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THE WORLD ECONOMY IN 3-D:
DEBTS, DEFICITS AND DOLLARS

by Graham Bird

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SUMMARY

The world economy in the 1980s has been dominated by problems of international debt, balance of payments (and fiscal) deficits, and exchange rate instability. Analysing these three problems, this paper attempts to demonstrate how changes in both the international financial regime and the conduct of macroeconomic policy at the global level are required if they are to be avoided in the 1990s.

Recognising the bureaucratic and political constraints on far reaching reform, the paper spells out a number of less ambitious options which, even so, could have a beneficial effect on the world economy. An implication of all the reforms discussed, touching on both financing and adjustment, is an increase in the relative importance of the official sector, in the form of the IMF and the World Bank, as compared with the private sector, in the form of the international commercial banks.

In this regard, as well as in terms of some of their specifics, the proposals find a strong antecedent in the Keynes Plan that was presented to the Bretton Woods Conference in 1944. As then, the argument here is that international financial reform based on a coherent perspective of the world economy can make an important contribution towards bringing about balanced and sustainable world economic expansion.

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1. INTRODUCTION

Just as the 1970s are remembered for the two oil price shocks and the ravages of rapid world inflation and recession, the 1980s have been marked by three global phenomena. The first is the international debt problem which began to receive media attention after the Mexican crisis in 1982. The second is the existence of fiscal and trade deficits in the United States and their implications for the rest of the world economy. The third is the volatility of exchange rates; this being most dramatically illustrated by the steep appreciation in the US dollar up until the mid-1980s and its subsequent decline. In connection with this last phenomenon experience during 1987 also illustrated the linkage between foreign exchange markets and stock markets. In the minds of many, Black Monday, 19 October 1987, which saw the beginnings of the world stock market crash, will remain one of the most enduring economic memories of recent years.

It is the contention of this paper that these various phenomena can be usefully analysed by using simple and conventional macroeconomic concepts. The underlying framework for analysis also reveals how the phenomena are inter-related, and, perhaps more significantly, how policies, including international financial policies, may be modified to reduce the likelihood of such problems occurring again.

By analysing debt, deficits, and dollars (the 3 Ds), the paper attempts to put some perspective on what has been happening to the world economy in the 198Os and to build on this understanding in order to improve global economic prospects for the 199Os.

2. RETROSPECT ON THE 3Ds

2.1 Debt

Much argument has raged over the causes of the world debt problem. In essence the debate has centred on the question of whether it has been internally caused by economic mismanagement within the debtor nations or externally caused by events outside their control. Such debate is, to a degree, arid since common sense, as well as empirical and econometric evidence, suggests that these causes are not mutually exclusive[1]. If it can be demonstrated that the global environment in which debtor nations found themselves deteriorated, and yet, at the same time, that some nations managed to cope with this deterioration better than others, does this lend support to the idea of internal or external causation?

Clearly in the sense that without a deteriorating environment poor economic management would have been less exposed, external factors may certainly be regarded as important. But in what way did the global economic environment facing debtor nations get worse?

Perhaps the most significant factors were rising real interest rates and declining export growth. Prior to 1982 real interest rates had been negative, providing debtor nations with a strong incentive to borrow. With a positive marginal productivity on borrowed funds, there was every presumption that they would be able to service and eventually repay their loans. On top of this, relatively rapid export growth during the late 197Os suggested that the foreign exchange necessary to service debt could be earned. However, rising interest rates and falling export receipts combined to push up debt service ratios to historically high levels and to create difficulties from which the debtors have yet to recover. But why did interest rates rise and export demand falter?

Conventional macroeconomic analysis suggests that interest rates will rise either as a result of fiscal expansion or monetary contraction. Similarly import demand in the industrial world, and therefore the demand for exports from the developing world, will decline if the richer countries undergo either fiscal or monetary contraction. While the simultaneous existence of

rising interest rates and falling export demand is therefore inconsistent with fiscal expansion amongst industrial countries, it is quite consistent with monetary contraction.

This may be illustrated in the context of a global IS–LM model, see Figure 1, by suggesting that the global LM schedule shifted to the left, thereby forcing Y down and r up.

In the early part of the 1980s a number of industrial countries had recently elected governments which believed in the central importance of 'sound money' and which were much more convinced by monetarist analysis and policy advice than by the Keynesian alternative. No more was this the case than in the United States. Yet the rise in real interest rates was global. This partly reflected similar trends in a number of major economies, but it also reflected the knock–on effects of US policy; thereby illustrating the constraints on independent monetary policy even within an environment of flexible exchange rates.

The upward trend in real interest rates was, however, not only caused by rising nominal rates but also by the fact that inflation was beginning to fall as counter–inflationary policies, pursued in response to the second oil price hike in 1979, began to take effect. Just as debtors normally benefit from inflation, so the debtor nations of the world lost from the global success at reducing it.

2.2 Deficits

While these global developments combined to help weaken the balance of payments of developing country debtors, attention in the mid–1980s began to focus rather more on the twin fiscal and trade deficits in the United States. Of these 'terrible twins', the fiscal deficit may be regarded as the more fundamental.

Again simple micro and macro economic analysis goes a long way towards explaining what happened. On the micro side, it seems to have been a belief in the relationship between taxation and effort. Even though economists have long been aware of the possibility that the

supply curve of labour may bend backwards above a certain wage rate, this idea now found new expression and new political support in the form of supply-side economics (or Reaganomics, as it became known after its principal political mentor). The simultaneous existence of unwillingness both to curb the growth of government expenditure, and to raise taxes, combined to increase sharply the size of the US fiscal deficit.

