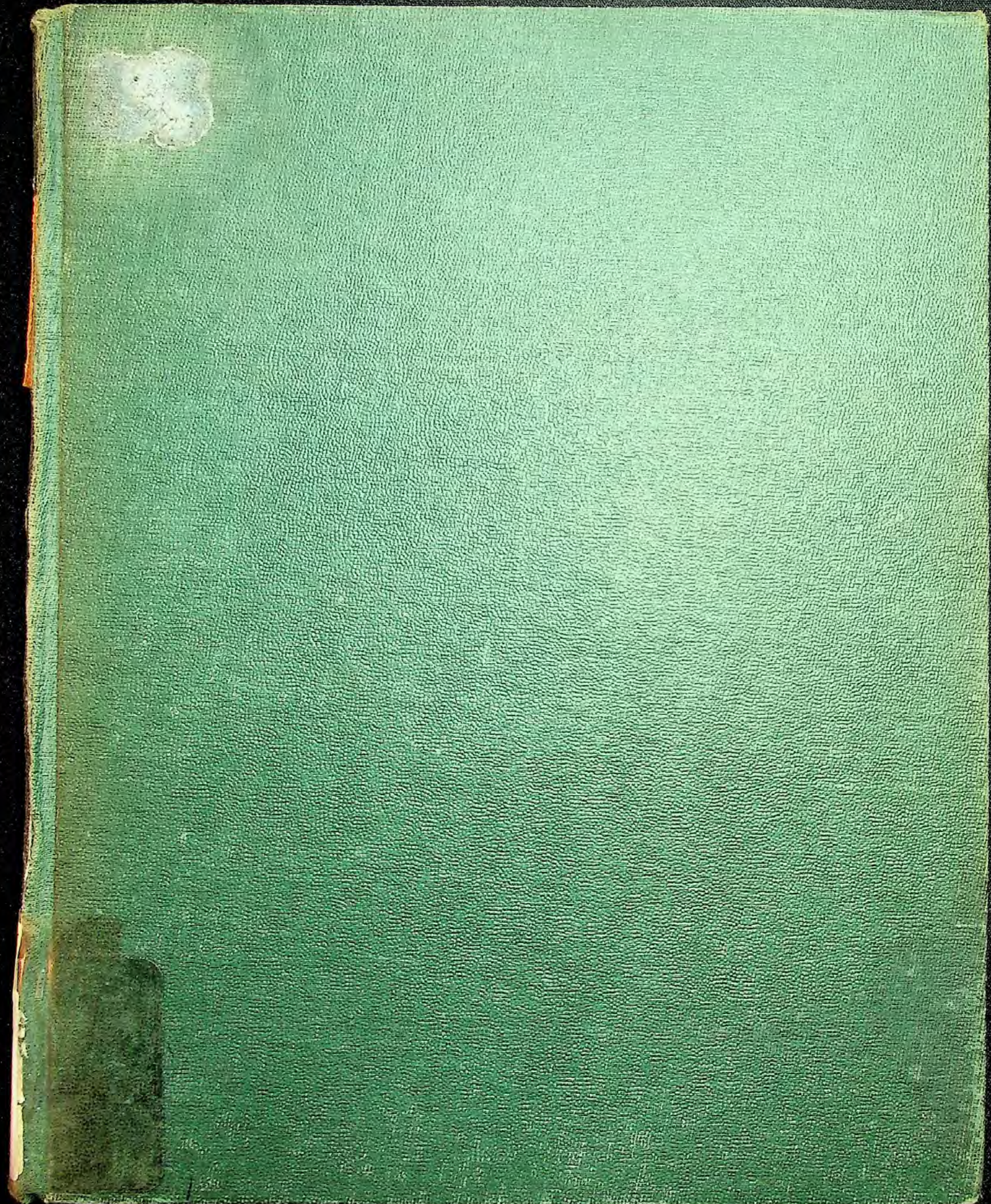
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INTERNATIONAL LIQUIDITY

AND

DEVELOPING COUNTRIES

INTERNATIONAL LIQUIDITY
AND
DEVELOPING COUNTRIES

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W. 9

Thesis Presented In Partial Fulfilment Of The
Requirements For The Master Of Arts Degree
In Economics

Thesis
13/66

BY

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The American University in Cairo

(1966)

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INTERNATIONAL AGREEMENTS
AND
CONVENTIONS

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These are presented in partial fulfillment of the
requirements for the Master of Arts degree
in Education

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TO MY WIFE

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INTRODUCTION

International liquidity is a subject of great importance, not only with regard to the industrial countries, but also with regard to the developing world. The demand for international liquidity is determined not only with the types of policies and measures followed internally, but also it is a function of oscillation in the balance of payments imposed by external forces. The availability of international liquidity has an important bearing on the rates of growth.

There has been a tendency among some industrial countries to consider that the problem of international liquidity is fundamentally a problem for the developed countries. This is not true, since the developing countries are also part of the problem. Their need for international liquidity stems, not only from their internal developmental efforts, but also from the sharp oscillations in their export proceeds, which are mainly dependant on raw-materials, where values change a great deal. Besides, international financial assistance oscillates a great deal between one year and another for many political and economic reasons. The need of developing countries for international liquidity is far larger than that of the industrial countries.

It is the object of this thesis to study international liquidity with particular reference to the developing countries. For that purpose we shall first define international liquidity and survey in brief its recent developments. This is the subject matter of the first chapter. The relationship between international liquidity and international trade is developed in the second chapter, followed in the third chapter by a discussion of the relationship between international liquidity and the process of adjustment. In the fourth chapter a survey is made of the problem of international liquidity as it stands today. In the fifth chapter the problem of international liquidity is discussed with particular reference to the developing countries. Finally, in the last and sixth chapter, the various schemes proposed to improve the present international monetary system are surveyed critically, taking into consideration the needs of the developing world.

While the author does not claim originality of thinking for a subject of this range, it is hoped, that this thesis, at least attempts to survey the problem in a logical order and to discuss the extent of its dimensions on both the economic and political aspects.

I have had the honour of being supervised by both Dr. G.A. Marzouk and Dr. A. Murad. Dr. Marzouk, Director Bank and Credit Control Department, Central Bank of Egypt, represented the U.A.R. in the annual meetings of the IMF constantly since 1960. He also represented the U.A.R. in the UNCTAD at the 3rd. committee dealing with finance and invisibles. I have benefited a great deal from his wide experience and insight in the problem. Dr. Murad, Professor of Economics at the American University, gave valuable guidance and contributed substantially to the framing of the plan of this thesis.

I am also extremely indebted to my professors, Dr. R.B. Halley and Dr. A. Qayum, in the Department of Economics and Political Science, at the American University in Cairo. Their criticism and encouragement are highly appreciated.

A. K. Barsoum

Cairo, U.A.R.

May, 1966

CHAPTER I

INTERNATIONAL LIQUIDITY DEFINED

International liquidity is the total of internationally acceptable means of payments available to the world for the settlement of commercial and financial transactions among different countries. For an individual country, its external liquidity consists of all resources which possess a determined value, enjoy enough stability, are available or become available, after negotiations, to the monetary authorities,⁽¹⁾ and are acceptable by other countries to effect international payments.

These resources may take different forms : reserves of gold and foreign exchange, automatic drawing rights on the International Monetary Fund, and other borrowing arrangements with foreign central banks or governments. They may also include, conceptually, elements that are

(1) Gold and convertible currencies and short-term securities held by authorities other than the monetary ones, may function in much the same way as reserves, when the holders use them to meet payments abroad or when they sell them to the monetary authorities (Adequacy of Monetary Reserves, International Monetary Fund, Staff Papers, 1953, P. 183).

not readily subject to statistical measurement, such as the country's capacity to borrow in the monetary markets of other countries.⁽¹⁾

In recent years total liquidity has been classified according to its nature into two categories⁽²⁾ : unconditional liquidity or reserves which are more or less at the disposal of the country, and conditional liquidity which is available only on prescribed or negotiated conditions. The former would include, holdings of gold and foreign exchange in freely convertible currencies, gold tranche position in the IMF, and in many instances bilateral mutual credit or swap arrangements. Other forms of international liquidity fall in the second category. The IMF is much the largest provider of conditional liquidity in the form of drawing rights under the quota

(1) Stocks of silver and precious stones are not reserves, because they are not readily salable at an approximately predetermined price. Though they can be salable abroad and could be used to secure additional foreign exchange, when necessary (ibid., p. 184)

(2) This classification is used by the IMF and accepted by most countries. Other classifications, such as owned reserves and borrowing facilities, were not accepted; since it is difficult to determine, for such items, as the drawing facilities on the IMF, to be either owned reserves or borrowing facilities (IMF, Annual Report, 1964, p. 25)

system.

In practice, however, countries like to have the largest part of their external liquidity at their free disposal in order to be free to adopt the policies they deem fit without outside interference.

During the last decade while the average rate of growth of international trade amounted to 5.8% per annum, (1) that of international liquidity hardly reached 2.8%. The rates of growth of the different components of the reserves were unequal. The growth of gold reserves amounted to 1.6%, whereas that of foreign exchange was 4.3%, as

Table 1 -- All Countries' Official Reserves and Credit Facilities.

(in billion dollars)

All Countries	Reserves					Credit Facilities		
	gold	foreign exchange	gold tranches	special U.S. bonds	swaps used by other party	swaps unactivated	IMF standbys	other IMF tranches
1953	34.32	17.11	1.89	0	0	0	0	7.14
1959	37.88	19.10	3.25	0	0	0	0	12.90
1963	40.20	25.07	3.94	.71	.29	3.16	.51	13.48
Change	+ 5.88	+ 7.96	+2.05	+ .71	+ .29	+3.16	+ .51	+ 6.34

Source: Annex - Ministerial Statement of the Group of Ten

(1) Ibid., p.29

compared with 7.6% in the gold tranche position in the IMF.⁽¹⁾

The factors, that have determined the growth of international liquidity during the last decade, differed according to the individual components. While the growth in the unconditional (gold tranche position) and conditional liquidity of the IMF members was attributable to the quotas increase in 1959,⁽²⁾ the increase in foreign exchange holdings mainly in the form of dollars, resulted from the persistent balance of payments deficit of the U.S.A. vis-a-vis other countries.⁽³⁾

-
- (1) The Fund estimates that the annual growth rate of the conditional and unconditional drawing facilities and the mutual credit arrangements between different countries amounted to some 3.3% (ibid, p.30)
- (2) Another increase in quotas was adopted in 1964/65.
- (3) Between 1950-1960 more than half of the expansion of monetary liquidity in the world came from the accumulation of short-term credits in dollar (Central Bank of Egypt, Economic Review, Vol. IV, No. 3/4, Cairo, 1964. P. 292)

Table 2 -- All Countries' Total Official Holdings
of Gold and the Two Key Currencies^x

(in billion dollars)

All Countries' Total Holdings	1950	1960
Gold	33.8	38.2
Dollars	4.4	10.5
Pound Sterling	7.9	7.4
errors & omissions	+ 2.4	+ 2.5
	48.5	58.6

^x Source : International Financial Statistics (1960)

The small increase in gold holdings is attributable to the slow growth in the gold production and sales on the part of both South Africa and the Soviet Union.

