AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D. C. 20523
BIBLIOGRAPHIC INPUT SHEET

FOR AID USE ONLY
Batch 65

1. SUBJECT CLASSIFICATION
A. PRIMARY
TEMPORARY
B. SECONDARY

2. TITLE AND SUBTITLE
Payments arrangements for less developed countries,the role of foreign assistance

3. AUTHOR(S)
Michalopoulos,Constantine

| 4. DOCUMENT DATE | 5. NUMBER OF PAGES | 6. ARC NUMBER |
|---|---|---|
| 1973 | 62p. | ARC |

7. REFERENCE ORGANIZATION NAME AND ADDRESS
AID/PPC/PDA

8. SUPPLEMENTARY NOTES (Sponsoring Organization, Publishers, Availability)
(In AID discussion paper no. 26)

9. ABSTRACT
(ECONOMCIS R&D)

10. CONTROL NUMBER
PN-AAE-097

11. PRICE OF DOCUMENT

12. DESCRIPTORS

13. PROJECT NUMBER

14. CONTRACT NUMBER
AID/PPC/PDA

15. TYPE OF DOCUMENT

AID 590-1 (4-74)

AID/PPC/PDA
PN-AA-097

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D.C.

Bureau for Program and Policy Coordination

A.I.D. Discussion Paper No. 26

# PAYMENTS ARRANGEMENTS FOR LESS DEVELOPED COUNTRIES: The Role of Foreign Assistance

Constantine Michalopoulos

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February, 1973

SUMMARY

Interest in payments arrangements for developing countries has risen in the last few years. A number of clearing arrangements have been established in Latin America and Asia, reserve pooling through a stabilization fund has been organized in Central America, and additional proposals for monetary cooperation have been under discussion in the ECAFE region. This paper summarizes the objectives of payments arrangements among the Less Developed Countries (LDCs), the issues that they raise, and their usefulness for attaining overall development objectives of the participants. The analysis gives special attention to the proposals now under consideration ECAFE. On the basis of the overall analysis, the last section investigates the role that the IMF or developed country donors can play in assisting the establishment and operation of these arrangements.

A very large proportion of all the writings or pronouncements on payments arrangements among developing countries conclude with a more or less enthusiastic endorsement of such arrangements as useful instruments through which developing countries could attain a variety of development objectives. By extension most studies recommend that developed countries provide financial

assistance to make the establishment of payments arrangements possible. This paper sounds a few notes of caution. We recognize the usefulness of some types of arrangements, primarily in improving payments facilities and providing intermediate balance of payments support, but we question the role payments arrangements can play in expanding intra-developing countries' trade as well as the need and/or desirability of developed countries or the IMF providing them with financial assistance.

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## I. Introduction

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Recently the third UNCTAD Conference, in Santiago (April-May 1972), recommended inter alia that: "developing countries, where appropriate, promote...the establishment of suitable payments arrangements among themselves;... developed countries support such payments or monetary arrangements;...and the Secretary General of UNCTAD request the IMF to consider the possibility of establishing a special facility to support trade expansion efforts among developing-country members of regional or subregional groupings."* These recommendations raise policy questions about the role that developed countries or the IMF can play in assisting the developing countries in these efforts and the relationship of such assistance to overall development assistance from bilateral or multilateral sources.

The purpose of this paper is to summarize the objectives of payments arrangements among the Less Developed Countries (LDCs), the issues that they raise, and their usefulness for attaining overall development objectives of the participants. The analysis will give special attention to the proposals now under consideration in

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The argument can be summarized as follows:

(a) An arrangement limited to clearing, while not likely to stimulate intra-developing countries' trade, could provide limited benefits by improving the mechanism of effecting payments among developing countries. Developing countries' trade is not generally inhibited by bilateralism and inconvertibility, but the payments mechanism in some instances is seriously deficient. In these cases a simple clearing arrangement could in fact provide a stimulus to trade. However, since in simple clearing arrangements by definition only very short-term credit is extended to each participant, there is no need for outside financing. Instead, there is probably some scope for technical assistance which could be extended either by the IMF or by developed-country donors to enable developing countries to carry out the detailed analyses necessary to determine the desirability and feasibility of establishing a clearing or other payments arrangement.

The IMF has provided such assistance in the past by providing technical assistance missions to groups such as LAFTA, ECAFE and franc area countries in Africa. In light of the expertise developed by the IMF in this area there would appear no present need for involvement in this area by the U.S. or other developed-country donors.

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The IMF has provided such assistance in the past by providing technical assistance missions to groups such as LAFTA, ECAFE and franc area countries in Africa. In light of the expertise developed by the IMF in this area there would appear no present need for involvement in this area by the U.S. or other developed-country donors.

(b) In the case of payments unions which involve medium-term credit, we first questioned the fundamental assumption that intra-LDC trade liberalization is seriously inhibited by balance of payments considerations. Nevertheless, we recognize that if such arrangements are properly tied to commitments to trade liberalization they could contribute to the attainment of broad development objectives. However, there are various serious obstacles to the establishment of such arrangements. The most fundamental is that in the absence of foreign assistance, an arrangement based on the extension of mutual credit by developing countries provides very limited incentives for participation of developing countries likely to be creditors within the union.

A payments union becomes far more feasible if foreign donors or international institutions provide at least part of the funding. In fact it could be argued that it is highly unlikely that a payments union such as the EPU (European Payments Union) could be established among developing countries without at least some outside funding.

However, payments unions suffer from an additional serious drawback: The outside credit is distributed automatically on the basis of the balance on trade or current account within the union. It could be argued first, that financial assistance may not be very productive if it is used for balance of payments support without consideration of the LDC policies that contribute to the payments difficulties, and second, that if balance of payments support is extended, it should be with reference to the global arrangements picture and not the partial payments surplus or deficit arising from transactions with a small group of developing countries. These objections may be overridden, at least in part, if there are assurances that the payments arrangements will in fact provide a strong stimulus to trade expansion which in turn is beneficial to output growth. Yet, there is considerable doubt that payments arrangements among LDCs at present are likely to provide strong incentives to trade liberalization. For these reasons, it seems that financial support by developed-country donors to payments unions should receive low priority at present.

(c) The effectiveness of reserve pooling arrangements in promoting trade expansion is also doubtful. However, where feasible -- and they appear more feasible than payments unions -- they may make a positive contribution to meeting developing countries' needs for medium-term balance of payments support. It is difficult to determine the general need for such arrangements. Obviously, developing countries can obtain medium-term balance of payments assistance from the IMF. But reserve pooling can provide a first line of assistance even when the developing countries have unused credit tranches in the IMF.