Once more a simple macroeconomic model predicts the consequences of such fiscal expansion. However, the specific prediction depends on what is assumed about the monetary sector of the economy. With matching monetary expansion the effects of fiscal expansion will be felt primarilly in the form of increasing nominal national income and output rather than rising interest rates. Without it, but with a relatively low interest rate elasticity of demand for money, the effects will instead be felt in the form of a rising rate of interest. In the latter case the government is, in effect, financing its net expenditure by outbidding other borrowers for loans from the private sector.

Figure 2 shows how a rightward shift in the IS schedule combined with a static but steep LM schedule results in a relatively large increase in r and a relatively small increase in Y.

In the United States, expansionary fiscal policy was initially juxtaposed with fairly restrictionary monetary policy. Although national income rose, so did the rate of interest. Whatever the merits of the policy for the US economy, it was a mixed blessing for the indebted nations. On the one hand those that traded with the US benefitted from the US expansion in the form of additional export orders, but on the other hand they lost from the increased costs of servicing their debt, as well as from the additional competition for international loans coming from the US. For indebted countries without strong trading ties with the US the policy was more unambiguously disadvantageous.

Whereas restrictionary US monetary policy had been matched by similar policies abroad, expansionary US fiscal policy was not. Indeed in most other industrial countries the desire to control inflation found expression in a restrictionary fiscal stance.

2.3 Dollars

It was the mismatch in fiscal policy which lies at the heart of the variations in the value of the dollar which have been observed throughout the 198Os.[2] While, under a fixed exchange rate regime domestic economic policies will have ramifications for the balance of payments, under a flexible exchange rate regime, balance of payments disequilibria will in turn impinge on the international value of the domestic currency. In what way did US domestic economic policy impinge on the value of the dollar?

It is important at this point to make two distinctions. The first is between the current and capital accounts of the balance of payments, and the second is between the first half of the 198Os (Phase I) when the dollar appreciated, and the second half (Phase 2), when it depreciated.

During Phase I expansionary fiscal policy served to raise US interest rates and to generate a capital inflow into the US, which more than offset a deteriorating current account. The dollar's value therefore rose. However, the rise was unsustainable for two reasons. First, it further contributed to the weakening of the US current account, although the effects were somewhat lagged. Second, the capital inflows represented stock adjustments to international portfolios. As optimal portfolio balance was restored so flows diminished. Moreover monetary policy was relaxed. With these developments the market's perception of the equilibrium exchange rate for the dollar changed and expectations of dollar depreciation helped fuel the actual depreciation.

The course of events may be illustrated by Figures 3 and 4 which supplement the IS–LM model with a BP (balance of payments) schedule. In the short run the BP schedule is assumed to represent a high degree of capital mobility. The short–run impact of a rightward shift in IS is therefore to generate a balance of payments surplus and exchange rate appreciation. In the longer run, however, and as shown in Figure 4, the LM schedule is assumed to have shifted to the right and the BP schedule becomes steeper. The currency becomes overvalued and the exchange rate depreciates.

The falling dollar had overspill effects on world stock markets and on the real economic prospects of the rest of the world. In the former case the transition from foreign exchange movements to stock market movements seems to have involved the following elements. First, the perception was that the depreciation in the value of the dollar had been insufficient to correct the underlying US current account deficit. The presumption was therefore that the dollar would need to fall further or that interest rates would have to be increased to encourage capital to flow into the USA. Second, supply side economics did not appear to be working in the sense that tax revenue was rising insufficiently fast to eliminate, or substantially reduce, the US fiscal deficit. The presumption here was that the US Administration would be forced to raise taxes.

With an outlook of rising interest rates and falling disposable income, the prospects for US industry, and for those parts of foreign industry which relied heavily on the US market, became less bright, and therefore the stock market assessment of the value of such companies was modified downwards. The liquefication of assets and the implied increase in demand for money further suggested that interest rates would rise. Moreover, the fall in asset values seemed likely to have the effect of reducing still more current levels of expenditure, as individuals attempted to restore the real value of their personal wealth.

As far as the rest of the global economy is concerned, variations in the price of the dollar had mixed effects. The effect on any one country depends on whether it holds net assets or net liabilities denominated in dollars and on the extent to which exports and imports are priced in dollars. With net liabilities and net imports in dollars, it will benefit from dollar depreciation and will lose from dollar appreciation. However,even when over a period of time depreciations outweigh appreciations, such a country may still prefer the less uncertain environment associated with a more stable dollar. For many developing countries which traditionally face the problem of export instability, variations in the international value of the dollar became a more significant source of instability than variations in the dollar price of exports.[3]

Although, in the ways outlined above, individual countries in the rest of the world are affected by variations in the price of dollars, they are also affected indirectly by the broader global macroeconomic consequences. A dollar depreciation against other currencies clearly means a currency appreciation in the rest of the world. To the extent that depreciation tends to have an expansionary/inflationary effect on the domestic economy, appreciation may be expected to have a contractionary/counter inflationary effect. Where levels of unemployment are already causing concern in the rest of the world, the contractionary effects of the dollar's depreciation will be an additional source of worry. These worries will be endorsed when it is recalled that a depreciating dollar may be accompanied by a tendency for global interest rates to rise.[4]

3. LINKAGES BETWEEN THE 3Ds AND AN ALTERNATIVE PERSPECTIVE

Although the previous section has treated debt, deficits and dollars under separate headings, the discussion has already revealed the linkages between them. Macroeconomic policy in the US and other industrial countries had a clear bearing on the worsening debt position of many developing countries at the beginning of the 1980s. Similarly, a failure to co-ordinate macroeconomic policy amongst richer nations during the 1980s resulted in substantial disequilibria, and in large movements in relative exchange rates. These in turn fed back on debtor nations through interest rate, demand and terms of trade effects.