As is shown in table 3 , gold production increased in South Africa, and declined almost steadily in other parts of the world outside the Soviet Union. Furthermore, an important part of gold production is either consumed in industry or held as private hoardings . During the last

year only 37% of the total gold available from production or sale by the Soviet Union went into official reserves, and the remainder was consumed in industry or swelled private hoards.

Behind the comparative stagnation in gold production is the stability of gold prices since 1934.⁽¹⁾ As a result of the rising cost of production coupled with the stagnation of gold prices, the profitability of gold mining fell substantially.⁽²⁾

(1) Charles P. Kindleberger, International Economics, (3rd. ed., Homewood, Illinois; Richard D. Irwin, Inc., 1963), p. 550.

(2) Several Governments have granted assistance to their gold mining industries; in some countries this assistance has taken the form of subsidies, as a consequence of the increasing gap between rising costs of production and the fixed price of \$ 35 a fine ounce (IMF, Annual Report 1965), p. 97.

Table 3 -- Sources of Changes in World Gold
Reserves*

(in million dollars)

Countries	1959	1960	1961	1962	1963	1964
South Africa	702	748	803	892	961	1020
Canada	157	162	155	145	139	133
U.S.A.	57	59	53	55	51	51
Australia	38	38	37	38	36	34
Ghana	32	31	28	31	32	30
Others	139	137	144	139	135	132
	1125	1175	1220	1300	1354	1400
Soviet Sales	255	200	275	215	550	330
Total available	1380	1375	1495	1515	1904	1730
Industry & Hoardings	-685	-1035	-890	-1185	-1064	-1005
Total added to World monetary gold stock	695	340	605	330	840	725

* Calculated from : International Financial Statistics
(1962, 1965)

As mentioned early in this chapter, international liquidity has increased during the past decade by 2.8% p.an.

compound, as against an increase of 5.6% in international trade. This, together with the policies adopted by the U.S.A. to restore the balance of payments into equilibrium prompted the fear that a shortage in international liquidity may ensue in the future. It will be recalled that it was the deficit in the balance of payments of the U.S.A. which contributed more than any other factor to the increase in international liquidity, during the last decade. As previously indicated, gold production has stagnated and is likely to stagnate as long as gold prices are maintained unchanged.

CHAPTER II

INTERNATIONAL LIQUIDITY and INTERNATIONAL TRADE

International liquidity is needed to finance international transactions and to meet future deficits in the balances of payments. But while the need for international liquidity is a function of international trade, it is, also a function of the process of adjustment and the policies followed in that respect. The shorter the period of adjustment and the more effective the policies followed to achieve the required equilibrium, the smaller would be the need for international liquidity and vice-versa.

This chapter discusses the relation between international liquidity and international trade, leaving for the third chapter the exposition of the relationship between international liquidity and the process of adjustment.

There is no fixed relation between international liquidity and foreign trade. Admittedly the size of a country's reserves, together with its available

international credits and proceeds of exports, set a limit to the amount of goods and services it can buy from other countries. Theoretically speaking, there is no limit to the desire of any country to accumulate reserves. Its accumulation differs according to many factors, such as the growth of its foreign trade, the imbalance in its international payments and psychological attitudes.

In 1958, the Fund estimated the world's need for additional reserves for the period 1958-1967 based on the relation between international liquidity and world trade.⁽¹⁾ On the assumption that international trade, will increase by 3% per annum the Fund forecasted that the required increase in international liquidity would be around U.S.A. \$ 19 billion. This estimate was reduced to \$ 8 billion, assuming that four countries are unlikely to need additional reserves, as they were already in possession of abundant liquidity.⁽²⁾

(1) Central Bank of Egypt, Economic Review, op. cit.
p. 29+

(2) These countries are U.S.A., West Germany, Switzerland and Venezuela.

In the Fund's opinion, at that time, a crisis in international liquidity was not probable; but subsequent developments in international payments showed that the Fund's view was not completely right. World trade expanded at a rate larger than that forecasted by the Fund. The exclusion of the U.S.A. from countries needing additional reserves was not compatible with the large deficit which that country encountered thereafter, and which necessitated the holding of additional reserves.

Therefore, the Fund changed its view regarding the relation between international liquidity and international trade. In its 1964 report, the Fund admitted that liquidity considerations should not inhibit countries from pursuing policies designed to liberalize trade and augment capital flows and aid together with the attempt to achieve full employment. The Fund added that developing countries have a rising need for liquidity in order to be able to avoid the disruption of their development programs. In 1965 the Fund tried to find criteria on which considerations for liquidity needs could be based. It indicated that resorting to qualitative judgement is inescapable since there is no close relationship between international liquidity and such simple

indices as the value of international transactions. The Fund added that in this judgement, attention has to be focussed primarily on the nature of reactions, the encouragement or discouragement of which may seem appropriate in accordance with the interest of sound development of world economy with a minimum of monetary disturbance. An increase (or decrease) of international liquidity will depend, therefore, on the influence of the level of world reserves on the countries' financial policies.

The Group of Ten stated,⁽¹⁾ that the aggregate need for liquidity is related to different factors : growth of world trade, capital movements, imbalances of international payments, the efficacy of adjustment policies, psychological attitudes towards accumulation and movements and use of available credit.

Apart from the difficulties of estimating the global need for international liquidity, there are many factors which affect the accumulation or release of

(1) "Although we know of no satisfactory quantitative formula for the measurement of liquidity" Ministerial Statement of The Group of Ten and Annex Prepared by Deputies, (n.p., 10th August 1964), p.8

reserves for each individual country. A Country's demand for reserves will vary positively with the amplitude of the cycle abroad, the income elasticities of demand for imports and the variability in the price of both exports and imports. The demand will also vary according to the extent of policies designed to maintain the price of exchange rates stable, as well as the policies and opinion towards exchange control, and restriction of capital flow. The amount of reserves sufficient for a country, which restricts the transfer of capital or puts controls on its foreign exchange, varies to a great extent from that needed by another country which does not impose any restrictions whatsoever.

A new tendency to impose restrictions on capital movements has been developed recently in some European countries, as a result of the destabilizing effect of capital movements,⁽¹⁾ especially after the introduction

(1) In the last quarter of the nineteenth century, largely characterised by stabilizing speculations, no one raised the question of the adequacy of the Bank of England's gold reserves, when the total stock of this world currency amounted to about \$ 100 to \$ 200 million. Today in a world of destabilizing speculation it is clear that \$ 2 billion of reserves are inadequate, and likely that \$ 3 billion are still short of appropriate level" Kindelberger, op. cit., p. 539.

of currency convertibility by most of these countries. (1)

Other factors accentuated the question of international liquidity. The demand on the part of the developing countries for capital flows, both officially and privately, increased substantially, in order to supplement their meagre domestic savings which are not sufficient to finance their development plans. Not only larger imports are required but also a growing part of their earnings is now being directed towards the servicing of their external debts. To this should be added the fact that a number of countries may prefer to accumulate some specific elements of international reserves (such as the case of France increasing the portion of gold within its total reserves). A country's level of reserves may also be affected by the movements of funds undertaken to combat speculative capital movements.

Reserves may also be affected by commercial banks' operations and the extent to which they succeed in raising

(1) It is difficult to determine either the origin or the final destination, as well as which country will benefit from the increase or decrease of these flows. (IMF , Annual Report 1965, op.cit., p. 60)

foreign credits,⁽¹⁾ as well as by the supplementary reserve assets available and their use in international settlements.

Reserve centers can affect other countries' reserves by taking action to offset their deficit whether through taking measures to restrain the outflow of its currency (such as the equalization tax introduced by the U.S.A.), or through accumulating other currencies as part of their own reserve. At the same time the reserve center itself can be affected by other countries' actions, such as a widespread demand for convertibility of their holding of the reserve center currency to gold, or the inclination to transfer their reserves to another currency of a potential new reserve center.

The Fund operations also affect the reserves in different ways. In the case of the inadequacy of a certain currency highly demanded, the Fund may convert part of its gold holdings to the currency under pressure.

(1) "Recourse to foreign short-term credits may take place under the influence of official action to reduce the need for international liquidity available to monetary authorities" Ministerial Statement of Group of Ten, op. cit., p.13 .

This procedure will not only constitute a change in the Fund's reserves, but it will also cause an increase in the volume of the currency demanded in the holding of the drawing country.⁽¹⁾ Quotas increases may affect both individual countries and currency reserve centers. As 25% of the increase is usually paid in gold, countries which hold the great bulk of their reserves in foreign exchange might have to acquire gold needed to subscribe to the Fund by converting part of their holdings of reserve currencies into gold. Thus the quotas increase while affecting the total holdings of reserves of different countries, the payment of 25% of the increase in quota in gold would reduce the gold stocks and adversely affect the reserve position of the reserve center country. Also the drawings from the Fund will affect the magnitude of reserves. The drawings in the gold tranche⁽²⁾ are usually

(1) In 1957 the Fund acquired \$ 600 million of U.S.A. dollars for gold, in 1961, it acquired \$ 150 million of U.S.A. dollars and \$ 350 million of currencies of eight industrial countries for gold.

(2) Gold tranche position in the Fund stands at about \$ 3.9 billion, while conditional drawing facilities in the credit tranches total about \$ 14 billion.
(IMF, Annual Report, 1964, op. cit., p.37)

considered as part of the country's reserves. But where the member is utilizing its drawing right facilities in the credit tranche, the net result of the operation will be to reduce the aggregate conditional facilities and to increase the aggregate reserves.