These arrangements do not need outside support for their operations as much as payments unions do, although they would obviously benefit from such support. At the same time, since their focus is the overall balance of payments position of developing-country participants, they may be superior to payments unions from the standpoint of efficiency in aid allocation. In that respect their attractiveness is also enhanced if they are intimately related to LDC trade expansion measures. Thus, while it is difficult to argue that financial assistance to these arrangements is of high priority relative to other competing claims on donors' aid resources, assistance should not be ruled out and should be entertained under the appropriate circumstances.

(d) All payments arrangements, to a larger or smaller extent, are likely to make a positive contribution to strengthening economic ties and cooperation among developing countries. In the past, payments arrangements followed rather than stimulated far-ranging integration commitments among developing countries, particularly with respect to trade liberalization. While clearing arrangements are not likely to stimulate trade significantly, they are simple to agree upon and involve only small commitments on the part of participating countries. As a result they may be an attractive first step in cooperation among countries within a region which for a variety of reasons have found cooperation difficult.

(e) This study has concluded that the scope for financial assistance to payments arrangements is quite limited. This conclusion by no means implies that developed countries should not endorse these arrangements or worse, oppose them. All such arrangements, if feasible, are likely to yield some benefits to the developing-country participants either in the form of improvement of the payments mechanism, or in some instances balance of payments support and trade expansion, and in most cases increased cooperation among developing countries. There is no substantial evidence that the arrangements discussed here, with the exception of discriminatory exchange rate proposals, are likely to have adverse effects on the rest of the world or the operation of the international monetary system in general. Thus when such arrangements are proposed, particularly in international fora, it would appear that developed countries should concentrate not on abstract discussions of principle, which is often the case, but on seeing to it that the developing countries concerned obtain, primarily from the IMF, the technical assistance often necessary to devise workable arrangements which maximize the benefits LDCs are likely to derive for any given amount of international commitments LDCs are willing to undertake.

## III. Institutional Alternatives

Up to now consideration has focussed on three basic variants of monetary cooperation:

(a) Simple clearing arrangements with a relatively short interval between settlement dates and the provision solely of interim credit. Such arrangements are in force among members of the CACM and elsewhere and are proposed for ECAFE.

(b) A payments union where clearing is supplemented by a facility that provides medium-term credit to the participants.

(c) A reserve pooling arrangement which can range from partial arrangements that pool a portion of total reserves and extend medium-term credit to participants, to complete monetary union.

For each of these basic institutional variants, there are numerous options with respect to specific features. There are obviously options with respect to such matters as the contributions of non-participants, the credit terms, the terms of settlement, the types of transactions covered, and the degree of monetary integration. This section discusses the three basic alternatives, in part on the basis of available experience with individual arrangements and, in part, on an analysis of some alternatives which have been proposed in the past but not put into effect to date [19]. Readers familiar with the institutional features of payments arrangements might wish to omit this section and proceed directly to Section IV.*

A. Clearing Arrangements

The establishment of a clearing arrangement among a group of LDCs, usually within the same region, seeks to provide an alternative to the existing payments network, which involves denominating transactions in some convertible foreign currency, such as dollars, francs or sterling. This system is substituted by a centralized arrangement of mutually compensated settlements for intra-group transactions using an agreed-

*The discussion of some payments arrangements in this section, e.g., the RCD, LAFTA, and the African Monetary Unions, draws heavily on the description provided in the IMF study [12].

upon unit of account. Typically these arrangements involve the extension of only interim credit up to certain predetermined limits and periodic settlement in convertible currencies of net balances arising from trade and service transactions among the participants. In the CACM clearing arrangement, participants have agreed to extend credit up to $.5 million to each member, with a six-month settlement period. If members exceed those limits, they must pay the excess in full and convertible currencies, unless a central bank agrees to increase the credit it extends.

In the proposed Asian clearing union, each country would extend credit equal to one-sixth of annual exports to participants and receive credit amounting to one-twelfth of its imports; the settlement period would be one month [7]. In both instances clearing would be voluntary for individual traders, and in each instance a common unit of account has been established or proposed--the Central American peso, the Asian dollar. Similar, if slightly less formal, arrangements have been established among the RCD countries. The terms include a one-month settlement and a $2 million credit ceiling.

Among the members of LAFTA and the East African Community, agreements have also been reached for the establishment of reciprocal lines of credit. In addition to the basic clearing mechanism, LAFTA central banks agreed in 1969 to extend longer term reciprocal lines of credit to be used by countries in balance of payments difficulties.* The total initial amount of credit available was to be $30 million. However, the agreement has not yet entered into force [3]. In both these groups the interim credit extended is less automatic than in the others discussed above, in the sense that it is based on the overall balance of payments and reserve position of the debtor, as well as the country's credit position within the group.

B. Payments Unions

While at present no prototype of a payments union among LDCs exists, the creation of such a payments arrangement has been the subject of discussion and proposals on numerous occasions in the past [19]. The basic distinction between a payments union and a clearing arrangement is the provision of medium-term credit. The union could be based on mutual credit extended only among the participating members, or could be financed in

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*In LAFTA the establishment of bilateral credit lines was left up to the individual members.

part by outside contributors. The European Payments Union was such a mixed arrangement, with the U.S. contributing $100 million but not in fact participating in the arrangement. The use of outside assistance makes it possible for creditors to be paid in part or in full by the outside credit with larger credit extended to the debtors than would have otherwise been possible.

The apparent success of the EPU has led to repeated efforts to create similar institutions in the developing countries. Some of the original proposals in the ECAFE region called for a payments union without outside credit (although the option of contributions from developed countries was left open) but on the basis of initial positions [11, p.5].* Thus, an LDC would be asked to participate in the arrangement not with respect to all its trade, but only with respect to changes from the original position.**

None of the efforts to establish payments unions by LDCs have succeeded to date for reasons to be discussed

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*A payments union based on initial positions is an arrangement whereby credit is provided only with respect to increments in trade among LDCs.

**How these original positions are established presumably would be subject to negotiations among the LDCs. One approach would be to take a three-year to five-year average prior to the establishment of the union.

later in this paper. Instead, in recent periods attention has focussed on reserve pooling arrangements.