The mechanics of the linkages are complex and difficult to model with any great precision, but it is clear that economic policy within one important country or group of countries can have significant external effects on others and that flexible exchange rates do not provide complete insulation from these.[5]

While the discussion has so far focused on the central role of the US fiscal deficit and the dollar, a rather different perspective can be adopted. As noted above, it has been the mismatch in macroeconomic policy which has been at the heart of many of the world's economic problems during the 1980s. Such a mismatch may indeed be viewed as reflecting the

policies of the deficit nations whose currencies tend to fall in value. But it may also be seen as reflecting the policies of the surplus nations whose currency values rise. From this perspective it is not so much the inappropriateness of US policy that is central, but rather the inappropriateness of policies in other OECD countries. If these countries had pursued more expansionary policy, the US trade deficit would have been smaller, the movements in the values of currencies less pronounced, and the debt problems of many developing countries less severe. It must be regarded as one of the cruel ironies of the international economy that whereas developing countries have been put under immense pressure to reduce or eliminate their payments deficits, the United States is able to finance its deficits, and other industrial countries which are in surplus are, in practical terms, able to side-step all effective pressure to adjust their economies in order to eliminate disequilibria.

Ultimately what the 3Ds of the 1980s reflect is a series of structural deficiencies in the operation of the international financial regime. The first is the over-reliance on one specific currency, the quantity and value of which it is difficult to control. The second is the asymmetrical distribution of the adjustment burden as between different deficit countries, as well as between deficit and surplus countries. The third is the apparent inability of countries to remove disequilibria within their economies by measures which maintain the stability of the world economy, and the inability to co-ordinate policy adequately. The 3Ds of debt, deficits, and dollars reveal 3Ds, or three deficiencies, in the international economy.

Having acquired a perspective on what went wrong with the world economy in the 1980s, the next question is whether this perspective enables something to be said about what may be done to improve its operation in the 1990s. Can we learn from our mistakes?

4. THE WORLD ECONOMY IN PROSPECT AND POLICY OPTIONS FOR THE FUTURE

The first policy option is to 'do nothing'. However, if nothing is done, there is little reason to believe that the problems that have dogged the world economy in the 1980s will disappear

in the 1990s. Indeed, in certain respects, things may be expected to get worse rather than better. With regard to debt, for example, negative net transfers, along with the possibility that there may be a limit on how far, and for how long deflationary adjustment policies may be pursued, may increase the risk of formal debtor default. Although such action may be globally beneficial in the long run if it were to galvanise appropriate international debt policies, the short run effects could hardly be other than disruptive to the international economy.

The inadequacies of a do–nothing strategy suggest that a positive or activist policy approach is needed. Policies to help deal with the problems identified earlier in this paper may be pursued on two basic levels. On the lower level, they may be designed to alleviate, neutralise and compensate for some of the symptoms of what are in fact more fundamental problems. These policies seek to limit the damage caused by deficiencies in the international financial regime. On the higher level, they may seek to address these fundamental deficiencies.

4.1 Damage limitation reforms

These would essentially accept the world as economically unstable but would seek to minimise the adverse effects of instability. Such reforms would include the liberalisation of export compensation schemes, such as the IMF's Compensatory Financing Facility, and the introduction of schemes to cap interest rates and to allow borrowers to spread their debt obligations over an extended period of time. In each of these cases it would need to be demonstrated that export and interest rate instabilities were caused by factors beyond the control of those countries concerned, in order to avoid problems of moral hazard.[6]

On the same level, the distribution of payments surpluses and deficits could be treated as given, or at least beyond the control of international economic policy, and reforms could therefore concentrate on seeking to recycle financial resources from those countries in balance of payments surplus, where there are excess domestic savings, to those countries in payments deficit where there are deficient domestic savings. Such recycling could, in principle, be

achieved either through the official sector, by expanding the financing role of the IMF and the World Bank, allowing them to borrow more from members from international capital markets, or through the private sector, via greater commercial bank lending or more international lending by other financial institutions or indeed more direct foreign investment by private business enterprises.[7]

The activities of the two sectors need not, however, be independent. Reforms to the official sector could, for example, be designed to support and facilitate lending by the private sector. Cofinancing, loan insurance, as well as policy conditionality, would fall into this category.[8]

4.2 Fundamental reforms

These would be more directly focussed on correcting the fundamental shortcomings of existing international financial arrangements which may be seen as lying at the heart of many of the observed problems discussed so far.