CHAPTER 111

RELATIONSHIP BETWEEN INTERNATIONAL LIQUIDITY AND THE PROCESS OF ADJUSTMENT OF INTERNATIONAL PAYMENTS

International liquidity is not directly used to settle international transactions. Exporters and importers normally resort to the services rendered by the international banking and financial system.

The need for international liquidity arises from the fact that no country can expect to be at all time in exact balance in its external payments. Temporary imbalances are bound to arise and, during the period of adjustment the payments gap has to be financed through the use of international liquidity. The process of adjustment required to eliminate disequilibria normally takes time. Besides, it is essentially dependent upon the availability of international liquidity as the means to finance the disequilibria.

This interrelation is two sided. On the one hand the adequacy of international liquidity to an individual country affects the policies taken to adjust the payments deficits; and on the other hand, the process of adjustment and the efficacy of the policies adopted

restore
to/the equilibrium affect the need for international
liquidity.

The amount of international liquidity available determines the process of adjustment in two ways. First, if there is too much liquidity, countries normally hesitate to take the appropriate measures necessary to restore balance, and the adjustment process functions in that case rather slowly. ⁽¹⁾ This delay may in some circumstances be wasteful. For a country having persistent payments deficits, the increase in its international liquidity will provide it with greater breathing space and may, therefore, tend to prolong the period of disequilibrium. For a country tending to run into persistent surplus, the concomitant increase in international liquidity tends to encourage more liberal trade and expansionary policies. The effect of these policies will naturally spread to other countries through international

(1) The reason is simple for that. When a country has large foreign exchange reserves it tends to delay the restriction measures to rectify the deficit in its balance of payments. But when it has no reserves at all or have very little reserves it tends to take immediate and drastic actions.

trade with consequent pressure on the general level of demand and employment, even though some countries may seek to offset the domestic impact of the enhanced foreign demand, by domestic policies. The second assumption is that if there is not enough liquidity or if it fails to expand adequately, countries may not have enough time or elbow-room to make adjustments in an orderly fashion, and this may, therefore, disrupt their development plans and programs. Countries will be forced to take restrictive measures that are disruptive both to their domestic economics and to international trade.

On the whole, the need for international liquidity not only depends to a great extent on the types of policies to be taken towards the adjustment of the balance of payments, but also on the objectives of these policies with regard to the level of employment, rates of growth and exchange rate stability.

Rules of the game :

The process of adjustment under the gold standard differs significantly from that under the Bretton Woods Agreement. Under the Gold standard mechanism the

adjustment of balance of payments is automatic. Before World War 1 most legislations provided for certain ratios to be maintained in the form of gold as cover for the notes issued by the central banks or other monetary authorities. Any outflow or inflow of gold was consequently accompanied by parallel or multiple movement in money supply. The fall in money supply concomitant with the balance of payments deficits tends to reduce effective demand and consequently the level of domestic prices, and this encourages exports, and ultimately leads to the equilibrium in the balance of payments. On the contrary, when a surplus in the balance of payments ensues, money supply expands leading to increased imports, reduced exports and ultimately the vanishing of the balance of payments surplus. Thus the gold standard system, firmly tied the quantity of money supply in circulation to gold. ⁽¹⁾ Changes in gold reserves used to have a large impact on money supply and, the movement of gold was the initiator of the policies to be adopted.

(1) Kindelberger, op. cit., p.71

The acceptance of the principle of contraction at times of deficit, and of expansion at times of surplus, rested on the idea that prevailed at that time that economic cycles were beyond control.

Costs and earnings before the first World War were considerably elastic. This enabled different policies to be effective without bringing about serious unemployment. (1) Short-term capital flows were easily attracted, at that time, through the use of the interest rate. Capital inflows occurred when the interest rates were raised as a means to contract the economy and, outflows took place when the interest rates were reduced in order to encourage the expansion of the economy. Obviously, these capital movements were of an equilibrat- (2) ing nature.

The mechanism of the sterling exchange standard had many features in common with the gold standard in so far as it tightly linked money supply with sterling assets in a larger number of countries. The confidence

(1) Dr. Zaki Shafei, International and Regional Financial Cooperation, Lectures delivered at The Higher Institute of Arab Studies, Cairo 1959/60. p. 5 (In Arabic)

(2) Ibid. p. 5

in sterling encouraged a number of countries to hold large deposits in London, which had been recognized as a world central bank.⁽¹⁾ These deposits were used in financing a large part of world trade.⁽²⁾ The Bank of England had a de-facto influence on monetary policies of member countries.

According to the Bretton Woods Agreement member countries have to maintain a fixed value for their currencies relative to gold and other currencies - the par value system-. Changes in the par value are reserved only in the case of fundamental disequilibrium⁽³⁾ and this necessitates prior consultation with the Fund.

-
- (1) About 90% of universal transactions were performed in sterling - It is alleged that the gold standard was in reality sterling standard (ibid. p. 8).
- (2) Central Bank of Egypt, Economic Review, op. cit., p. 291.
- (3) The fundamental disequilibrium is nowhere defined in the Articles of Agreement of the Fund. The concept and arguments are clearly discussed by Prof. Kindelberger, op.cit., chapter 27.

Together with the General Agreement of Tariffs and Trade the IMF articles of agreement stipulate that restrictions on current payments and on trade are permissible only in situations of balance of payments difficulties and are subjected to international regulations. These requirements are destined to foster international cooperation and prior consultation with the IMF. As a means to avoiding taking policy measures which are destructive to the world economy. Fundamental disequilibrium is to be managed by corrective policy actions left to be determined according to the individual internal and external trends.

It is necessary to mention that there are more reasons which made the adjustment of balance of payments disequilibrium of a non-automatic mechanism. Internal economic considerations have to be taken into account, in the process of adjustment. It is no longer accepted that economic stagnation is to be suffered as conditions beyond the control of economic policies. Appropriate policies have to be taken to maintain high level of employment and economic growth as well as price stability.

It should be mentioned here that internal prices

and incomes have become increasingly rigid as compared with the pre World War I period. The maximum that can be done in such circumstances is to keep wage increases in deficit countries within the limits of the increases in productivity.⁽¹⁾ Under such conditions international adjustments through changes in relative costs and prices, fundamentally involve upward adjustments in surplus countries rather than downward adjustments in deficit countries.⁽²⁾ This is, of course, not acceptable in the surplus countries since it implies inflation and deterioration in the competitiveness of their industries vis-a-vis the deficit countries abroad.

To this should be added that recently, massive movements of long-term as well as short-term funds have taken place between the main industrial countries. This played a disequilibrating rather than an equilibrating role.⁽³⁾ These capital outflow from the deficit countries (the U.S.A. an example) accentuated the

(1) IMF, Annual Report, 1964, op.cit., p. 28.

(2) Ibid. p. 28.

(3) IMF, Annual Report, 1965, op.cit., p. 13.

difficulties and in many cases impaired the use of appropriate monetary policies suitable for internal purposes.

In recent years there has been a great tendency⁽¹⁾ towards the policy of sustained growth which rejects the return to stop-go economics as a means to restore external balance in the deficit countries. The key in the new policy adopted by both the U.K. and U.S.A. is to increase productivity and competitiveness through appropriate cost policy and sustained investment which is the lever to increased efficiency.

Obviously, it is a long-run policy that entails in the interval certain balance of payment deficits. Even setting aside the probable reduction in the overall balance of payments deficit of the United States which contributed during the past decades to the increase in the dollar assets of the world, the new and commendable policy of achieving external strength through economic expansion points towards the need for a substantial

(1) Statement by the Governor of the Bank for U.A.R., Dr. A. M. El Kaissouni; IMF, Summary Proceedings, Annual Meeting, 1965; p. 202.

increase in international liquidity to the benefit of both developed and developing countries.⁽¹⁾

If the rates of growth are to be sustained without interruption, balance of payments deficits can normally be rectified over relatively long periods of time. It is now widely accepted in both developed and developing countries that it is inappropriate to apply corrective measures that interfere unduly with domestic economic growth. Similarly, and very rightly too, there is reluctance and indeed no obligation on the part of the surplus countries to allow the inflationary forces resulting from their balance of payments surpluses to work their normal course which would be to the benefit of the deficit countries and enhance the rectification of their deficits. To put it more crisply, the set of obligations or "the rules of the game" whereby the deficit countries have to apply restrictive measures and slow down, and the surplus countries to permit excess demand to develop, are not acceptable either to the

(1) Ibid.

surplus or to the deficit countries. Both sets of countries would like to apply the rules of the game slowly and in a fashion that neither interrupt growth nor lead to inflation. (1)

Here the spirit of compromise and wisdom as rightly stated by Prof. El-Kaissouni suggests the necessity for a systematic creation of a new asset, coupled with the re-adaptation to world needs and feasible policy objectives of both the automatic and conditional credit tranches of the International Monetary Fund. (2)

This systematic reserve creation is an international responsibility and not that of a limited number of industrial countries. If the developments in the industrial countries point to the necessity of increased international liquidity to maintain steady growth at the time there is external imbalance, the developing countries are in the same conditions. Their need is even more urgent, genuine, and legitimate. Over and above the wild oscillation in their export prices and export proceeds, the developing

(1) Ibid.

(2) Ibid.

countries have development plans which requires an assured level of imports. While welcoming the sustained growth in the United States, the United Kingdom, Continental Western Europe and the Union of Soviet Socialist Republics, which is beneficial to the world at large, including the developing countries, it should be stressed that the disparity between the developed and developing countries is widening sharply. Per capita income is growing in the industrial countries at 4% per annum, against less than 2% in the developing world ⁽¹⁾ where about two thirds of the world population are living.

Admittedly, the balance of payments deficits of the developing countries require in the first place the inflow of long-term capital and grants. But as pointed out before, with the sharp fluctuations in their export proceeds, the deterioration in their terms of trade, and above all the oscillations in long-term capital inflow to individual developing countries, the need of these countries for increased international liquidity is very urgent. They need increased foreign exchange resources exactly for the same objective as the industrial countries do, namely to maintain steady growth and to avoid the disruption of their development plans and programmes.

(1) Ibid.

CHAPTER IV

PROBLEMS OF INTERNATIONAL LIQUIDITY

The accentuation of the problems of international liquidity at present time stems from two main reasons, the first is the expected shortage of supply of reserves in the future. The second is the growing need for a system of comprehensive control and planning over the system whereby the increase in international liquidity is made according to world needs rather than haphazardly as it is the case so far.