C. Reserve Pooling

The most highly integrated system of reserve pooling at present exists in the francophone countries of Central and West Africa. These arrangements have involved the creation of two monetary unions--the West African Monetary Union (UMOA) and the Equatorial and Central African Monetary Union (UMAEC)--both using a common currency (the CFA franc), but each with its own central bank.

The reserves of the participant countries are pooled in each case and deposited in the French Treasury, which guarantees the convertibility of the CFA franc into French francs, as well as unlimited overdraft facilities. If a country's imputed reserves in the pool become negative, the country pays a charge on the debit balance.

An arrangement involving far less monetary integration was established in Central America in 1970 in support of the regional common market. The Central American Monetary Stabilization Fund (CAMSF) is in fact a partial pooling of reserves. Its objectives have been, first, to create a mechanism for mutual balance of payments assistance to member countries experiencing reserve losses as a result of short-term disequilibrium in the balance of payments; and, second, to contribute to the stability and broadening of the base for cooperation in trade and payments policy among the participating countries. In case of balance of payments difficulties by one of its members, the CAMSF can extend loans up to 75 per cent of the reserve loss in the previous twelve months and subject to conditions designed to effect improvements in the country's balance of payments.

Each of the five participants has agreed to deposit $1.5 million of its reserves in the Fund. The Fund obtained, in addition, a loan from the U.S. A.I.D., swap arrangements with the central banks of Mexico and Venezuela, and lines of credit from American commercial banks, bringing its total resources to $77.5 million, in 1972.

The proposed Asian Reserve Bank (ARB) is similar to the CAMSF but somewhat more ambitious. The ARB would serve the region much as the IMF serves the whole monetary system. Members would deposit 10 per cent of their official reserves with the Bank and could borrow in case of overall balance of payments stringency. The basic differences are that the ARB would be able to borrow in convertible currencies, buy bonds issued by international organizations, such as the Asian Development Bank, and receive loans from non-participating countries. In addition, the following features in the most recent proposals for the establishment of the Bank are outlined in an ECAFE report [2, pp.7-8]:

"(a) All deposits will earn interest, comparable to the interest earned on deposits in major financial centers.

(b) Deposits will be denominated in an Asian unit-of-account, possibly fixed in value in relation to SDRs.

(c) The Bank will be required at all times to maintain freely usable foreign exchange, gold and SDRs, equal to two-thirds of its deposit obligations. If such assets of the Bank fall below the minimum reserve position required, all lending and investing operations of the Bank will be halted until the minimum reserve position is restored.

(d) Member borrowing will be limited to one-half the decline in a member's official reserves during any one quarter. Within this limit, members may borrow, at an interest rate based on the rates prevailing in the major international financial centers, amounts up to their statutory deposits (i.e., 10 per cent of their total official reserves) automatically. They may borrow more than their statutory deposit and up to twice that deposit if approved by a majority vote of the managing board. Borrowing beyond this latter sum requires approval of a four-fifths majority of the managing board.

(e) The full amount of any increase in a member's reserves subsequent to borrowing from the Bank must be repaid to the Bank. If this is not accomplished in three years' time, then the remaining balance must be repaid in full by contractual quarterly instalments extending over a period of not more than two years. In the event of a default, the facilities normally available to the member from the Bank will be suspended."

If all ECAFE countries had joined the scheme proposed for the region as of November, 1971, the ARB would have had total assets of $2.3 billion, with $727 million available for lending or long-term investment.

The limit on the Bank's reserve creating capacity would depend on the Bank's excess reserves. The Bank's excess reserves, in turn, would depend on the total reserves of members and the proportion of these reserves that members are required to deposit with the Bank, on any other deposits attracted from members or non-members, and on the ratio of required reserves to the Bank's deposit liabilities. This limit could be increased by the Bank's own short-term borrowing.

The ECAFE report expresses the view that:

> "eventually, if the Reserve Bank operated efficiently and its liabilities became competitive with other reserve assets, members might deposit more than the sums required, increasing the Bank's lending capacity, as would non-member deposits, without increasing the automatic claims on that capacity. From this point it would be a short step to acceptance by members of the Reserve Bank's liabilities in settlement of intraregional payments deficits and the Bank would become more like a regional commercial bank" [2, pp.9-10].

## IV. Benefits and Objectives

The benefits that would presumably accrue to developing countries from payments arrangements fall into four broad categories: (1) improvement in the payments system, (2) expansion of trade, (3) increased ability to deal with short- to medium-term balance of payments disequilibria, and (4) enhancement of the regional integration process.

Obviously, the relative emphasis placed by different types of payments arrangements on each of these objectives is likely to differ. Yet all arrangements seem to stress the benefits that will result in increased regional cooperation and integration. In this section we will examine the extent to which the various types of existing or proposed payments arrangements have contributed in the past and/or can be expected to contribute in the future to the attainment of these four broad objectives.

### A. Clearing

Multilateral clearing arrangements will improve the payments system as well as promote trade expansion if international trade is hampered by bilateral agreements leading to inconvertible balances. This is not the case at present in trade among developing countries. Unlike the situation prevailing in Europe prior to the establishment of the EPU, the incidence of bilateral agreements in developing countries is minimal. Trade among developing countries is carried out in convertible currencies, primarily dollars, sterling and francs, through banking arrangements that developing countries' banks establish with banks in major financial centers [5].

While this conclusion may apply to the developing countries in general, there is good reason to believe that trade among certain specific subgroups may in fact be inhibited by inadequate clearing and payments arrangements. Difficulties in obtaining conversion in foreign exchange and tardiness in clearing have been considered to be serious handicaps to expanded trade between the anglophone and francophone countries of West Africa and more specifically between Niger and Nigeria, and Ghana and Upper Volta [6]. Undoubtedly in these instances of partial inconvertibility, improvements in the payments mechanism may have a direct beneficial result on trade expansion, and clearing arrangements have been established among the pairs of countries mentioned above. However, the effects on trade expansion have not been substantial, because of the existence of large contraband trade carried out at black market rates of exchange. Without appropriate exchange rate adjustment, which would reduce the incentives for making payments through the black market, it is doubtful whether a clearing mechanism based on the official rate can have a significant effect on increasing trade [4].

Clearing arrangements are also likely to provide only very limited support to trade liberalization, because the interim credit they provide is by definition very much short-term and its amounts are usually quite limited. Even if it were assumed that LDC balance of payments difficulties inhibit trade liberalization, the provision of short-term liquidity by clearing arrangements is not likely to become a catalyst for the undertaking of trade liberalization commitments [18, p.19].

