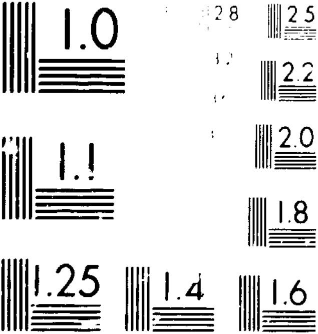
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Mobilizing Additional Financial Resources * Through Greater Use of National Currencies of Developing Countries

by

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** IDC: Institute for Developing Countries.

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1. During the last few years there have been increasing attempts to substantially improve economic co-operation among developing countries. Obviously such attempts have to be accompanied by substantial improvements in monetary and financial co-operation among developing countries (DCs).

As is well known even the existing modest volume of trade among DCs is still substantially based on reliance on financial services provided by a relatively small number of developed market economies and their banking systems. In the contemporary world, with some 150 sovereign countries, the overwhelming majority of all international economic transactions are being settled and financed with approximately ten "leading" currencies. The great majority of all other currencies are, de facto, restricted in their use for domestic transactions only. Therefore it appears justified to assume that there are some potential benefits that could be exploited through much greater use of national currencies of DCs.

2. Several specialised conferences on financial and monetary co-operation among DCs have been held over the last ten years.

Their most tangible result, until now, seems to be a consensus by DCs about the list of priorities for particular areas in which monetary and financial co-operation should be systematically pursued.

While the 1981 Caracas Conference identified eight rather broad areas for financial and monetary co-operation among DCs, the 1982 conferences in Geneva and Kingston concentrated their work on the following subjects:

- Joint ventures among developing countries;
- Energy development, which is to take place together with developed countries;
- Export credit arrangements for DCs;
- Commodity finance;
- Financing of regional credit arrangements among DCs;
- Special payments arrangements for oil imports of DCs.

Naturally, systematic co-operation by DCs on such issues automatically raises various organizational problems and questions about the establishment of new specialised institutions. Most prominent among those are projects for a special Bank for Developing Countries and a specialised Corporation for Multilateral Investment Guarantees in DCs. All such attempts are conceived as parts of efforts towards greater self-reliance by DCs.

3. While work on the above mentioned problems proceeds at various political and expert levels this paper aims to point out another possibility by which a greater volume of financial resources would be mobilized by DCs which face particulary severe balance of payments constraints and made available for the financing of development projects in general, but, above all, for the financing of exports.

At the same time, it should also be possible to reduce a large part of restrictive trade and exchange restrictions thereby helping to increase the overall efficiency of resource allocation in those DCs.

4. As is well known, one of distinguishing characteristics of DCs is a structural shortage of capital formation. This is usually accompanied by structural balance of payments difficulties and, very frequently, by a rather underdeveloped domestic financial infrastructure.

While balance-of-payments difficulties have, to a very large extent, their origin in the structural scarcity of capital in DCs, the underdevelopment of their financial infrastructure has to be attributed to other factors. The way in which many DCs try to deal with their balance-of--payments difficulties indicates that an underdeveloped financial infrastructure, and economic policy ideology, which goes with it, acts as an additional barrier against stronger development of domestic financial mechanisms - based on the greater use of domestic currency.

5. The problems arising out of structural balance of payments deficits are usually dealt with through various combinations of measures by which it is aimed: (i) to "regulate", i.e. to restrict imports, and (ii) to "stimulate" exports. A very common result of a rather large part of such measures is a frequently uncontrolled or even unconscious, sliding into a system of multiple exchange rates.

The various deficiencies associated with the system are already known. Here, it is of interest to point out that long-lasting use of multiple exchange rate practices leads to such large distortions in respective national economies that their national currencies become increasingly incapable of performing even typically "domestic" functions of money (as a general unit of account and as a store of value).

The capacity of national currencies to fulfil these functions is one of the indispensable conditions for the efficiency of the allocation mechanism and for the satisfactory formation of domestic financial resources.

6. If a DC is confronted with a very high degree of distortions in its price and allocation mechanisms, and, further, if it has great balance-of-payments difficulties, then the establishment of an equilibrium exchange rate which would balance autonomous demand and supply on the foreign exchange market is not likely to be achieved for some time. Therefore, for these DCs there is an unavoidable necessity to accept some kind of administrative procedures for distribution of scarce foreign exchange funds. But under such conditions domestic exporters can be guaranteed certain kinds od priviledged treatment in the sense that they obtain the <u>possibility to buy</u> certain amounts of foreign exchange to pay for imports of goods and services, which are necessary for their production for exports.

However, this argument should not be confused with seemingly similar ones which regard overvalued exchange rate policies as "normal", permanently sustainable, solutions and multiple exchange rates as a system which have to provide exporters with some compensation for the effects of overvalued exchange rate policies.

In addition to being able to provide institutional advantages for exporters, as far as the allocation of scarce foreign exchange funds is concerned, the implementation of this proposal is also expected to lead towards reduction of multiple exchange rate practices. Last but not least, it should give a strong impetus for a much larger mobilization of savings and other financial resources within the framework of the domestic banking system.