While there is no shortage of international liquidity at present, it is likely that a shortage will ^{in the} ensue/future. (1) This expectation is natural from both points of view of demand and supply of international liquidity. On the demand side it is reasonable to expect growing needs for monetary reserves, as a consequence of the growth in a dynamic world economy, with growing international trade, growing national outputs, growing domestic supplies of money, and growing incomes and profits, coupled with policies destined to enhance stabilization and economic growth.

(1) Ministerial Statement of the Group of Ten, loc.cit.

The demand for reserves represent a more difficult problem than the mere need for it on the part of the different groups of countries developed or less developed. This problem stems from the extreme difficulty if not the impossibility of measuring the overall needs of the world economy for liquidity, since the need of liquidity on the part of any individual country is not a good indicator of an overall inadequacy of reserves. Each country assesses its own demand for liquidity according to its own internal and external policies and their objectives. It is therefore an individual judgement of present and prospective needs, and influenced by past developments and trends. But the problem will be fatal if several countries simultaneously happen to feel that they are short of liquidity or they are not liquid enough. If the inadequacy of reserves is recognized by a large number of countries a wide spread resort is made to excessive restrictive policies, hampering trade and payments all over the world. The consequence of which will be extensive push towards accumulating reserves, reluctance towards extending credit, and at a later stage international transactions will tend to deminish. Obviously, international cooperation is the only means to avoid such serious developments at the right time even

though the added doses of reserves to offset that alarming situation may not necessarily be adequate in amounts or satisfactory in their distribution of in the desired form. (1)

While the need for international liquidity, is likely to grow in the future there are clear evidences on the supply side that factors which have been responsible for the growth in liquidity during the past decade, may not be repeated, or if repeated will lead to a much smaller annual rate of growth in liquidity over the decade to come.

As indicated in chapter I most of the increases which occurred over the past decade in reserve holdings were in the form of foreign exchange; whereas the growth of gold reserves amounted to only 1.6%, that of foreign exchange amounted to 4.3%. (2) Table 2 indicated that the rise in foreign exchange holdings was attributable

(1) Report of The Study Group on The Creation of Reserve Assets, report to the Deputies of the Group of Ten, n.p., 31st May 1965, (Known as the Ossola Report) p.19.

(2) The gold tranche increase does not represent any problem since it is merely a fixed portion of the quota.

to the dollar increase in the total of world reserve holdings. In reality, since the end of the second world war, the U.S.A. has provided the world with additional liquidity, which made possible the growth in world trade and payments despite the gap created by the insufficiency of gold production. Since 1958 about three quarters of the new reserves accumulated by the world has been created as a result of the deficit in the balance of payments of the U.S.A. (1)

It will be recalled that the post-war gold exchange standard, was created as a reflection of the inadequacy of the supply of gold and a means to economize in its use in international transactions. Under this system countries maintained their external reserves, not only in gold, but also in currencies that are convertible into gold. Thus although gold still represents about a half of the total world reserves, the remaining half of the reserves is held in the form of foreign exchange, particularly dollar and sterling pound

(1) Statement by the Governor of the Bank and Fund for the U.S.A., Henry W. Fowler, IMF Summary Proceedings, Annual Meeting, 1956, p. 103.

At the end of the second World War, the dollar was strong; while the European currencies were weak and inflation - ridden; the U.S.A. was the world's main supplier of goods and capital, and it was, therefore, natural that countries should hold their foreign assets in the form of dollars⁽¹⁾ or gold, since the large part of international transactions were settled in dollars. Although the gold exchange standard economized in the use of reserves, it ran in some circumstances the risk of instability, through the issue of excessive currencies by the key countries, an action which was capable of generating an international crisis. It is the position of the dollar which determines the future of the gold exchange standard.⁽²⁾ This is due to the decreasing gold reserves in the U.S.A. and the increase in monetary short-term liabilities of that country. Since the beginning of the fifties, Western European currencies have gradually become stronger. The gold reserves of the Common Market countries are roughly equal to those of the

(1) 68% of the World's monetary gold was held by the U.S.A. as a result of the movement of hot money from Europe in the last years of the war (Kindelberger, op.cit., p.541.)

(2) Central Bank of Egypt, Economic Review, op.cit., P. 296.

U.S.A., and they would, in fact, be larger if they should decide to convert their dollar holdings into gold. The gold reserves of the U.S.A. has decreased significantly during the last decade, while those held by the other eight countries and Switzerland members of the Group of the Ten increased considerably. The following table indicates this trend clearly,. The threat to the dollar position is also clear judging by the large holdings of dollars by other countries. ⁽¹⁾

Table 4-- Official Reserves, Selected Countries and Selected Years.

(in billion dollars)

	Gold	foreign ex- change	gold tranche	swaps used by other party	Total re- serves
United Kingdom					
1953	2.26	.28	.12	0	2.66
59	2.51	.24	.07	0	2.82
63	2.48	.17	.49	0	3.14
change	+ .22	+ .11	+ .37	0	+ .48

(1) Ministerial Statement of the Group of Ten, op.cit., p. 6.

Table 4 -- Continued

	Gold	foreign ex- change	gold tranche	swaps used by other party	Total re- serves
United States					
1953	22.10	0	1.37	0	23.47
59	19.51	0	2.00	0	21.51
63	15.60	.21	1.04	.05	16.90
change	- 6.50	+ .21	- .33	+ .05	- 6.57
(*) Eight Countries and Switzerland					
1953	5.49	5.05	.26	0	10.80
59	11.27	6.20	.86	0	18.33
63	16.44	10.13	1.80	.66	29.03
change	+10.95	+5.08	+ 1.54	+ .66	+18.23

Calculated from : Annex-Ministerial Statement of the Group of Ten (1964)

(*) Eight countries are : France, Germany, Italy, Belgium, Netherlands, Sweden, Canada, and Japan.

In 1962 the U.S.A. possessed \$ 16.4 billion in the form of gold, while its short-term liabilities amounted to \$ 23 billion. In 1963 the gold stock was reduced to \$ 15.5 billion whilst the short-term liabilities reached \$ 26 billion.⁽¹⁾ It is only because the creditors refrain from converting into gold their large holdings of short-term balances, the dollar is being kept convertible. This is to the benefit of the world at large since it is not a wise policy to force the debtor into bankruptcy.

The future supply of liquidity depends on what would happen if the U.S.A., prompted by its large external liabilities holdings, brought the creation of reserves for other countries to an end through bridging its balance of payments deficits and even attempting to achieve sizeable surpluses.

Paradoxically enough, the success of the gold exchange standard which involves holdings of foreign exchange by other countries depends greatly on the balance of payment position of the reserve centers and the confidence in

(1)a. A Central Bank of Egypt, Economic Review op. cit. p.290
 b. In the decade 1954-63 about \$ 6.5 billion was transferred from the gold holdings of the U.S.A. to the reserves of other countries - Ministerial Statement of the Group of Ten, op. cit., p.6

their currencies, this confidence if pushed too far ultimately leads to a serious shortage in international liquidity, if the reserve centers are prompted to rectify their balance of payments deficits.

The second major problem of international liquidity is the weakness of the present monetary system in so far as systematic creation of reserves to meet future needs is concerned. The currencies of the reserve centers, which now constitute the largest component of world's reserves, are created haphazardly depending to a large extent on the balance of payments position of the centre rather than the world economy. This haphazard way may lead to serious sudden and unpredictable developments. The reserve centers are in a position to obtain considerable credit facilities, over long periods of time, through offering their own currencies to other countries. So long as the center can finance some part of its balance of payments deficits by an accumulation of liabilities⁽¹⁾ with foreign

(1) " In the last six years as whole, the U.S.A. has financed some 40% of its deficit in this way. Most of the financing of the United Kingdom deficit in the last decade has been provided by the fund or by special assistance from the monetary authorities of other countries." IMF, Annual Report, 1965 op.cit., p. 13.

monetary authorities the reserve center may misuse such facilities by postponing as long as it can the adoption of appropriate adjustment policies. It is therefore contended that with the undue and exceptional facilities afforded to reserve centers, the magnitude of reserves is therefore determined by factors that have little to do with the world's need for reserves. The element of potential instability, might be a major factor.

The problem with capital movements, stems from the fact that the Articles of Agreement of the Fund left the control of capital movements almost entirely to the discretion of national governments. The freedom of capital movements was regarded as an equilibrating factor in international payments, which would diminish the need for reserves. In fact, the period starting with the late nineteen fifties, in particular after the main European currencies became convertible, has been characterized by a massive capital movements between the United States and Europe and among the industrial countries themselves. The massive movements of capital from the U.S.A. to European countries have caused persistent balance of payments problems for the U.S.A., and also accentuated the .

difficulties which the European countries have experienced in containing domestic inflationary pressures. At the same time the development of short-term and long-term capital markets in Europe, represents a direction toward financial integration. On the other hand it makes it difficult to adopt monetary and credit policies appropriate to the internal situations of the individual countries without causing at the same time undesirable capital movements.

Another weakness, is that while certain **specified** financial behaviour requirements are demanded from deficit countries, there are no requirements asked from the surplus countries. Admittedly the scarce currency clause can be put into operation in case a particular country has considerable balance of payments surpluses which make its currency scarce to the IMF. In this case the Fund can declare that currency scarce and member countries can, under **such circumstances restrict their transactions with** that country. But even here the main responsibility for such policies rests on the deficit countries themselves.

CHAPTER V

INTERNATIONAL LIQUIDITY AND THE DEVELOPING COUNTRIES

It might be appropriate, when discussing the liquidity problem, to make a distinction between the developing and developed countries. During the last fifteen years, production, in the industrial countries expanded at a rate more than 5%; unemployment has been largely absorbed; and labor force grew by 1.3%⁽¹⁾. The industrial countries of Continental Europe began the post war period with almost nothing in the form of reserves. Thanks to the tremendous financial assistance extended by the U.S.A. their reconstruction were accelerated, and these countries achieved a high level of prosperity, in a comparatively small number of years. However, in spite of the considerable financial assistance received from the U.S.A., Europe faced certain inflationary tendencies with consequent price increases. The cost of living indices in Europe rose during the same period, by some 2.5%⁽²⁾. This has been due to the difficulty involved in reconciling full employment and enhanced

(1) IMF, Annual Report 1963, p.11.