The experience of the CACM is instructive in this respect. Trade among the members of the CACM has expanded at a very rapid pace in the period following the formation of the common market and clearing arrangements.* However, this rapid growth in trade appears to have resulted primarily from the substantial preferential trade margins provided to participants in the CACM vis-a-vis outside producers and to the expansion of markets, and only to a

*The rate of growth of intra-CACM trade between 1960 and 1969 was 26% per annum, compared with 6.5% per annum for extra-regional trade.

very limited extent to the facilitation of payments through the clearing arrangement. In fact, the clearing arrangement had no cushioning effect during the recent Costa Rican balance of payments crisis.

Clearing arrangements with interim credit also do not reduce the need for foreign exchange reserves to meet balance of payments contingencies since net payments in gold and hard currencies are not affected, except in the very short term.*

While clearing mechanisms may not provide either a significant stimulus to increased trade among developing countries or a substantial reduction in these countries' foreign exchange needs, they may still result in improvements in the payments mechanism of participating developing countries.

In the first place the use of regional, as opposed to foreign, currencies for regional transactions may lead to some small economies in the use of foreign exchange. These economies might arise as follows:

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*The use of the clearing mechanism may tend to reduce the use of foreign credit for the financing of intra-LDC trade, since the amount of transactions carried out through foreign banks is reduced. To the extent that the loss of hard currency financing is not made up by the interim credit obtained through the clearing union, the developing countries' net payments in hard currencies may increase.

First, there is the possibility that a clearing arrangement will enable developing countries to reduce the level of idle working balances held with foreign banks. These balances are in convertible currencies maintained to finance day-to-day servicing of international transactions through the foreign banks. Since transactions would be carried on through the clearing mechanism, the funds required to be kept in foreign financial centers could be reduced, thus freeing some, albeit small, amounts of foreign exchange reserves. How much would be freed is difficult to say, because developing countries would still have to maintain balances to finance trade with third countries.

Second, use of the clearing mechanism will also reduce the need for transfers of funds between developing countries' accounts in foreign financial centers, such as New York or London, to settle individual traders' transactions. The charges that foreign banks make for these transfers are small--around .25 per cent. The CACM clearing union, the most successful perhaps of these arrangements, has clearly resulted in a significant increase in the use of regional transactions. In the CACM, about 85 per cent of all intra-member transactions are being handled through the existing clearing arrangement.* Assuming that clearing reduces fees in foreign exchange amounting to .25 per cent of each transaction, if all transactions cleared through the CACM between 1962 and 1970 had been cleared in London or New York, they would have resulted in an estimated $3.3 million in additional fees, Savings on these fees represents 1.2 per cent of the $267.5 million held by CACM countries in reserves in 1971. Thus, it would appear that the savings that could accrue to participants of clearing arrangements on account of the payments are likely to be small.

It should also be noted that clearing arrangements may result in some economies which accrue to traders in the participating countries but not to the countries as a whole. For instance, if transactions are carried out in the regional unit of account and participating countries deal in each other's currencies at par, this would reduce the conversion margin of the banks and hence the transaction cost to the trader. Traders would also benefit from not having need to obtain forward cover, as transactions under clearing are normally covered under exchange rate guarantees.

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*In LAFTA the proportion is 40 per cent, while in RCD it is barely 1 per cent.

Finally, a clearing arrangement can undoubtedly prove beneficial in promoting consultation and perhaps even cooperation among central banks and monetary authorities in a region. Having noted this fact, it is difficult to say much more in assessing the importance of clearing arrangements relative to other forms of international cooperation. In areas where such arrangements have been established they have followed or accompanied basic decisions to undertake important integration commitments rather than been the catalyst for undertaking such commitments. On the other hand, in regions where trade cooperation has proved difficult, the establishment of a clearing union might prove a useful first step. It is relatively simple to establish and operate, and in particular requires few commitments on the part of the participating countries. In Asia, where past integrative efforts have had little success, in part because of the tremendous political and economic diversity of countries in the region made it difficult to undertake extensive trade liberalization commitments, clearing appears to be a promising mode of cooperation.

B. An Aside - Clearing under Preferential Rates

The conclusion that clearing alone would not provide a strong stimulus to developing countries' trade would appear at first contrary to Vanek's conclusion, that considerable benefits can be derived by the less developed countries [from payments arrangements, essentially of a clearing nature] even in the absence of accompanying forms of economic integration [20, p.187]. Upon closer examination, however, it appears that Vanek's conclusion is based on slightly different assumptions about the nature of the clearing arrangement involved.* He notes that developing countries usually have overvalued exchange rates coupled with high protection, which makes it difficult for them to expand exports to each other. He then suggests that the creation of a payments arrangement with short settlement periods and interim credit among developing countries would promote a vigorous expansion of trade among them.

These results would ensue only if the exchange rate at which accounts are settled with members of the payments arrangement differs from the exchange rate at which transactions with the rest of the world are settled. The establishment of such differential exchange rates would promote trade in the same fashion that the creation

*While Vanek's paper talks about "payments unions," it is clear that the arrangements he means are more akin to clearing since he does not envisage more than short settlement periods and short-term credit.

of customs unions does, except that the preferences are granted through the exchange rate mechanism rather than through tariffs. Thus, payments arrangements of this type are substitutes for, rather than complements to, trade liberalization through reduction of trade barriers.

Undeniably, preferential exchange rates might provide a strong stimulus to developing countries' trade. Their usefulness in this respect must be evaluated in terms of the alternatives of attaining the same objective--namely, providing preferential treatment to other developing countries' exportable goods. It appears to this writer that such arrangements suffer from two basic problems: First, since the exchange rates presumably would cover all transactions, their effects would be pervasive and similar to those of a customs union. While their effects might be cushioned by introduction of some type of differential controls, it would seem that they require the kind of political commitment to integration whose very absence, with few exceptions, has hitherto inhibited the establishment of bona fide customs unions among LDCs. Second, it would seem that geographically differentiated exchange rates might be more difficult to manage than preferential tariffs and would present serious problems of compliance. For these practical reasons, it would appear that payments arrangements such as those proposed by Vanek have limited prospects of being implemented.

One should perhaps also mention in this context the proposals of Michael and Frances Stewart for the establishment of monetary arrangements covering <u>all developing countries</u>. The Stewarts start from the premise that prospects of developing countries' exports to developed country markets are dim and, for a variety of reasons, developing countries ought to restrain imports from developed countries [15]. This leads them to emphasize expansion of trade among developing countries as a solution. The proposed monetary arrangements would then be an instrument to promote trade expansion among developing countries based essentially on the same discriminatory principle implied by Vanek [8].