7. The banking technique needed in order to implement such a system is following: instead of foreign currency accounts, domestic exporters would have the right to have convertible accounts denominated in the domestic currency. Such accounts would be held and managed by authorised domestic banks.

For the sake of economy of works, such accounts will be called convertible "dinar" accounts. ("Dinar" is given in quotation marks in order to indicate that it does not specifically refer to Yugoslav dinars, but to a currency of any DC).

Although the idea to establish freely convertible accounts denominated in currencies which are generally regarded as non-convertible may sound rather surprising it has to be pointed out that there should be no substantial difficulties in establishing and managing such accounts. In fact, this should be much easier for any banking system because the management of accounts denominated in its own currency does not carry with it an exchange rate risk which is otherwise imminent.

Naturally, the assets that could be used to credit such convertible "dinar" accounts would have to originate basically from the same sources as the funds which are presently credited to foreign exchange accounts. An exporter who receives a certain amount of freely convertible foreign currency in payment for this exports would have to sell the whole amount of his export proceeds at a prevailing - unified - exchange rate. From the total "dinar" value of these proceeds the exporter would be entitled to retain a certain percentage and keep it on a freely convertible "dinar" account with his authorised bank. These funds would have to have absolutely free access to the organized domestic foreign exchange market. Exporters would have the right to freely convert any amount of their convertible "dinar" funds into a desired foreign currency, at the existing market rate. All this would have to be guaranteed by law and strictly observed by current policy measures.

In respect to the problem of exchange rate risks, the domestic exporters, holders of convertible "dinar" balances, would be put in the same position as all other residents. This means that they would have to bear the exchange rate risk unless they enter into deliberate deals in the forward exchange market. Authorised banks should, therefore, be encouraged to take a lead in order to organize and to "create" such markets.

Convertible "dinar" accounts treated here are, obviously, <u>accounts of domestic residents</u>. Within the entire domestic monetary system the residents would, in principle, not be permitted to have any foreign currency accounts but only "dinar" accounts with various degrees of convertibility. According to the origin of export proceeds and the nature of currencies in which those proceeds are received, a set of different kinds of convertible "dinar" accounts should be established. If export proceeds are obtained in freely convertible currencies, then freely convertible "dinar" accounts should be established. Analogously, for export proceeds obtained in currencies with limited convertibility different kinds of "convertible" or "transferable" "dinar" accounts should be established from freely convertible accounts.

The establishment of special "dinar" accounts with regionally limited convertibility or transferability could prove to be of great help as one of the means to finance the increase in trade among DCs.

For non-residents it is obvious that they have a choice to accept or not to accept banking facilities offered by a particular country. Therefore, they should be granted the possibility to have accounts in foreign currencies within "our" banking system. It should, however, be pointed out that from any single country's point of view it is much more advantageous to attract foreigners to have their accounts with "our" banks in "our" money rather than in a foreign currency. It follows that also a set of non-resident convertible "dinar" accounts should be created. Obviously, conditions offered by authorised banks to holders of such accounts have to be competitive in relation to conditions offered to similar accounts elsewhere. This could also give an impetus to greater economic co-operation among DCs.

8. This proposal to switch from foreign currency accounts into a set of convertible "dinar" accounts is not intended only to create a more rational system of banking

and export promotion but, above all, as a mechanism which should also facilitate the formation of a substantially larger volume of domestic financial resources. This should occur primarily with authorised banks who would be entrusted to manage such accounts.

This goal can be accomplished by giving exporters the right to retain a somewhat larger share of their export proceeds in relation to what they would need for the immediate financing of their own import needs. Authorised banks in which convertible "dinar" accounts would be held should obtain the exclusive right to "buy" or to take into time deposits any amount of available balances in such funds. On the other hand, authorised banks would also have the right either to "sell" such funds or to extend credits with such funds, mostly to prospective domestic importers. In all these transactions the authorised banks would have to deal in these funds exclusively al pari, i.e. they would have to "change" one convertible "dinar" for an inconvertible one and vice-versa.

In order that such transactions produce the desired results it is necessary that they all be accompanied with a corresponding credit operation. That is also the reason why all such deals have to be transacted via authorised banks.

Domestic exporters whose available convertible "dinar" funds would be put at the disposal of interested prospective domestic importers should simultaneously receive credits in internal "dinars". The amount of credits granted in internal "dinars" should be greater than the amount of convertible dinars "sold" or lent by the exporter.

The source of funds for such credits is, obviously, to be found with potential users of such funds who would have to maintain deposits in internal "dinars" with authorised banks.

According to the term and interest rate structure of internal "dinar" credits demanded by domestic exporters, the authorised banks would determine conditions under which the internal "dinar" funds of prospective importers would have to be deposited with them. Prospective buyers and/or borrowers of convertible "dinar" funds would be asked either to make advance deposits, or to maintain larger amounts of internal "dinars" in respect to the amount of convertible "dinars" which they would want to buy or borrow. This proposition obviously rests on the assumption that potential importers dispose of freely usable internal "dinar" funds.