(2) Ibid.

income growth with price stability.⁽¹⁾

It should be stressed that this great progress has been made without much recourse to the instruments of payments adjustments that were stipulated in the Bretton Woods Agreement. There have been relatively little change in par values.⁽²⁾ Payments restrictions have been abandoned after a small number of transitional years, and currency convertibility was widely adopted in the early sixties. Similarly, the instruments of quantitative restrictions on imports, stipulated for in the Gatt Agreement, as a facility for meeting balance of payments difficulties, have also been put into little use.⁽³⁾

It is natural, therefore, that the rapid reconstruction of Europe during the later nineteen forties and early fifties should tend to generate some

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- (1) This difficulty is evoking attempts at establishing, in recent years, "incomes policies".
 - (2) Devaluation by France and Canada, and revaluation of DM and the Guilder.
 - (3) The accelerated movement toward freer commodity markets, and the relatively slow progress towards convertibility is clearly discussed by Dr. Per Jacobsson, Problems of The Return to Convertibility, Basle Centre For Economic and Financial Research, Basle, Switzerland, series A: No.14.(1955)

inflationary pressures. However, high demand abroad coupled with expanding output at home, enabled most industrial countries to correct their balance of payments deficits without too much recourse at the beginning to restrictive financial and monetary policies. Only temporary pauses were encountered in the expansion of domestic output. (1)

But later on, particularly after 1951, the use of monetary policies for equilibrium purposes gained certain acceptance in official quarters and among economists. (2) However, surplus countries continued to be reluctant to resort to expansionary policies for the sake of correcting their payments surpluses.

In recent years, two major developments came to the forefront having important implications for the international payments system. First, there has been a considerable increase in international mobility of

(1) IMF, Annual Report 1965, op.cit., p. 12.

(2) J. Marcus Fleming, "Developments in the International Payments system" IMF, Staff Papers, Vol. x No. 3, Nov. 1963, P. 469.

capital resulting from the relaxation of capital controls in European countries. This together with the relatively high rates of profit in Europe encouraged in particular considerable capital inflow from the U.S.A.

The second major development was the slowing down in the rates of growth of international reserves,⁽¹⁾ as a consequence of the declining confidence in the U.S.A. dollar .

Paradoxically enough, the deficits in the balance of payments of both the U.S.A. and U.K. increase the level of world reserves. But this can only continue up to a point, beyond which the propensity of other countries to hold part of their reserves in these two reserve currencies tends to slow down. In recent years, the position changed substantially as a result of the considerable improvement in the balance of payments position of the U.S.A.

The first tendency, namely the considerable movements of capital between the industrial countries,

(1) Ibid. p. 470.

imposed serious problems to balance of payments of these countries. These difficulties were allayed considerably by a policy of financial cooperation and coordination⁽¹⁾ among these countries, particularly those members of the Group of Ten.

As a consequence independent monetary policies suitable for internal developments alone, became increasingly narrow, since such policies are apt to enhance undesirable capital movements. In these circumstances more emphasis must fall on fiscal policy alone. Where countries have found the mobility of capital to hamper the use of monetary policy for domestic purposes, they tended to intervene directly by restricting the freedom of capital movements. Several surplus countries have restricted the inflow of foreign funds, and certain deficit countries have discouraged the outflow of funds by different formal and informal measures.⁽²⁾

(1) Dr. Per Jacobsson, The Present International Monetary Situation, Central Bank of Egypt Lectures, Cairo 1962.

(2) IMF, Annual Report, 1965, op.cit., p. 13.

As previously indicated, the second major tendency was the slow growth in world liquidity. This resulted from two factors. The first was the restrictions imposed on capital movements and the second the improvement in the balance of payments position of the U.S.A.

The above mentioned two major tendencies in the industrial countries are of great importance to the developing world, through their effect on foreign trade and foreign aid. The outcome of the recent developments in the industrial countries is that both the deficit and surplus countries became more preoccupied with their actual and prospective balance of payments positions. They are now inclined to follow cautious and even restrictive policies.⁽¹⁾ Some developed countries resort to restrictions because they are losing reserves,

(1) "One school of thought would like to resort to the application of restrictions enforced by exchange control (techniques envisaged at Bretton Woods) for dealing with the problem of speculative or other unwelcome capital movements." Fleming; IMF, Staff Papers, 1963, op.cit., p. 474.

while some others apply restrictions because they are afraid of losing more reserves. If we add to this that the adjustment of the U.S.A. and the U.K. balance of payments would imply ultimately a reduction in the global reserves of European countries, they would inevitably resort invariably to restrictive practices. The results would be adverse consequences to the world trade.

Since Continental Europe absorbs an important volume of the developing countries exports, a restrictive European policy would accentuate the difficulties of the developing world.

The developing countries are in great need of foreign aid. But potential donors (1) - the European countries - are inhibited about increasing their aid, not through poverty, but through pretending that their foreign reserves are inadequate. Some others such as the

(1) "With their recovery and prosperity, the European countries have been able to make increasing contributions to the world's exports and to international aid programs. They have now, I think, to make all feasible progress in becoming net exporters of capital" Mr. P. Schweitzer - Managing Director of the IME, The International Monetary System and International Liquidity, Lecture delivered at the "Institut d'Etudes Bancaires et Financières, Paris, 2nd. June 1965.

U.K. and the U.S.A. indicate that they are not in a position to give more aid owing to their balance of payments difficulties. This is in spite of the fact that their aid is tied to purchases from their own countries.

Industrial countries, particularly Western European countries, have thus achieved, since the end of World War II, a very high degree of success, and have experienced the high rates of growth in productivity. During the same period, the achievements in the developing countries were the reverse. These countries have found it extremely difficult, if not impossible, to achieve simultaneously the goals of rapid growth coupled with internal and external stability. Restrictions on imports and invisible payments have often been resorted to, and exchange rates have tended to depreciate. The disparity between the developed and developing countries is widening sharply. Their balance of payments deficits require larger inflow of capital and grants than otherwise available. Their need for international liquidity is urgent and legitimate. They need foreign exchange resources to maintain steady growth and avoid disrupting their development

plans and programmes.

According to the IMF, 1965 Annual Report, the aggregate world reserves increased by \$2.5 billion in 1964, which is considerably less than the increase of \$3.4 billion in 1963. In both years, the growth rates in total reserves was considerably smaller than that in the value of international transactions, which for the two years combined rose about three times as fast as reserves. The smaller increases in world reserves was associated with a marked reduction in the balance of payments surpluses of the non industrial countries. Within this group, the increase in reserves of the more developed countries fell from \$0.8 billion to \$0.5 billion, while that of less developed countries declined from \$1.0 billion to about \$ 0.1 billion. Reserve developments are shown in the following table.

Table 5 -- Development Of Official Reserves,
Including Reserve Positions in the IMF[⊠]
between 1961 and 1964

(in billion dollars)

	1961	1962	1963	1964
Industrial Countries (other than the U.S.A. and the U.K.)	26.97	28.40	30.56	33.38
Other developed Countries [@]	4.67	5.35	6.18	6.72
Other countries	8.96	8.81	9.78	9.90

⊠ Calculated from: International
Financial Statistics.

@ Other Western European Countries, Australia,
New Zealand and South Africa.

It might be important, before proceeding with the liquidity problem of the developing countries, to realize that the unsatisfactory development of their foreign exchange earnings, has been the main factor which prompted them to impose trade and payments restrictions. These restrictions are not desired for their own sake.

The flow of financial resources to the developing

countries over the last few years has not been very encouraging. The expansion of world trade during the last 15 years has to a large extent by-passed the developing countries. Their share in world exports has fallen from nearly a third in 1950 to a fifth in 1964.⁽¹⁾ The terms of trade have also moved against them. The rates of growth in export earnings rose only by an average of about 3 ½% between 1952 and 1964, with the result that the capacity of these countries to import out of export earnings has grown less than the volume of their exports.⁽²⁾

In the nineteen fifties, the volume of imports of the developing countries increased by 4.1% per annum compound, while the volume of exports rose by only 3.9%. The same disparity has continued during the first part of the nineteen sixties.

The problem of the developing countries in Africa and particularly Asia was more serious. While

(1) U.N., Conference on Trade and Development, Report of The Group of Experts (New York: 25 Jan. 1966)

(2) Ibid.

the volume of imports expanded by 4.8% and 4.3%, in turn, the volume of exports rose by 4.4% and 1.9% respectively.⁽¹⁾ These unfavourable developments were accentuated by the deterioration in the terms of trade of developing countries by about 10% during the past decade. The gap in the balance of payments of those countries widened substantially; part of this gap was met by foreign loans and financial assistance, and the remaining part was financed by drawing on the foreign reserves.

It is of interest to note that the volume of imports by both Africa and Asia countries increased at rates higher than for their gross domestic product. An important reason for this trend is that any acceleration in the rate of growth for the less developed countries requires additional investment, the import content of which is normally much larger than that of income as a whole. Another contributing factor was the concomitant increase in consumption of foodstuffs which, unfortunately, was not accompanied by sufficient expansion in domestic production. Thus not only the surplus available for exports fell, but also

(1) U.N., Bulletin for Asia and the Far East, Vol. XV, No. 1, June 1964.

imports of foodstuffs by a number of developing countries increased substantially.⁽¹⁾

Similarly, the statistics on the commitments for the flow of long-term financial resources to the developing countries are not encouraging. Only in 1964, the resources committed rose back to \$ 9.0 billion, the level reached in 1961.⁽²⁾ These figures include private and official bilateral financial resources as well as capital made available to multilateral institutions.⁽³⁾ They represent commitments and not the physical movement of resources indicated only in the balance of payments estimates.

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- (1) Dr. Girgis A. Marzouk, Import Requirements of Economies in the Process of Development; Specialized Course, Foreign Trade and Payments Organized jointly by African Institute of Economic Development and Planning (United Nations), Dakar & Institute of National Planning (Cairo; 7 March, 2 April 1966).
- (2) World Bank And IDA, Annual Report, 1964 - 65, p. 29.
- (3) In 1963 four fifths of total inflow of foreign finance resources in developing countries was in the form of bilateral and multilateral aid (IMF, Annual Report, 1965, op.cit., p. 5.)