This is not the appropriate place to discuss the complex and far-reaching implications of the Stewarts' assumptions and argument. Nevertheless, some general observations are appropriate. First, the creation of a third world monetary system can have potentially adverse repercussions on the existing system of trade and payments, resulting in a reduction of overall efficiency in the payments mechanism and discrimination particularly against the developed third countries. While such discrimination may be justified as a means of effecting resource transfers from developed to less developed countries, it would appear that direct transfers to LDCs are a more efficient transfer mechanism. Second, the creation of such a system does not appear to be a practical alternative. At present, trade and payments relations of LDCs with developed countries play a dominant role in the former's trade. These relations would pose insuperable obstacles to the establishment of an alternative and competing payments mechanism.* For example, to establish a new and competing payments mechanism would require the establishment of an alternative international banking system, as the existing one is dominated by developed-country banks. The capacity for such an undertaking does not appear to exist. In addition, it is appropriate to recall that an alternative exchange system would require commitments of convertibility on the part of LDCs if it were to function as efficiently as the competing system. It is clear that only a few LDC currencies are strong enough to pass the convertibility test.

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*The Pearson Commission has also endorsed the creation of worldwide payments arrangements among LDCs without the preferential aspects of the above proposals [14]. In this case as well, the proposals appear impractical for the same reasons discussed below in the section on payments unions; only the problems seem to be magnified as a result of the inclusion of more potential members.

C. Payments Union

It is widely recognized that a simple clearing arrangement alone is not likely to yield substantial benefits to the participants and materially contribute towards the realization of the objective of liberalizing and expanding LDC trade. Thus it has often been necessary to explore the various aspects of a credit arrangement involving a payments union that could be established to supplement it.

At the start of our analysis it is appropriate to discuss the validity of one of the basic assumptions underlying proposals for payments arrangements: that trade liberalization in developing countries is inhibited by their balance of payments fears and, hence, that special payments arrangements are a necessary, although not sufficient, condition for trade expansion and liberalization among developing countries. Payments arrangements with intermediate credit, it is asserted, will provide developing countries with the necessary "security" in the balance of payments to enable them to liberalize trade. This assertion rests at the core of payments union proposals [18].

To determine the validity of this assertion, one must explore the factors that are responsible for the establishment of trade controls in the first place, as well as the likely effects of trade liberalization on the balance of payments. In recent periods, considerable attention has been focussed on the pattern and factors responsible for the trade barriers erected by developing countries [1, 9]. It is fair to conclude from these investigations that developing countries have in most instances erected a system of haphazard trade controls, often quite restrictive but typically subject to very large variations in the level of effective protection afforded to various industries. Originally the motivation for trade controls may have been short-term balance of payments crises and/or a basic policy of industrial promotion through trade barriers.

Irrespective of the original motivation, the unplanned application of controls has led to the establishment and expansion of numerous activities of widely divergent efficiency and ability to compete without substantial protection. Thus, the problem most developing countries face with trade liberalization is not so much its overall balance of payments effects but, rather, its adverse effects on output and employment in the individual industries which have flourished under protection.
A devaluation-cum-trade liberalization package may not adversely affect the balance of payments. It does affect,

however, individual industries which had flourished behind extreme protection provided, for example, through total bans of imports. In intra-LDC trade liberalization, where the trade involved is not a large proportion of overall trade, the problem is compounded because there is no incentive to adjust the overall exchange rate in order to deal with potentially adverse effects on a few individual industries. As a result, developing countries often find it very difficult to liberalize trade among themselves because of the repercussions liberalization might have on inefficient industries* rather than because of the effects of such liberalization on their balance of payments, which in most cases are likely to be small given the amount of trade involved. Undoubtedly, payments unions can be of some help, through extension of medium-term credit to developing countries in support of balance of payments disequilibria. But there are serious doubts as to the validity of the assumption that a payments union is a necessary or even an important factor in determining the willingness of developing countries to liberalize their mutual trade.

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*In efficiency terms it is precisely this displacement of inefficient domestic production of imports from members of a preference group that is most beneficial.

It is impossible to say how in practice payments unions among LDCs have affected their efforts at trade liberalization. The establishment of payments unions among LDCs has been inhibited by so many additional problems that none have been concluded to date. It is to these problems that we can now turn our attention.

1. Mutual Credit

In the case of a payments union with mutual credit, the fundamental problem is to discover developing countries that would be willing to become creditors within the union. This is because developing countries typically are large debtors in the overall balance of payments. Whether LDCs would be willing to participate in such a scheme would depend first, on the possibility that their position as creditors within the group might change and they might become debtors, and second, on the expectation that, as a result of the union, trade would expand considerably faster than without it. While the constant maintenance of balanced intra-union trade should not be expressly the objective of the union, it is important that reversals in existing imbalances occur over time, so that some incentive exists on the part of initial creditors to participate. In fact, if trade balance among participants were to be followed as a conscious objective of a payments union it could be argued that the arrangement may have adverse repercussions both on the efficiency of resource allocation in the participating countries, and on the trade of non-participants. Trade balance in the longer run is important to the viability of the union but should not be regarded as a deliberate short-run objective.*

Unfortunately, it appears that trade balance reversals are not common among LDCs insofar as intra-LDC trade is concerned. In intra-CACM trade there was only one trade balance reversal among the five countries in the five-year period 1964-1969. Similarly, a small number of reversals occurred in the ECAFE region. Finally, an AID study of sixteen developing countries in various regions accounting for 42 per cent of total intra-developing country trade showed that only two experienced trade balance reversals in intra-group trade over the period 1962-1968 [10].

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*It is conceivable that LDCs with extensive foreign exchange reserves, such as petroleum producers, could be willing to participate although they may be continuous debtors in the union. Few of these countries, however, have been involved in regional integration schemes. The Middle East oil producers have made contributions to regional objectives nevertheless, primarily because of political considerations. They could perhaps form a base for monetary cooperation among Arab countries in the Middle East.

To some extent, reversal in the existing positions could also be affected by the provisions guiding the extension of credit and repayment that are postulated by a payments union. In general two approaches can be used: Repayments could be based on the reversal of position, or on a pre-arranged time schedule.