They would set out to deal with both financing and adjustment elements and would address questions of efficiency and equity. The object of reforms on the financing side would be to establish the SDR as the principal reserve asset within the international financial 'system'. Achieving this objective would lend stability to the world economy since it would eradicate oscillations associated with speculative changes in the composition of reserves and would enable greater control to be exerted over the quantity of international reserves. At present, with an unstable global demand for reserves, largely associated with exchange rate flexibility, and an inability to control their supply, there is no scope for global macroeconomic management by this means. Moreover, as part of its role as the principal reserve asset, the SDR would replace the dollar as the main international unit of account, and would be used to denominate trade and financial flows.[9]

Enhancing the role of the SDR would not only contribute to raising global economic efficiency, however, it would also facilitate the pursuit of equity objectives by channelling

more reserves to developing countries. This, in turn, would make a worthwhile contribution to alleviating the debt problems faced by many developing countries; in part by increasing their command over world resources, but also by improving their credit—worthiness.

Controlling the quantity of reserves has little predictable impact where exchange rates are freely flexible. Yet the need for exchange rate flexibility could be reduced by increasing the affinity between domestic macroeconomic policies in the major industrial countries. Multilateral monetary policy executed through SDR creation, would therefore need to be complemented by domestic macroeconomic policy co-ordination[10] leading to a redistribution of the adjustment burden.

Currently there is little systemic pressure to ensure that co-ordination takes place. One way of encouraging it would be through the introduction of a clearly defined incentive structure. The problem here has always been that of exerting pressure on surplus units to adjust their economies. The implication of this is that the world economy tends to have a demand deflationary bias.[11]

One institutional arrangement designed in an attempt to overcome this problem is the IMF's Scarce Currency Clause, which permits members of the Fund to take discriminatory measures against a country whose currency is declared scarce in the Fund, because of excess demand for it. But this arrangement has never been invoked and has therefore become effectively inert. Other potential remedies might therefore usefully be considered.

Two alternative approaches are possible. The first sets out to encourage surplus countries to modify their economic policies. This approach is in the tradition of the Scarce Currency Clause, but might also draw on an element of the Keynes Plan presented to the Bretton Woods conference in 1944.[12] The idea here is to tax excess reserve accumulations. Under such a scheme countries would be set balance of payments targets which they could then achieve either by reducing their reserve holdings through domestic demand expansion or by allowing their exchange rate to appreciate. Failure to comply with the target within a specified period

would lead to the country being required to deposit a proportion of its reserves with the IMF which would then on-lend them to appropriate deficit countries.

The second approach eschews the idea of encouraging surplus countries to expand their economies. Instead it seeks to protect deficit countries from the external effects of under expansionary policies in the surplus ones by allocating them SDRs which will enable them to finance that part of their deficits which may be attributed to the policy stance of surplus countries[13]. Such an approach would make effective the notional demand which exists in the deficit countries and would counter-balance the global demand deflationary bias resulting from lack of adjustment in the surplus countries.

While such reforms could help deal with some deficiencies on the adjustment side of the international financial regime, there would still be a need for countries in payments deficit to undertake appropriate adjustment measures. Reform in this context should concentrate on encouraging measures which achieve the necessary adjustment within the context of sustained economic growth. International agencies should therefore modify conditionality to offer more support to supply-side structural adjustment.

However, an important overall consideration is to maintain the correct blend between adjustment and financing within the international economy. Figure 5 illustrates the various combinations of financing, and internal and external adjustment that any regime facilitates[14]. Each vertex represents exclusive use of one particular balance of payments policy. The lines FF, II and EE illustrate the constraints imposed by the regime in reaching each vertex. The area bounded by these constraints illustrates the fluidity of the regime. In recent years the international financial regime has become less fluid. There has been growing dissatisfaction with flexible exchange rates, increasing problems with internal adjustment, and declining financing capacity at least for some groups of countries. Each constraint in Figure 5 has moved away from the relevant vertex and the regime has become less fluid. It will be difficult to relax the constraint on external adjustment, and that on internal adjustment unless the nature of such adjustment shifts away from demand management. Greatest emphasis

should therefore be placed on relaxing the financing constraint by re-establishing the financing role of the official as opposed to the private sector. This is illustrated in Figure 5, by shifting F^1F^1 to F^2F^2 and thereby increasing the fluidity of the regime as represented by the increase in the area of triangle ABC, to ADG.

5. THE POLITICAL ECONOMY OF REFORM

Although the reforms discussed in the previous section differ in terms of how far-reaching they are, all of them imply an enhanced role for the official sector, comprising the IMF and the World Bank.

Such enhancement may be deemed appropriate in the light of the problems associated with private sector balance of payments financing. These include both inefficiencies caused by the instability of international bank lending, its failure to relate to underlying marginal productivities, and the externalities it generates, as well as inequities caused by the distribution of private lending.

There would appear to be a growing consensus amongst industrial country governments, the commercial banks and the international institutions that the move to the market place which occurred during the 1970s went too far and that some realignment of roles is now needed. Indeed steps in this direction are already to be seen in terms of the expansion in the Fund's Structural Adjustment Facility and the proposed increase in the World Bank's capital base and lending capacity. But how far down the road to reform are these steps likely to go?

The objective of establishing the SDR as the principal international reserve asset was established in 1976, and yet by 1988 SDRs account for a smaller share of total reserves than they did then. The importance of creating pressures on countries with persistent surpluses to carry a share of the international adjustment burden was recognised in 1944, and yet forty

four years later they still stand condemned of insufficient adjustment. Clearly it is not enough just to state objectives.

Failure to realise them reflects either the inadequacy of economic incentives within the system or a lack of political motivation to carry through the required reforms. In the case of the SDR, for example, it has proved to be a relatively unattractive asset; where attractiveness depends on capital value, the rate of interest paid, and usefulness and liquidity. It has not performed a medium of exchange function, nor has it represented a competitive way of storing wealth.