Over and above, the stagnation in total commitments⁽¹⁾ there were important changes in the composition indicating a worsening in the overall terms of financial resources. Official aid commitments disclose the decline in the share of grants from 60% in 1962 to 54% in 1964.⁽²⁾ This decline by 6% in the share of grants considerably exceeds the reduction in the average rate of interest for official bilateral commitments from 3.6% in 1962 to 3.1% in 1964.⁽³⁾

While that share of official grants fell, that of private long-term capital including trade credits

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- (1) Development assistance commitments by socialist countries sharply declined in 1962 and 1963. They increased in 1964 to slightly less than 1961 peak level of \$ 1.1 billion (U.N. conference on Trade and Development, Note by the Secretary-General of UNCTAD, submitted to Trade and Development Board, Committee on Invisibles and Financing Related to Trade, First Session, Geneva, 6 to 22 December 1965, headed "Consideration of The Adequacy of The Rates of Growth Achieved by the Developing Countries: Problems and Issues".)
- (2) Total grants from Development Assistance Committee (DAC) Countries declined from \$ 4 billion in 1962 to \$ 3.8 billion in 1964 (ibid.)
- (3) Due to the reduced proportion of total assistance accounted for by grants the weighted average interest rate (grants being assigned zero interest charges) on assistance commitments of DAC countries increased from 1.4% in 1963 to 1.5% in 1964 (ibid.)

rose.⁽¹⁾ Here the interest charges seem to be heavy, since the general trend of interest rates in the U.S.A. and Europe has been upward in recent years. Due to the volatile nature of private capital there is no certainty that the increase of 1964 will prove to be permanent.⁽²⁾

While the financial resources flowing into the developing countries are stagnating or slightly deteriorating, the external indebtedness of these countries is increasing. A number of developing countries are at present faced with debt repayments, which are very heavy compared with their potential earning of foreign exchange. According to The IMF,⁽³⁾ outstanding public and publicly guaranteed debt with a maturity of one year or more for 37 developing countries included in the survey, rose from \$ 18 billion at the end of 1962 to some \$ 25 billion in 1964, an increase of about 40%. Debt service, for the

(1) In 1964, total financial assistance from DAC members increased due to a large increase in private capital flows (ibid.)

(2) Ibid.

(3) IMF, Annual Report, 1965 op.cit., p. 24.

same countries, which includes payments of both amortization of principal and interest, rose at the same time, from about \$ 2 billion to about \$ 2.5, an increase of 25% only. This seems to be the result of the lengthening of the amortization period rather than of a reduction in interest charges. The Fund indicates⁽¹⁾ that the structure of these debts has altered, and that relatively short-term debt forms a larger part of the total which reflects the fact that sufficient long-term funds were not available. The maturity schedules of these debts are not in line with the ability to pay schedules of the receiving countries. Also the increase of short-term debts reflects a "rolling-over" of some previous short-term capital receipts, and borrowings greater than repayments, with a consequent increasing obligation to meet outstanding commitments.

The following table indicates the increase of short-term government and private liabilities of many developing countries to private U.S.A. lenders. The U.S.A. is the main provider of short-term capital to

(1) Ibid.

Latin America.

Table 6 -- Short-term Claims on Selected Countries
Reported by U.S.A. Banks and Non-Financial
Concerns

(in million dollars)

	1960	1961	1962	1963	1964
Latin American Republics and other Western Hemisphere (excluding Canada)	1,650	1,810	1,989	2,157	2,746
Other primary product exporting countries	454	610	595	703	929

Source: IMF, Annual Report, 1965.

Private capital flow to developing countries, is to great extent of changing manner and unevenly distributed. This is a result of different causes which encourage or discourage its flow. Besides its onerous terms, private capital is quite sensitive to political attitudes. A substantial flow of private capital to developing countries undoubtedly requires a willingness on the part of both investors and developing

countries. It is equally essential that the industrial countries should consider doing everything in their power, by fiscal or other means, to stimulate capital exports particularly official capital to the developing countries. (1)

The adequacy of reserves, or more precisely the flow of long-term capital and aid to developing countries is to a great extent related to their rate of growth. The developmental process requires various types of intermediate and capital goods which have necessarily to be imported. The capacity of these countries to import is positively connected with their export earnings as well as foreign capital inflow. But with the sharp fluctuations in export proceeds, (2) the deterioration in terms of trade, the import capacity of these countries seems to be badly affected. If we add to this the oscillations in long-term capital inflow (which is now becoming more than ever politically influenced), and the

(1) IMF, Annual Report, 1964, op.cit., p. 5.

(2) Annual debt service payments accounted for 12% of export earnings of developing countries and even higher in number of cases in 1964 - a sharp contrast with that of mid 1950's (U.N. conference on Trade and Development-Dec. 1965, loc.cit.)

policies followed in the developed countries tending to restrict imports⁽¹⁾ from developing countries which are pledged to development plans, it will be clear how urgent and legitimate is the need of these countries for increased international liquidity. Supply of external resources is a limiting factor on the rates of growth of developing countries. Developing countries, in a desperate effort to maintain their rates of growth, are forced to accumulate short-term liabilities to banking and other agencies,⁽²⁾ as well as to tighten import restrictions. The pressure on their balance of payments is accentuated by serious problems of debt servicing and repayment of debts.

Recently, the growing fear of a shortage of liquidity in the developed countries has threatened to create an environment unfavourable to rapid growth of developing countries. The fear of illiquidity, tends to increase their concern about their balance of payments considerations. This will affect adversely the scale of aid extended to the developing countries.

(1) UNCTAD, Report of the Group of Experts, loc.cit.

(2) Ibid.

Developing countries are in acute need of additional reserves. Their need for reserves may be expected to rise with the growth in their economies and external transactions. A question may now be posed about whether the recent experience of developing countries makes it possible for them to achieve the modest target rate of growth set by the United Nations for the Development Decade namely, a rate of growth of 5% p.an. in national income by the end of the Development Decade of the 1960's. On this point the United Nation's recent survey states that during the first part of the 1960's the actual growth rates in income and output of developing countries has generally not been sufficient to offer assurance that the target will be reached. The rates of growth of developing countries have in fact declined from about 4.5% p.an. in the early fifties to 4% p.a. in the early sixties.⁽¹⁾ The prospect is that more vigorous national and international policy measures would be needed in the second half of the Development Decade, if the target is to be reached.

The relatively low rate of growth of the

(1) Ibid.

developing countries is not wholly attributable to external factors. The development of these countries cannot be accelerated to the extent required without structural and institutional changes.⁽¹⁾ But although there are various inadequacies, which remain to be dealt with, it is to be noted also that many developing countries are making serious efforts to increase the efficient use of their resources. With more progress, these countries become more able to utilize increasing amounts of external financial assistance. The absorptive capacity of many countries has been steadily expanding.⁽²⁾ The World Bank's 1965 report indicates that between now and 1970, the less developed countries might productively be able to use an additional \$ 3-4 billion a year in the form of financial assistance.⁽³⁾ The increasing absorptive capacity will, therefore, require more of foreign external assistance than the present stagnating flow of capital.

(1) Ibid.

(2) Ibid.

(3) Ibid.

CHAPTER VI

SCHEMES PROPOSED TO IMPROVE THE INTERNATIONAL MONETARY SYSTEM

The problem of international liquidity is not an entirely new one. One may say, it is as old as international trade itself. The question came to the forefront in recent years, for the reason mentioned before and a number of proposals has been made suggesting the reform. Except for the Stamp plan and the Plan evolved by the group of experts appointed by the Secretary General of the United Nations Conference on Trade and Development, all the proposals give little weight to the urgent needs of the developing countries to increase their owned reserves.

But more than that, it has been claimed that there is no connection between international liquidity creation and the development needs of the less developed countries. The Governor for France in the IMF annual meeting of 1965, ⁽¹⁾ stated the view that while the reform of the world monetary system, concerns only the industrialized countries, efforts should be dedicated to increasing the resources available for the developing countries. Monsieur d'Estaing added "If there is a wish

(1) IMF, Summary proceedings, Annual Meeting, op. cit.,
p. 128.

that both the problem of reforming the monetary system and that of transferring more resources to the less developed countries should be dealt with simultaneously, one single endeavor is not enough. There is a need for both". This view emphasises that the developing countries need aid and not an increase in their owned reserves.

It would be better before proceeding to find the solutions for the problems of the developing countries to discuss very briefly the main schemes proposed, and their effect on that group of countries.

The proposal to reevaluate gold price, as a means to increase world liquidity,⁽¹⁾ would certainly benefit both producing countries (mainly South Africa and the U.S.S.R.) as well as the rich countries which already accumulate large gold stocks, Developing countries, with little gold reserves would not share in the benefits.

(1) "It had been suggested that at least the main industrial countries, should cease to hold foreign currencies in their reserves, and to counteract this by a large once-for-all increase in the price of gold in term of all the principal currencies" Lecture of Mr. Schweitzer, loc. cit.

This proposal is based on the desire of a number of economists⁽¹⁾ to return to the gold standard. A return to gold standard implies the rising of the gold price. Gold becoming the exclusive means of international payments, its supply must meet the increase in world trade. Since its production is limited, the revaluation of gold prices seems unavoidable. This proposal proposes the doubling of the gold price and a ban on the use of national currencies as exchange reserves.

The objections raised against gold price revaluation, are based on the fact that the beneficiaries of such policy would be the rich countries, which either produce or already accumulate large stocks of gold. Second, the devaluation of dollar as a consequence of the raising in gold prices would entail losses to dollar holders, which would impair confidence in that currency.

Thirdly, no country would accept today to submit its domestic economic policy to the rigid rules or the automatism of the gold standard. It is also added that

(1) "Ray Harrod, Michael Heilperin, Jacques Rueff"
General Bank of Egypt, Economic Review,
op. cit. P. 302

the raising of the gold prices would encourage speculative movements in the future and stimulate private hoarding since gold revaluation would be repeated at periodic intervals, in order to increase world liquidity in pace with the growth in world trade. The increase in gold price is obviously rejected by the U.S.A. since this policy entails the devaluation of the dollar.