The first approach was used in the EPU. In broad outlines, the following procedure was followed: Settlement was effected on a monthly basis. Part of it was settled in cash and part was in the form of credit within the context of a quota system. (Originally a sliding system of cash and credit was utilized, to be changed later on, to a uniform 50-50 rate.) Any payments in excess of the quota were settled in cash--with some exceptions relating to extreme debit or credit cases.

As a result of the system, a debtor country would enjoy continued credit as long as it remained within its quota for an indefinite period and repayment would hinge on a reversal of its position. The same applied to creditors. Such a system spreads the onus of adjustment between debtors and creditors, but at the same time provides a limit to the amount of credit that is extended to or received by any single country to predetermined amounts through the existence of quotas.

The alternative method requires repayments irrespective of position on the basis of a pre-arranged timetable. As such, it throws the onus of adjustment more heavily on the debtor, since it must either take actions to force a reversal within the union or gain a surplus on outside trade.

The relative feasibility of these approaches depends on the cooperation prevailing among the members of the union. If considerable cooperation between debtors and creditors exists on general economic policy questions which will assure that reversals of position would occur, then the former method would be preferable. If on the other hand such cooperation cannot be assumed, then the generally harsher terms implicit in the second approach may have to be imposed in order to reduce the amount of credit that would have to be extended by LDC participants to persistent debtors within the union.

Even if policy coordination is undertaken, there is no guarantee that intra-LDC trade would not leave many countries with large credit or debit positions. In that instance, it would make little sense for an LDC to participate in this arrangement as a creditor, particularly in light of the very real possibility that such an LDC, though a creditor in the LDC union, is an overall debtor, requiring foreign transfers to maintain a satisfactory growth performance.* Thus, the basic problem of payments arrangements focussing on intra-group trade and payments is that it focusses on only a segment of the overall balance of payments and probably on a relatively unimportant segment, at that.

The prospects for success of a payments union will increase if the creditors anticipated large increases in their exports as a result of the union. But for this to occur, the payments union must be specifically tied to an agreement which obligates participants to undertake trade liberalization over time. This is a very important condition which, if not fulfilled, is likely to render any payments arrangements inoperative. It should be recalled in this context that the EPU was expressly tied to a code of liberalization of intra-European trade to which members had to accede if they were to participate in the payments arrangements. This involved commitments to eliminate all quantitative restrictions over a five-year period, as well as other measures facilitating intra-

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*It is for this reason especially that the idea of a payments union was abandoned in the ECAFE region and instead a Multilateral Reserve Center was proposed. Robert Triffin, acting as consultant to ECAFE, was mainly responsible for proposing the Reserve idea [8].

European trade. The likelihood that groups of developing countries could agree to a similar code of trade liberalization at present appears remote.

2. Initial Positions

In order to avoid the problems resulting from large and persistent debtor or creditor positions and the need to finance substantial intra-regional as opposed to global deficits, it has been proposed to establish payments arrangements on the basis of initial positions. This approach could well achieve the main objective of the union, trade expansion and liberalization, at a lower cost in terms of financing needed and the scope of credit extended. Since the agreement would apply to changes in trade, it would be less likely that large, irreversible credit and debit positions would be established and thus LDC participants which are likely to be creditors on overall trade with LDCs would have more incentive to participate. Also, since the scheme would be related only to changes in trade, both the amount of financing needed and the scope of credit extended would be smaller than if all trade were included.

The AID study referred to earlier showed that if 100 per cent financing for all the intra-group balances for 16 developing countries had been undertaken in 1968, net credit outlay for that year would have been \$347.1 million. By contrast if the year-to-year changes in intra-group balances were fully financed, a credit outlay of only \$18.7 million per year would suffice on the average.

However, if such a modification is employed some additional questions are raised: Would the initial positions remain constant or would they be adjusted? And if they are adjusted, what rules should be used in this adjustment process? One answer might be to employ moving averages. The answer apparently proposed in an earlier ECAFE study is to embody in the agreement a growth rate for each country's exports and imports [11]. The difficulties in arriving at such commonly agreed rates of growth cannot be minimized; and the situation is not helped by the fact that there is no prior experience with a payments union operated on the basis of initial positions as defined above.*

The problem of devising solutions for these difficulties would be easier if it could be ascertained that the participants in the union were doing whatever possible to expand trade among themselves and to pursue

*The establishment of a payments union based on initial positions was favored in ECAFE for some time. The Indian Government held that view until early in the summer of 1970.

policies that did not take unfair advantage of the possibilities for credit opened to them by the payments union. This, however, requires a unity of purpose and a solidarity which has only rarely been present in the context of arrangements involving either LDCs or DCs.*

D. Reserve Pooling

The basic rationale of such arrangements is to provide a first line of defense for balance of payments problems experienced by developing countries in a region. By pooling reserves, each country presumably is better able to deal with occasional disturbances in its balance of payments. The major benefits expected from reserve pooling have been perhaps best articulated in the proposals for creating an Asian Reserve Bank, as follows:

"(1) facilitating members' participation in proposals for trade liberalization and expansion, either individually, regionally, or worldwide.

(2) reducing the likelihood that members losing reserves will adopt income, an

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*It is almost impossible to judge the role a payments union, as opposed to other arrangements, could play in promoting regional integration alone or in combination with regional trade arrangements, since none has in fact been concluded among developing countries.

exchange rate, and trade policies that would reduce regional and world economic welfare.

(3) directly economizing on the reserves held by members and so freeing some portion of these reserves to be used for investment in development projects in the region, raising regional growth rates and expanding regional markets.

(4) providing, at a low or zero marginal cost, reserve 'insurance' for the cooperating nations and so reducing the risk, when payments problems arise, of trade distorting and income reducing speculative movements in capital and commodities" [2, Add. 1, p.2].

In the case of the Central American Monetary Stabilization Fund, it was rightly believed that the creation of the CACM would result in significant trade liberalization among participating countries. It was expected that CAMSF would be a useful support for this liberalization and that cooperation in meeting balance of payments crises of individual CACM countries would be a further step towards economic integration of the region.

Past experience with these arrangements is quite limited and centers on the monetary unions in francophone Africa whose characteristics cannot be easily generalized to other developing countries because of the special monetary relations in the franc area.

On the payments side, a recent study concluded that BCEAO (Banque Centrale des Etats de l"Afrique de l'Ouest), the central bank for UMOA, is mainly committed to the "secondary," and basically commercial, objectives of keeping excessive external reserves and limiting credit facilities to avert balance of payments difficulties. It pays little attention to what should be the "primary" objective of economic development. In fact, the BCEAO customarily maintains external reserves at a level about five times higher than necessary to handle any likely UMOA external imbalances [16]. These assets, moreover, are immobilized in French francs in France rather than being used for African development.