As far as the distribution of the adjustment burden is concerned, the problem is that the reforms needed to induce a more even distribution require, in the first instance, the support, or at least the compliance, of the surplus countries. Why should they support measures which appear to limit their freedom of choice with regards macroeconomic policy, or which impose costs on them if their chosen policies are perceived from outside as being anti-social?

To carry through fundamental reforms would therefore require fairly substantial systemic and political change. Yet such change is not beyond the bounds of possibility. Growing dissatisfaction with the dollar as a reserve asset could refuel interest in improving the appeal of the SDR. Similarly, a major economic crisis brought on (say) by orchestrated debtor defaults could create the circumstances necessary for some reconsideration of the role of surpluses within the international financial regime. The threat of financial collapse could induce the industrialised surplus countries to accept confidence-restoring reforms designed to avoid deep world recession.

However, while it is possible to conceive of high level reforms being implemented, it is perhaps unlikely that they will be. It tends to be in the nature of international financial reform that action is only taken as crises approach. With expediency the main concern, reforms made are normally little more than adequate to avert the crisis. Thus crises that are sufficiently deep to induce fundamental reform do not tend to occur, and the crisis avoidance

nature of reform tends to favour the less ambitious options. Yet without crises there may appear to be little justification for fundamental reform.

If this is true, it would suggest that measures to raise the flow of finance to those deficit countries adversely affected by externally caused export shortfalls and interest rate excesses, and to enhance the accounting role of the SDR, are the best that can realistically be anticipated. Although less dramatic than some of the other reforms discussed above, these modifications could, however, still make a significant contribution towards avoiding many of the problems associated with debt, deficits, and the dollar. There is some evidence that this is the direction in which things are moving, with the introduction of an interest compensation scheme within the Fund, plans to offer debt relief to the poorest countries, and proposals to expand the lending capacity of the international agencies.

6. CONCLUDING REMARKS

It is an intriguing question as to whether it is the nature of the international financial regime which determines world macroeconomic performance, or world macroeconomic performance which determines the nature of the international financial regime. In reality the causal relationship is likely to run both ways.

This paper has attempted to demonstrate how changes in both the international financial regime and the conduct of global macroeconomic policy are required if the problems which faced the world economy in the 1980s are to be avoided in the 1990s. The paper also demonstrates how the international financial regime may be modified to encourage desired changes in macroeconomic policy, and how, if these latter changes are not forthcoming, more modest changes could substitute for them.

Recognising the bureaucratic and political impediments to far- reaching reform, the paper spells out a number of less ambitious options which, even so, could have a significantly beneficial effect on the world economy. However an implication of all the reforms mentioned,

both from financing and adjustment points of view, is to increase the relative importance of the official sector in the form of the IMF and the World Bank as compared with the private sector, in the form of the international commercial banks. In this regard, as well as in terms of some of their specifics, the proposals find a strong antecedent in the Keynes Plan that was presented to the Bretton Woods conference in 1944. In an increasingly inter-dependent world, appropriate, if only modest, international financial reform based on a coherent perspective of the world economy could make a major contribution towards bringing about balanced and sustainable world economic expansion.

NOTES AND REFERENCES

1. See for example, Donal Donovan 'Nature and Origins of Debt Servicing Difficulties, Finance and Adjustment, December 1984.

2. For a detailed analysis of the variations in the value of the dollar see, for example, Christopher Bliss, 'The Rise and Fall of the Dollar', Oxford Review of Economic Policy, Spring 1986.

3. For an analysis of this see J Love, 'Currency of Denomination and the Measurement of Export Instability', Journal of Development Studies, July 1986.

4. Exchange rate variations will also have implications for the balance of payments depending on the size of a range of foreign trade elasticities.

5. For an interesting explanation of why insulation may not occur see John Williamson, 'The Theorists and the Real World', in L Tsoukalis, The Political Economy of International Money, London, Sage, RIIA, 1985.

6. For a full review of such reforms see Graham Bird, International Financial Policy and Economic Development Approach: A Disaggregated Approach, London, Macmillan, 1987.

7. The chances of increased recycling via the intermediation of the commercial banks is fairly slim at present. The banks are in fact anxious to reduce their exposure in developing countries. Given uncertainties about the potential for increased foreign direct investment, enhanced recycling will rely heavily on expanding the official sector.

8. See Bird, op cit.

9. The unit of account role could also be played by the European Currency Unit. In either event, with international transactions priced in SDRs or ECUs, greater stability would be guaranteed, and this would help rational decision making and thereby raise economic welfare.

10. This would also be the case with proposals for managing exchange rates in such a way that they are maintained within 'target zones'. Since broadly defined ranges are only sustainable if there is broad consistency in terms of macroeconomic performance, target zones may be regarded as an intermediate reform. Whilst the proposal goes somewhat further than being simply a damage limitation exercise it is not as fundamental a reform as formalised policy coordination. Greater use of the SDR on a unit of account for the denomination of international transactions would also be an intermediate reform.

11. Of course, an important issue relates to the level of economic activity achieved by policy co-ordination. Here it needs to be recalled that not only should policy coordination aim to eliminate exchange rate volatility but it should also aim to achieve a level of world economic activity which avoids mass unemployment and enhances the export prospects of the developing world thereby raising its capacity to service existing debt obligations.