The second proposal for solving the world liquidity problem is the radical reform of the present monetary system by converting the IMF into an international central bank, having its own World currency which could be created deliberately. Prof. Triffin suggests that deposits at the proposed world central bank should be used as an international means of payments. The plan invites central banks to turn over to the proposed international institute or central bank their foreign balances and receive in exchange a deposit at that institution. After the establishing of the proposed institution members would hold reserves in only two forms, gold and deposits with the World Central Bank⁽¹⁾

(1) a- Oscar L. Altman "Professor Triffin, International Liquidity, and The International Monetary Fund", The Dollar in Crisis, Ed. Harris, Seymour E., (New York: Harcourt, Brace & World, Inc. 1961) p. 244.

b- These deposits-bancor accounts as in Keynes Plan- are fully equivalent to gold in international settlements (Central Bank of Egypt, Economic Review, op.cit, P. 303.

The new institution would create international money and expand its quantity in accordance with world needs for international liquidity. This is primarily estimated at some 3% to 5% a year. The new institution would implement its central banking functions by providing liquidity for its members. It could lend member countries having balance of payments deficits. On the other hand, the new institution could undertake open market operations to keep world reserves increasing in line with the expansion of world trade.

Triffin's plan, which is not final, but may be used as a basis for the discussing of international monetary reform, (1) tries to solve the problem of capital movements and that of increasing world liquidity. It amounts to an invitation to avoid the accumulation of reserve center currencies by foreign central banks.

This proposal would benefit the developing world if the new institution's loans and investment are granted directly to countries where capital is mostly needed or

(1) "It would be a miracle indeed if any plan of a lone student... proved fully acceptable.... I have never hoped to be able to do more than to initiate and stimulate a broad discussion..." "Robert Triffin Altman on Triffin: A rebuttal", The Dollar in Crisis, Ed. Harris, Seymour E., (New York, Harcourt Brace & World, Inc. 1961) p. 277.

indirectly "through purchases of IBRD bonds or other securities of a similar character."⁽¹⁾ But it is probable that the open market purchases of securities and loans would tend to be concentrated in the markets of the advanced countries which would benefit from such operations to the detriment of the developing countries.⁽²⁾

Some objections have been raised against this proposal. Prof. Bent Hansen raised the more difficult questions.⁽³⁾ Questions concerning the adequacy of the annual rates of increase in the international money in accordance with world needs. The creation of a world central bank necessitates the coordination of national monetary and fiscal policies. While this coordination can be done through consultations it will not be solved in a satisfactory manner until a true World Government is established. But even if the proposed central bank is established the problem remains as to how it could be run in an acceptable way.

(1) Ibid. p. 281.

(2) Central Bank of Egypt, Economic Review, op.cit., p. 303.

(3) Bent Hansen, International Liquidity, central Bank of Egypt Lectures, Cairo, 1962

The third proposal which attempts to solve the difficulties caused by capital movements and conversion of foreign exchange into gold, is that put forward by Prof. Bernstein. He suggested the creation of a subsidiary "Reserve Settlement Account" institution managed by the major industrial countries members of the IMF. These countries would lend to this institution by subscribing to IMF notes up to a stated predetermined amounts. In case of capital outflow from a particular country A to particular countries B and C, the "Reserve Settlement Account" would borrow from country B and C to lend to country A which would use the proceeds to offset the capital outflow. The plan also suggests periodic increases in the IMF quotas as a means to increase liquidity in the long-run.

Prof. Bernstein made a new version of his proposal suggesting that only the "Paris Club" countries should form through the IMF, a pool which would be fed by deposit quotas in national currencies.⁽¹⁾ The participants would receive the counterpart in "Reserve Units". These units would be an important source of

(1) Central Bank of Egypt, Economic Review, op. cit., p. 300.

liquidity, as their volume could be increased according to certain ratio to the gold holdings of member countries. International payments would be carried out in a certain proportion of both gold and reserve units, But this does not mean the exclusion of dollar and sterling as world reserves. (1)

The revised proposal seems to be similar to the scheme which has been proposed and described in the Ossola Report, (2) under the heading "Group Schemes Associated With The IMF.". According to this scheme the creation of an additional "Reserve Asset" will not involve capital flows. Participants would issue to the IMF non-negotiable government obligations, which would carry a gold-value guarantee and which might be interest bearing. In return they would receive "Reserve Claims" on separate account in the IMF. Since these non-negotiable government obligations would not be deducted in calculating participants' reserves, the "Reserve Claims" would represent a net addition to

(1) Ibid.

(2) Ossola Report, loc. cit.

total reserve assets. The non-negotiable government obligations would not affect the participants' normal IMF drawing rights, since they would be held in a separate account, and would not be counted as a part of Fund's holding of the participant's currency.

The use of these reserve claims will be either to meet direct transfers of claims between participants or to finance transfers via the IMF. It is also understood that participation is limited to a small group of the industrial countries, namely the Group of Ten itself.

Another proposal for the creation of reserves assets, as a means to increase international liquidity, is the "Collective Reserve Unit Scheme". The scheme, is common with the two previous proposals, ignores completely the developing world, since the C.R.U.s would be created and used only by those members of the "Paris Club".

This scheme differs from that described in the Ossola Report since the reserve creation would be made outside the IMF. The creation of the C.R.U.s would be on the basis of periodical assessment of global

needs for international liquidity. Decisions on the creation or cancellation would be taken unanimously. The C.R.U.s would be non-interest bearing assets, which would be distributed to members in proportion to their gold reserves or total monetary reserves or their IMF quotas. Any distributions of C.R.U.s that are not in proportion to gold reserves would be followed by a redistribution of gold against C.R.U.s among the participating countries in order to establish a uniform rate of C.R.U.'s to gold in each participant's monetary reserves. In other words any participant whose ratio of C.R.U.'s to gold in its reserve exceeds the overall ratio for the group as a whole would receive gold in exchange for C.R.U.s and vice-versa. Also C.R.U.s are not to be convertible to either currencies or gold, as they are not to be transferred from one participant to another between settlement dates.⁽¹⁾ They are not to be used in transactions with the rest of the world. The periodical settlements and accounts of the system would be functioned by an Agent, proposed to be the B.I.S.

(1) Ibid.

It would be appropriate here to indicate that this scheme represents an attempt, on the part of the "Paris Club" countries, to shift the center of gravity away from the IMF, where the voting power of the U.S.A. is large and substantial. It goes without saying that developing countries are excluded from such an arrangement.

The Ossola Report has presented the argument regarding the "Width of Membership Appropriate to Reserve Creating Arrangements". The argument was in favour of the limited group "with homogeneous composition", to judge on the operation and liquidity of the international monetary system. The group considers "The needs of the larger industrial countries which share the responsibility for the working of the international monetary system are different not only in scale but in kind from those of the rest of the world"....."These are the countries which principally hold and use reserves for international monetary purposes, and their reserve needs are a primary concern of the international system". The report also presented the view which considers that the liquidity of the whole international monetary system is of a world-wide nature. But the

report added that those who share this view reminded the group "... while the views of all participants in the international monetary system are heard in the Fund, the ultimate decisions remain in the hands of the limited number of countries which are chiefly responsible for the system's successful working".

The C.R.U.'s scheme represents the clash between the French on the one hand, and the U.S.A. and U.K. on the other. The uniform ratio of the C.R.U.s to gold holdings is in favour of most of the European countries which have accumulated large amounts of gold during the last few years, in particular France.

The French view on the creation of additional liquidity has been stated by the Governor for France.⁽¹⁾ He explained that a reform of the international monetary system implies the emergence of a new "instrument". This asset must be existent per se, it must be ranked as a genuine currency, not as a mere credit facility. It should be linked to gold, which remains the necessary and unchanging reference basis; moreover,

(1) Statement by the Governor of the Bank for France, Mr. Valéry Giscard d'Estaing, IMF - Summary Proceedings, Annual Meeting, 1965 p.124.

its circulation must be regulated along the same lines as gold movements between central banks, on which movements order and discipline in the whole system are ultimately dependent.⁽¹⁾ The Governor for France also expressed the view towards other countries participation in the creation of additional liquidity, by adding that "the volume of currency to be issued will have to be determined by an agreement between countries whose institutions and currencies are providing the basis for international settlements.... "

The French suspects that the two reserve currency centers want extra liquidity in order to finance their own balance of payments deficit. The Governor for France explained this by saying that the main contribution which the reserve currency countries can make to an international monetary reform is to restore a permanent balance in their external accounts. This should be a precondition to the study of any other device.

The French also criticises the U.S.A. for exporting inflation to Europe, and, therefore, any reform of

(1) This expresses the view of France to return to the gold standard system.

the international monetary system would not be possible before the deficit reserve centers take appropriate and immediate action to adjust their balance of payments positions.

At any rate, the C.R.U.'s schemes as well as the others contribute nothing directly to the solution of the problems of the less developed countries. The proposals are clearly "rich men only" schemes which ignore completely any attempt to bring the developing countries in the picture. In arguing against any plan limiting to the group of rich nations the reform of the international monetary system, Mr. Schweitzer, Managing Director of the IMF said "It seems to me highly desirable from the standpoint of the maintenance of good relations and a spirit of cooperation between countries at all stages of development that the richer nations of the world should not appear to be clubbing together to create reserves - out of nothing as it were - for themselves alone".⁽¹⁾

Now it is appropriate to look at the Stamp plan which gives paramount importance to the needs of the developing countries while attempting to increase international liquidity.

(1) Lecture, loc.cit.

The Stamp Plan, which is very favorable to developing countries, authorizes the IMF to issue gold certificates up to a certain value. Members should agree to accept such certificates when tendered by the Fund or by a central bank and to provide their own currencies in exchange. The IMF would give the certificates to an Aid coordinating Agency, which would allocate them to underdeveloped countries. The countries receiving the certificates would purchase capital equipment from the industrialized countries. These countries would accept these certificates to their reserve assets, or could use them to meet deficits among themselves. The result would be to increase international liquidity and also to extend them to areas which are most in need. (1) In the long run, periodical repetition of the same process can meet the increasing demand of international liquidity.

(1) The Stamp Plan combines the virtues of the Triffin plan and the Bernstein Plan. The gold certificates are comparable to the credit created by Triffin's International Bank. The acceptance of these certificates by the countries exporting equipment is comparable to the deposit of resources in the Reserve Settlement Account against Reserve Units as envisaged in the Bernstein Plan (K. Venkatagiri Gowda, International Currency Plans and Expansion of world Trade; Bombay: Asia Publishing House, 1964, p. 112.