The BCEAO's restrictive credit policy seems not to be designed to stimulate domestic saving but rather to protect the "theoretical" overdraft facilities on the French Treasury. Thus, it can be argued that, such a system is very costly to the participating countries, since it results, in effect, in lending by the developing countries of UMOA to France for the theoretical privilege of overdraft facilities, which in fact are strictly limited both in time and in amount. No deficit is allowed beyond sixty days and it can only be at a maximum 10 per cent of previous year's domestic fiscal receipts [16].

The CAMSF has been in existence too short a time to allow for a general judgment of its effectiveness in dealing with balance of payments questions. In the one important balance of payments crisis since 1970, Costa Rica in the summer of 1972, no assistance was extended by the CAMSF and none was officially sought. The crisis in fact led Costa Rica out of the clearing house arrangement temporarily because the application of preferential rates to other Common Market countries, through the clearing house, led to large trade deficits in inter-regional accounts.

Looking at the trade side next, again one must register reservations to the argument that reserve pooling will promote trade liberalization. The same basic reservations noted in connection with payments union above (see pp. 30-33) apply here as well: namely, it is doubtful that developing-country trade liberalization is seriously inhibited by balance of payments uncertainties.

In the CACM case, it is ironic that the expansion in intra-CACM trade after the CAMSF was established was lower than before. However, this should not be viewed as a by-product of the CAMSF; it has been mostly due to the *de facto* secession of Honduras from the CACM as well as the balance of payments problems faced by Costa Rica since 1970. The monetary unions in Africa without doubt have not helped promote intra-regional trade. The monetary integration has not even materially helped commercial integration. Rather, the arrangements seem primarily to facilitate business and trade with France and the EEC [16].

In light of these considerations it would appear that the expected benefits of the proposed Asian Reserve Bank in the realm of trade liberalization would be small, if any. On the other hand, from the payments standpoint, the proposed facility may well be feasible and have the potential to provide some benefits in intermediate balance of payments support to the participants.

ECAFE investigated the feasibility of an Asian Reserve Bank by examining what would have been the availability and use of reserves by an Asian Reserve Bank, had one been in operation in the period 1958-1970, under the basic conditions outlined in Part II above.* The study concludes that:

> "A reserve bank covering all ECAFE members (including developed countries exercising borrowing rights) would have enjoyed a mixed experience in the 1958-70 period. In eight of the thirteen years covered, the bank would have fallen below its reserve requirement if it serviced all the semi-automatic drawing rights (twice beginning period required deposits) of members and members exercised these rights (unlikely for several). Only by borrowing in several years could the bank both have serviced members' semi-automatic borrowing rights and maintained its required reserve position. In addition, the bank would

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*Any study of this nature implicitly assumes that the existence of the hypothesized Asian Reserve Bank would have had no effect on the payments transactions in the region. If it had, for example, stimulated trade expansion, as it is supposed to do, the analysis presented in the study, which is based on what happened without the bank in existence, would be inaccurate; and in fact any feasibility analysis would have been most difficult.

have had funds to invest in long-term securities in only five of the thirteen years" [2, Add. 1, p.6].

While some countries would have been on the creditor side most of the time, all LDC members would have used the Bank's lending facilities at least once. In fact, eleven of the eighteen members would have been in debt between four and eight years, and so would have alternately both used and contributed to the Bank's lending capacity. This suggests that the benefits would not be polarized.

The hypothesized Reserve Bank would have functioned better if the developed countries in ECAFE continued to deposit 10 per cent of their reserves but did not borrow. Under these circumstances, a regional reserve bank would have been able to meet its reserve requirement, service the semi-automatic borrowing rights of borrowing members, and have substantial amounts available for long-term investment in ten of the thirteen years covered, compared to five years for a regional reserve bank with <u>all</u> members borrowing. In fact, in the last five years, over $100 million would have been available for long-term investments [2].

Finally, the study suggests that all these operations would have been undertaken at minimum risk of reserve loss or illiquidity for the Asian Reserve Bank. To make the bank illiquid, total reserves in the participating members would have to decline by 30 per cent. In fact the largest annual decrease in this period, which occurred in 1961, involved a decline in total reserves of only 3 per cent [2].

The Asian Reserve Bank has other attractive features as well. Credit is extended on the basis of the overall balance of payments position rather than the balances on intra-group trade. This approach makes it possible to tackle one of the serious problems that are likely to be faced by payments unions among LDCs, i.e., how to deal with countries which are creditors within the union but overall debtors.

Thus, while its effect on trade liberalization is likely to be minimal, there is little doubt on the basis of this analysis that the establishment of a reserve bank in Asia is feasible, particularly if the developed-country members contribute but do not exercise borrowing rights. However, one further question needs to be raised: Do the countries in the region need the establishment of this additional facility in light of the facilities open to them at present for borrowing for medium-term balance of payments support?

Adequacy of existing facilities is difficult to determine, particularly when the region is composed of countries with great diversity in their balance of payments situation. If the ratio of reserves to imports in 1970 is used as an indicator, the ECAFE region fares on the average slightly worse than developing countries as a whole (28.7% versus 31.9%) but five of the sixteen countries have reserve-to-import ratios far higher than the average for developing countries. Similarly, looking at the IMF tranche position in 1971, one country in the region was in the third credit tranche, three in the second and two in the first. This pattern was similar to that prevailing for all developing countries. Thus on the basis of this criterion also, one could not conclude either that developing countries in ECAFE have nearly exhausted their credit with the IMF in absolute terms or that they are worse off than developing countries on the average.

In light of the inconclusiveness of these findings, one can only say that while there may be no urgent need for the Asian Reserve Bank, it has the potential of providing some tangible benefits to participants in the area of balance of payments support.

<u>LDC IMF Positions - 1972</u>

| IMF Tranches | ECAFE LDCs | Rest of World LDCs |
|---|---|---|
| Creditor 75% | 0 | 4 |
| No Drawings | 6 | 20 |
| Gold | 6 | 38 |
| First Credit | 2 | 11 |
| Second | 3 | 3 |
| Third | 1 | 0 |
| Fourth | 0 | 0 |
| TOTAL | 18 | 66 |

Source: IMF *International Financial Statistics*, September, 1972, pp. 8-9.