12. See, 'The Keynes Plan: Proposals for an International Clearing Union', in A P Thirlwall (ed), Keynes and Economic Development, London, Macmillan, 1987.

13. A scheme of this type would clearly face problems of quantification. But similar problems are present in existing compensation schemes where compensation is offered against that part of payments deficits which are beyond the control of the country concerned.

14. This diagram was originated by Richard Cooper, in his book The Economics of Interdependence, McGraw Hill, 1968.

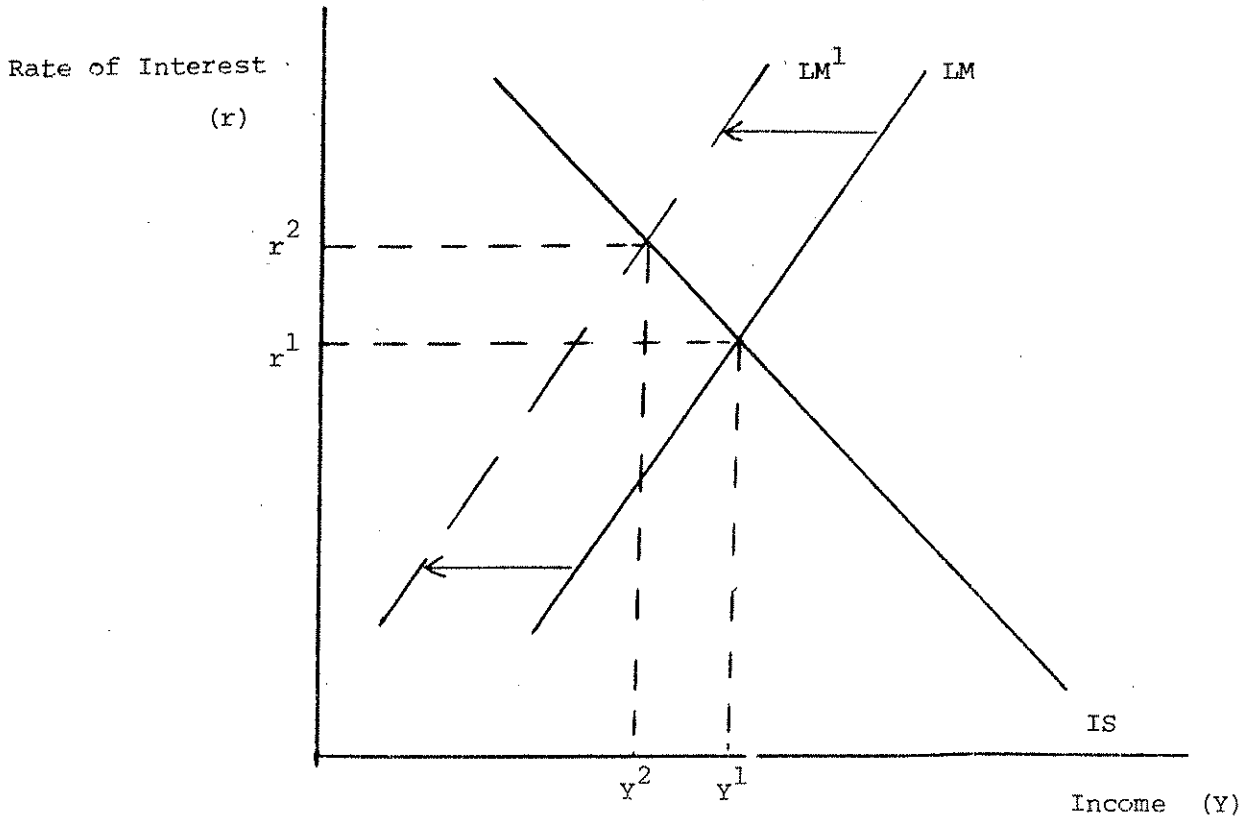

FIGURE 1