Or, to put it differently, the underlying logic of the whole scheme is based on the propositon that the excess supply of liquid funds, which undoubtedly exists in most developing countries with severe balance-of-payments deficits, be chanelled to authorised banks in order to enable them to use those internal currency funds for the financing of current export production and new export developments.

Considering the excess supply of domestic liquidity which corresponds to an excess demand for foreign exchange at a given exchange rate, authorised banks will be in a position to obtain the more favourable borrowing conditions for internal "dinar" funds which they need to finance export activities. According to the state of these ratios, prospective "buyers" or borrowers of convertible "dinar" funds could be asked to maintain deposits in internal "dinars" with a very low or even a zero interest rate. Analogously, authorised banks would demand relatively high interest rates for convertible "dinar" funds lent to prospective importers.

Such policies would enable authorised banks to extend credits in internal "dinars" to domestic exporters at a very low cost. At the same time banks would be capable of paying relatively high interest rates on convertible "dinar" deposits which exporters would hold with them. This should encourage exporters to keep their convertible "dinar" funds on deposit with authorised banks for longer periods of time, thereby helping to economize with scarce foreign exchange funds.

Apart from providing a strong impetus for a substantially greater mobilization of domestic financial resources and their more efficient allocation, primarily in favour of the export sector, such a system would also provide additional support for a substantial reduction of multiple exchange rate practices and for the overall development of domestic financial infrastructure.

9. With respect to multiple exchange rate practices, particularly in those cases where such practices have taken very large or uncontrollable dimensions, it is to be assumed that they cannot be eliminated overnight. A gradual approach towards this goal has to be found.

The scheme which has been presented is also intended as a means for a gradual, but decisive, reduction of multiple exchange rate practices with the ultimate aim being their total elimination. It is also intended from the very beginning of the application of such a scheme, to bring multiple exchange rate practices under the strict control of national economic policies. This would be achieved, largely by the channeling of all transactions in question to authorised banks which have to act as obligatory intermediaries between "buyers" and "sellers" of convertible dinar funds.

As can be easily discerned, the proposed scheme assumes that there would exist a difference between the real value of internal and external, i.e. convertible, "dinars". This difference would consist of different interest rates and different deposit and credit conditions for these assets. External, convertible "dinars" would be worth more than internal, "dinars".

Although such a solution can certainly not be regarded as an ideal one it would still represent a very substantial improvement in respect to conditions of uncontrolled exchange rate differentiation. Instead of a grat variety of effective exchange rates, the only difference would, in principle be between the value of internal and convertible "dinars", this difference being known to economic policy-makers.

Policy makers would be put in a position to become more efficient in respect to foreign trade policies. Those branches, or particular products, whose exports should be particularly encouraged would be granted a right to retain a somewhat higher percentage of their export earnings on convertible "dinar" accounts. Alternatively, it would also be possible to pursue policies of conscious discrimination against certain non-essential imports. Such an approach to trade policy problems would imply that certain forms of effective exchange rate differentiation are maintained. There is, however, a much greater likelihood that such practices can be better kept under guidance and control within the framework of the proposed scheme than under conditions of ad hoc differentiation of effective exchange rates.

Another potential advantage is that the system as a whole can be kept rather transparent for economic policy makers while, generally, inaccessible and non-transparent for the general public. This may be very important in those cases where foreign exchange transactions of domestic and foreign citizens are of relatively large dimensions.

As it has been pointed out, one of the goals of the proposed scheme is also to create a substitute for the non-existent or highly inefficient domestic capital markets. This explains, why it is not advisable to allow direct dealings between domestic exporters and importers. Namely, if they were allowed to deal directly, at freely established rates, then the market price of rather limited convertible "dinar" funds would, most likely, be formed at an exceptionally high level. While this would certainly exert a very strong pressure on the official exchange rate policy it would not help at all towards eliminating the underlying causes of the external imbalance. If authorised banks are included as obligatory intermediaries between "buyers" and "sellers", or borrowers and lenders, of convertible "dinar" funds then quite different effects can be achieved.

When all transactions in various "dinar" funds have to be carried out al pari, then the equilibriating element has to be found in the variations of the credit component which have to accompany each such deal. This allows for a specific, but relatively free working of underlying market forces. In other words, a specific market mechanism, which is proposed here, should act not only as a substitute for deficient capital markets but, also, in part, for a free foreign exchange market. Obviously, that mechanism would have a chance to function satisfactorily only if it were competently managed by a limited number of qualified authorised banks, and if it were accompanied by appropriate macro-economic policy measures.

As to the latter-particulary the exchange and interest rate policy measures-the scheme cannot serve as a substitute for such policies but only as a means for their gradual application under particularly adverse and unfavourable circumstances.