It is also hard to judge whether the agreement is likely to provide a positive stimulus to general integration efforts in the area. However, past experience in Africa and Central America seems to indicate that the monetary agreements tend to follow basic integration decisions in the trade area, rather than lead the way to further integration.

## V. The Role of Outside Assistance

The usefulness or desirability of developed-country or IMF participation in payments arrangements of developing countries varies considerably with the nature of the arrangement envisaged. The basic distinction is between the role foreign participation can play in strictly clearing arrangements, on the one hand, and payments unions or reserve pooling agreements, on the other. In the first instance, foreign participation is not needed, because the amount of credit extended can and has been easily managed by the LDC participants. In fact, foreign participation has neither been sought by the various clearing arrangements already in existence nor does it appear to be a serious constraint inhibiting the creation of others. However, the situation is quite different in the case of payments unions and reserve pooling. In the case of the former arrangements, more than the latter, foreign participation has been considered of crucial importance to their establishment and successful operation. It has been often pointed out that the EPU success was made possible in large part because of the original U.S. grant of $100 million which in part enabled the union to deal with the problem of persistent debtors (see above, p. 13).

The argument for developed country or IMF contributions to payments unions is simple.* Outside aid simply facilitates the problem of financing credit positions within an LDC payments union. The use of aid funds would make it possible for creditors to be paid in part or in full by these funds while a certain amount of credit would be extended by the other LDC participants. The incentive for an LDC creditor to participate would then be the clear benefits that it would derive from potential trade expansion resulting from the union.

The basic issue raised by a payments union with outside credit relates to the criteria for allocating the credit: Essentially the LDC debtors within the union get the credit. If these are persistent debtors, then one group of LDCs enjoys the benefits of the outside credit, implying transfers of resources, while the other group benefits only to the extent that their exports as a result of the union increase.

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*The discussion that follows is in terms of assistance primarily from developed countries directly. However, the same considerations apply to indirect assistance through the establishment of a special fund in the IMF.

The more fundamental problem is whether the criterion of allocation of aid funds employed by a payments union is rational or not: The debtors, whoever they are, get credit automatically according to certain prespecified rules whose stringency can vary with the amount of credit they request. But it cannot be established whether the need for this credit is the result of incorrect domestic or international trade policies or not.* Furthermore, the extension of credit relates to a balance of payments position with respect to the region and not with the world as a whole, and, if anything, it is the latter and not the former that must be considered when foreign aid is extended to an LDC on balance of payments grounds.

Extension of credit for intra-union balance of payments support could be rationalized if it were demonstrated that the need was related to trade liberalization undertaken by the country in question. However, it does not appear possible to demonstrate this proposition empirically. One way out may be institutional; namely, that the LDCs make the payments agreement contingent on the undertaking of mutual trade liberalization measures by all the participants. Thus we return to the proposition raised earlier: A payments union of any configuration would have to be associated with

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*EPU had OEEC as the analytical and enforcement arm. And of course trade liberalization was built into the basic agreement.

a trade liberalization agreement by the developing countries involved. Unless such an agreement is reached and becomes an organic part of the payments union, the latter alone would provide little incentive for creditors to participate and might result in an inefficient allocation of outside credit. Unfortunately, as noted earlier, there are serious obstacles inhibiting developing countries' mutual trade liberalization which are unrelated to balance of payments risks.

It should be pointed out that U.S. support for the EPU was intimately related to the European commitment to liberalize trade [13]. The letter of the U.S. Special Representative in Europe to the Secretary General of OEEC transmitting the decision of the U.S. to materially assist the creation of EPU read in part as follows:

> "The Government of the United States understands that the embodiment of the Council Decisions relating to the liberalization of trade in a separate document from the Agreement of the Establishment of a European Payments Union does not in any way derogate from the well-established understanding that the decisions on trade liberalization and the financial

principles of the European Payments Union are both parts of a single comprehensive program."

Similar trade liberalization and general economic integration objectives were also prominent in the U.S. decision to assist the CAMSF in the form of a $10 million loan. Perhaps because such benefits are not likely to materialize in the case of the Asian Reserve Bank, or other similar pooling arrangements, outside assistance is sought on different grounds. It is suggested that outside depositors could be attracted to the Bank because: (a) the rate of return on such deposits in combination with the little risk associated might make them attractive to developed-country central banks; and (b) such deposits would be an inexpensive form of foreign aid [2, Add. 1, p.8].

It is difficult to accept the proposition that such an allocation of reserve assets would be attractive from the standpoint of reserve portfolio management since these deposits, irrespective of relative earnings and risk considerations, would be highly illiquid. The only way to view such deposits is as a form of economic assistance, much the same as the contribution of outside creditors to a payments union.

Looking at the possibilities for external support of regional reserve pooling arrangements, it should be pointed out that from the standpoint of efficiency in aid allocation such arrangements have the advantage that credit would be apportioned on the basis of the overall, rather than the regional, balance of payments position. Thus it could be argued that if the objective of foreign transfers were simply to provide general balance of payments support for developing countries, the allocation resulting from operating through the Asian Reserve Bank would not result in serious distortions, assuming of course that the balance of payments deficits, in part financed through the Bank, did not result from policy deficiencies in the recipient countries participating.

Nevertheless, there are additional problems with allocating aid funds in support of payments arrangements, either of the payments union or reserve pooling type. In the first place, given the nature of reserve pooling mechanism, only a portion of the deposits can be lent out; the rest must remain intact in order to maintain bank liquidity. This by necessity will have a smaller impact on a developing country's balance of payments picture than if, instead, the whole amount were used by a donor for balance of payments support of a country, assuming that that is a priority aid objective. But, since the Asian Reserve Bank would not have any problem in meeting demand for loans even if it operated without outside credit, outside deposits would not be needed to provide more loans for balance of payments support. Rather, outside deposits would enable the ARB to increase its holding of securities issued by regional or other development institutions, which would result in increased transfer of resources to the developing countries. But then the question is why is it necessary to use the ARB as an intermediary and not allocate increased funds directly to regional development institutions.

Finally, it should be stressed that it is quite doubtful whether scarce foreign aid funds are best used in support of short-term or medium-term balance of payments objectives in LDCs. There is good reason to believe that the marginal productivity of aid is higher when it is used in support of long-term development projects or programs. Hence, the former is of lower priority than the latter, particularly when, as in reserve pooling arrangements, there is little incentive towards trade liberalization.*

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*This should not be interpreted to mean that present patterns of transfer maximize the marginal productivity of aid transfers nor that balance of payments support is not given to individual countries.

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