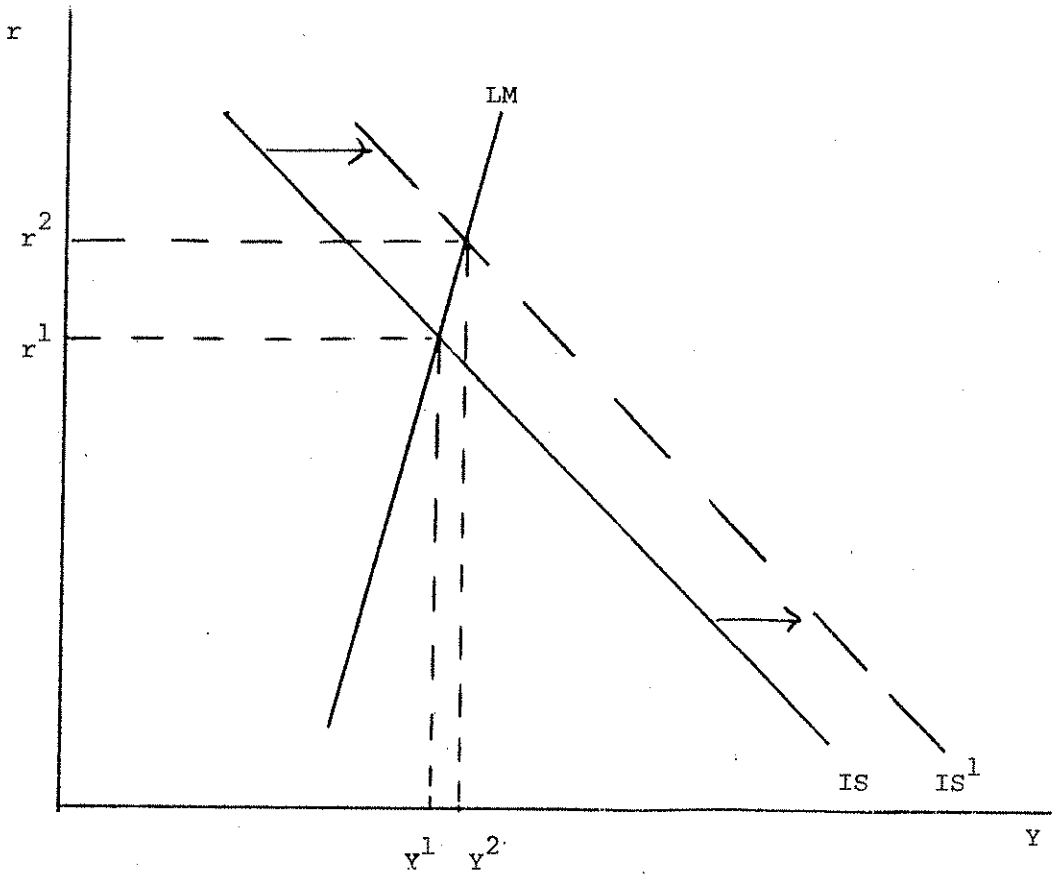

FIGURE 2

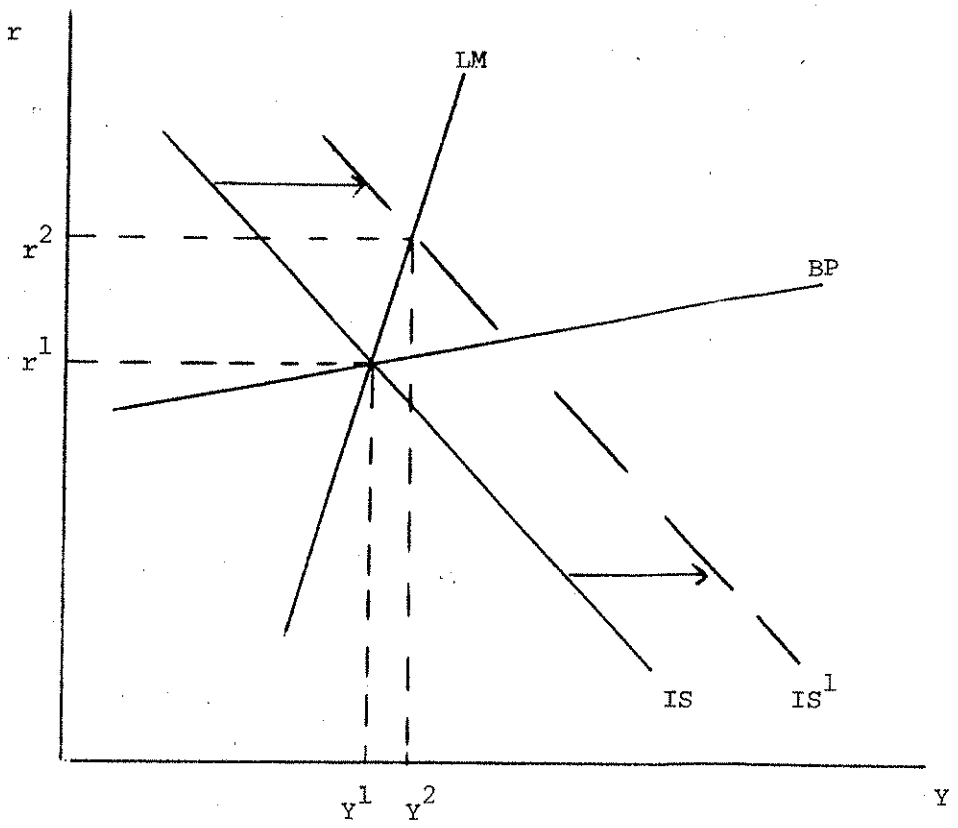

FIGURE 3

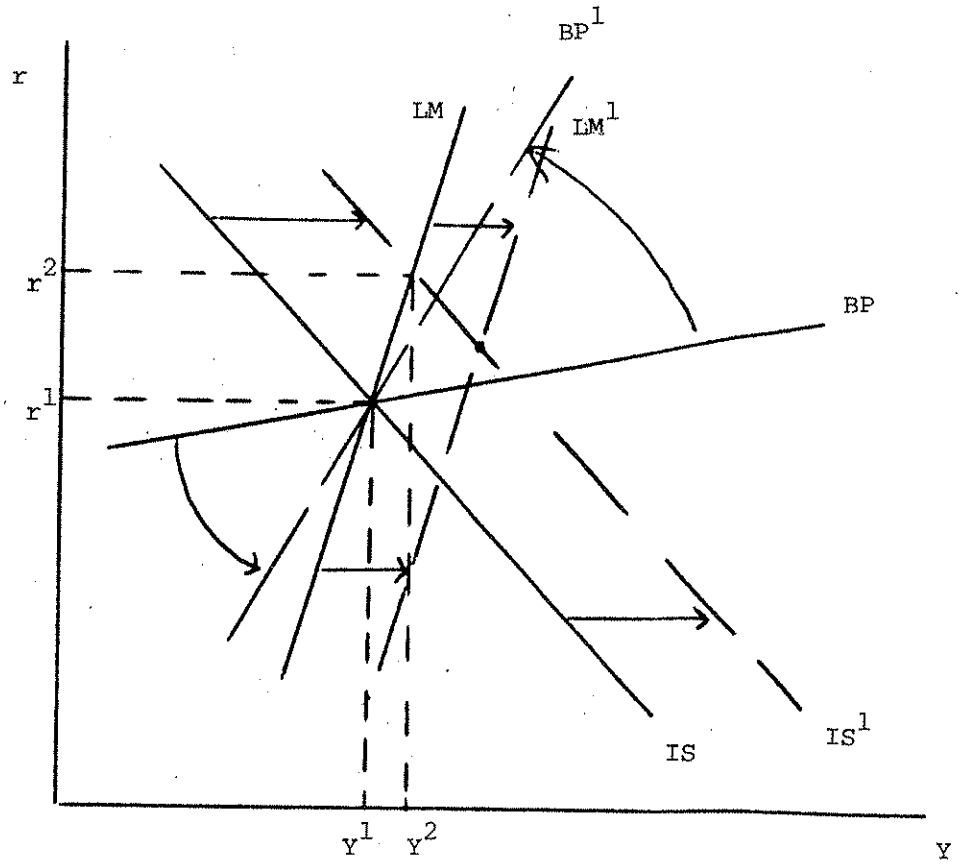

FIGURE 4

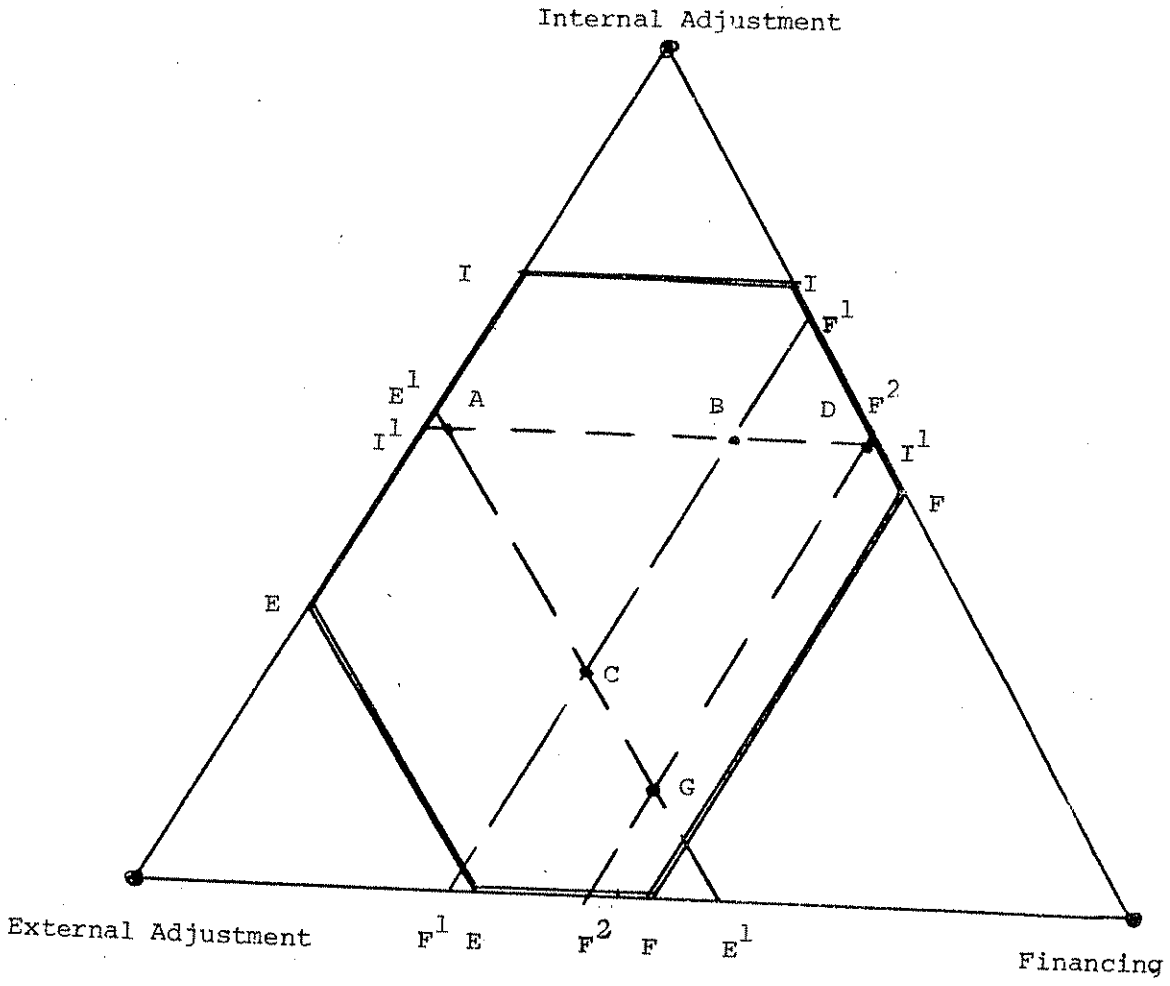
Internal Adjustment
I
I
F1
E1
A
B
D
F2
I1
I1
F
E
C
G
External Adjustment
F1
E
F2
F
E1
Financing

FIGURE 5