The main criticism of the Stamp Plan is that the developing countries would press for the creation of too much new certificates which would threaten the industrial countries with inflation. Mr. Stamp has suggested that, to meet this objection, the creation of these certificates would be limited. Member countries would agree to receive these certificates only up to a total amount equal to their quotas. There would be no need for continuing control once the annual amount had been agreed upon. On the other hand, in order to encourage the acceptance of these certificates, they would be denominated in dollar at par value and would be convertible into other Fund currencies also at par.

The Stamp plan seems to be not acceptable to the industrial countries who see in it an inflationary threat. It also does not seem to agree equally with the French views, since it preserves the key position of both the dollar and sterling. But this plan, has a certain advantage. The benefit which would accrue to the developing countries is quite apparent. At the same time the developing countries have the means to control on the issue of these certificates. This will limit any possibilities of excessive amount to be issued.

Because of its merits to the developing countries this plan is widely accepted by these countries. The developing countries are deeply convinced that the liquidity problem concerns all members of the IMF, and that they have equally a vital interest in finding a quick solution. These countries which encompass - large proportion of the World's population, are facing the problem of raising the standard of living of their people within a short time. The problem of closing the gap between the developed and the developing countries is the most important problem of our time. The need to lay firm basis for the rapid growth of their economies is urgent and the problem of international liquidity is obviously a common concern of both developed and developing countries. The Governor for Australia in the IMF⁽¹⁾ had put this fact firmly when he stressed that "it would not be acceptable to the great majority of members to have decisions on matters so vitally affecting every one of us determined in substance, if not also in form, by a small and strictly

(1) Statement by the Governor of the Bank and Fund For Australia, Harold Holt, IMF, Summary Proceedings Annual Meeting, 1965, p. 79.

limited group ...".

The developing countries observed that the industrial developed countries are trying to confront the IMF with a fait accompli, without giving them the reasonable opportunities to express their views. They also recognized that it seems unlikely that there will be any fundamental solution to the cause of international liquidity in the near future, because of the political challenge. According to this and their need for a sound solution that would help the steady growth of their economies, the developing countries expressed their desire for a quick remedy. At the United Nations Conferences on Trade and Development which were held in Geneva in spring 1964 and at the IMF annual meeting of the same year the developing countries emphasized their concern about the discussions which are taking place among the industrial countries to reform the International Monetary system. They agreed that the Secretary-General of the UNCTAD should establish an expert group to consider the International Monetary issues from the point of view of the developing Countries.

The group of experts has advanced a number of proposals⁽¹⁾ which "would help to restore a better balance in the temporary discussion of International Monetary issues, which tended to concentrate on problems facing the developed countries".

The group of experts rejected completely the suggestion that the essential need of the developing countries is for additional aid rather than liquidity. The liquidity requirements of developing countries are greater relatively to their imports than those of the developed countries. The fluctuations of both the prices and volume of primary commodities exported by developing countries make these countries subject to short term disturbances. These disturbances are great and disruptive in relation to the small reserves. Many of these countries have adopted restrictions on imports and payments and foreign exchange controls for the purpose of adjusting external payments to external receipts. Yet the absence of adequate reserves and

(1) UNCTAD, Report of the Group of Experts, loc. cit.

short-term resources imposes strains on the administration and the smooth functioning of their economies. The developing countries attempt to obtain suppliers credits which are very onerous, and impose considerable burdens on their import capacities. The result is more cumulative extension of controls and increasing rigidities over the economy. The inadequacy of reserves and the consequent problems in meeting external payments would aggravate the situation and weaken the confidence and thus deteriorate the credits provided to them. Also the developing countries' need for reserves is expected to increase with the growth of their economies and external transactions. Inadequacy of reserves would oblige these countries to sacrifice development since the deterioration in their terms of trade will force them to cut their essential import of development goods. Most developing countries are conscious of the advantages of having adequate reserves. It is essential for the developing countries not only to have additional liquidity but also the existence of an environment favourable for its proper use. Long-term development finance from abroad is imperative and should accompany liquidity creation.

To this effect the group of experts proposed a new scheme which would provide all members of the IMF developed and underdeveloped, with the additional liquidity needed .

Without giving technical details and exposition on the extent of the amendments required in the Fund's Articles of Agreement, or its drawing policy, the scheme rests on two pillars. First, a periodic creation of additional international liquidity through a separate machinery in th IMF for issuing "Fund Units" to all its members, against currencies contributed by the members. Second, a sizable part of the currencies of the developed countries so acquired by the Fund could be made available to the World Bank and its affiliates against IBRD bonds. Thus providing the World Bank by additional currencies to finance developmental loans in developing world.

In the final analysis, the developing countries will gain in two ways. They will have their share in the original creation of liquidity, and they will obtain real resources for development purposes to the extent that the Fund invests the currencies of the developed

countries in the IBRD bonds. The developed countries as a group would gain of additional international liquidity in proportion to their share in the original creation of Fund units.

The group of experts explained that there are several ways to increase the availability of liquid resources to the developing countries. Among these ways are expansion of short-term credits delivered to these countries by banking systems or treasuries of certain developed countries, as well as reducing the interest rates charges. Improving the scale of Fund facilities, lengthening the period of repayment, which now ranges from three to five years, to say six to eight years thus giving longer period for the developing countries to adjust their balance of payments deficits. Increasing flexibility of drawing rights within the Fund has also been proposed. Owing to the low level of reserves, the developing countries reach the conditional tranches much sooner than the developed countries. It is therefore desirable that conditions applicable to the first tranche be extended to the second tranche. Additional liquidity can be provided

through increase in Fund quotas. The compensatory financing introduced by the Fund in 1963 could increased from 25% to 50% of the member's quota. Monetary cooperation between the developing countries, such as regional pooling of reserves is a good possibility as a means of providing regional credit.

SUMMARY AND CONCLUSION

International liquidity is a very complicated subject. The demand for international liquidity is a function not only of the value and volume of international trade and transactions but equally a function of the process of adjustment and the efficacy and objectives of the monetary and economic policies. But while these factors are of fundamental importance in influencing the demand for international liquidity, there are other important factors which affect the supply of international liquidity. International liquidity means not only gold but also foreign exchange reserves as well as mutual credit arrangements. While gold production, as any other commodity, depends on gold prices and cost of production as factors determining profitability, the creation of key currencies is dependent above all on the balance of payments position of the key currency countries. The larger the deficit in the balance of payments of key currency countries, such as the U.S.A. and the U.K., the larger would be the increase in world liquidity and vice versa.

Paradoxically enough, while larger deficits in the balance of payments of the U.S.A. and the U.K. are

essential for the increase in world liquidity, such deficits are on the other hand detrimental to the reputation of the dollar and sterling. Besides it is not feasible that the future developments in international liquidity which affect the world at large and the level of international trade, should depend on the haphazard developments in the balance of payments position of both the U.S.A. and the U.K. The creation of international liquidity should be made on bases of world need at large and should be pragmatic and well planned rather than haphazard.

The rules of the game of the gold standard which has many features in common with the rules of the game implied in the Articles of Agreement in the IMF have proved futile. Neither the deficit countries nor the surplus ones are willing to adopt these rules abruptly. The deficit countries feel that the only politically feasible and economically sound road to rectify their balance of payments deficits is to improve the competitiveness of their home industries through increasing investments in the form of new machinery and new implements coupled with an appropriate wage policy that confines future increases in wages within

the limits of improvements in productivity. This requires time. If to this is added the impossibility of adopting a policy of wage cuts and the absolute necessity of maintaining full employment, it is quite evident that their governments are not in a position to resort to serious restrictive measures either in the form of abrupt and sharp increases in taxation or in the form of enhanced deflationary credit policies that seriously reduce the disposable income and lead to a sharp fall in the standard of living as well as stop go economics.

Under such circumstances deficit countries - developed or developing - would rather borrow from abroad to meet their balance of payments deficit until they are in a position to rectify slowly the balance of payments deficits without undue hardships to their economies.

On the other hand surplus countries, according to the rules of the game, are expected to leave the increase in their foreign assets to expand their disposable income. At the time when they have full employment of their resources and factors of production this amounts

to inflation which they are very rightly reluctant to accept. If to the inflationary potentials resulting from the increase in foreign assets is to be added the additional expansionary developments concomitant to their extending considerable credits to the deficit countries to enable them to meet their balance of payments deficits, it is quite obvious that the doses of inflation which the surplus countries have to face would be tremendous.

The Germans and French, as well as many other Continental European countries, suffered a great deal from inflation during the last two World Wars and they learned the destructive impacts of inflation and so they are unwilling any longer to bear its blunt. This is the reason behind the split among the Group of Ten. The two deficit countries, namely the U.S.A. and the U.K., prefer to go through the process of adjustment slowly. On the other hand the Continental European countries are not willing to lend funds as that would lead to inflation and deterioration in the competitiveness of their industries vis-a-vis the American and British industries.

In other words while the Americans and British are for an increase in international liquidity through the machinery of the IMF, where both countries have substantial voting power, the Continental Europeans are not in favour of an expansion in international liquidity. There are two reasons behind their attitude. The first is that, thanks to the persistent deficit in the balance of payments of the U.S.A., they have ample international reserves. The second reason is that they have a smaller voting power in the IMF as compared with the U.S.A. and U.K. Hence they are for discussing the problem within the Group of Ten arrangement where they have one vote for each country and therefore they have the majority votes.

This is the basis of the problem. It is both a political and economic problem. Not only political because of the problem of voting power, but also because there is a growing feeling among Continental Europeans and Japan that the U.S.A. balance of payments deficit is the result of the considerable investments made by that country in Continental Europe and Japan. They do not want the U.S.A. to dominate their own industries.

In this tumultuous dead lock the developing countries have been entirely ignored. Admittedly, the revolt against the rules of the game is to the interest of the world at large, including the developing countries. The abandonment of the policy of stop - go economy or slackening down in the rates of growth in the deficit countries gives to the developing countries better export prospects. Similarly the refrain of the surplus countries from inflationary measures is also beneficial to the world at large, it being understood that inflation leads ultimately to stagnation. If to this we add that the policy of sustaining growth irrespective of balance of payments deficits is the policy commendable to the developing countries and that this policy necessitates among other things a substantial and systematic expansion in international liquidity, it is obvious that it is in the interest of the developing countries to stand on the side of both the U.S.A. and the U.K. for increasing international liquidity within the frame - work of the IMF where the developing countries have a certain voting power.

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