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Towards a Development-Oriented Approach to the BOP in LDCs

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Abstract

The main argument here is that the conventional approaches to the Balance of Payments (BOP) deal with the symptoms but not with the original causes or sources of BOP difficulties in Least Developed Countries (LDCs). Trying to benefit from the current world economic situation, this article calls for a development-oriented approach to BOP adjustment in LDCs which refreshes and extends calls and suggestions, of few economists during the last three decades, that emphasised the need to deal with BOP difficulties of these countries in the context of a structural transformation process. The suggested development-oriented approach represents a general guideline and thus supposes that the detailed policy prescription must be left to the peculiarities of every economy to determine what is needed.

1. Introduction

The current conditions created by the world financial and economic crisis initiated a new stage of discussions about many issues concerning the philosophies underlying different policies being used in handling economic problems of different economies. The macroeconomic problems of LDCs and the approaches that deal with them would not be an exception in these discussions, particularly in view of the increasing recognition of the need to review the role and working mechanisms of the Breton Woods Institutions (BWIs) which, for a long time, focused on the economic reforms in these countries. The BOP adjustment in LDCs has been a major subject of the BWIs programs with a limited success, and sometimes failure, achieved under them, particularly in attaining a viable BOP position. This in turn raises questions about the philosophical ground underlying the policies package of BOP adjustment that usually prescribed to these countries. As is well known, the demand side prescription, which is usually given within the BOP stabilization programs of the International Monetary Fund (IMF), is based on the conventional approaches to BOP, namely elasticities approach, absorption approach, and monetary approach. Over the course of the past decades, a number of calls and studies have been devoted to explaining the inapplicability of the interpretation and thus the treatment of these approaches to the BOP difficulties in most LDCs, particularly the least developed ones. Nonetheless, the explanation of BOP disequilibrium and remedies according to the conventional approaches dominates the literature through the implementation of the IMF and World Bank programs by many LDCs.

It is true that starting from the mid-1970s, the IMF expressed growing emphasis on the structural nature of the BOP difficulties facing LDCs and therefore, recognized the necessitation of supply side policies in these economies to restore equilibrium in the external payments position. Since then, the IMF decided not to confine its programs to the management of aggregate demand. Instead, the aim of improving the supply of resources and broadening the productive bases of these economies has become an important ingredient of its programs. This is because the improvement of the supply side will also lead to an improvement in the current account of the BOP. Therefore, similar to the World Bank's policies, the IMF has started concentrating on the investment programs, prices policies, tax reforms, etc. Nevertheless, its explanation of the structural inflexible productive bases and shortfall of supply side in these countries is simply the insufficient integration of their economies in the world economy and the over intervention of state in various economic aspects[1].

Consequently, the liberalization of foreign trade and payments, changing relative prices, and removing prices distortions and controls are crucial for attaining resources reallocation towards export industries and import substitutes in the current account and realizing convenient environment for foreign capital to flow in the capital and financial account. However, the high priority of the IMF remained the policies of demand management.

It can be noted that the above mentioned diagnosis of the BOP disequilibrium's causes and remedies ignores the different levels of economic development and, thus, levels of diversification of productive bases among LDCs, particularly between those industrialized developing economies and poor or least developed ones which face innumerable structural obstacles. Under the circumstances of the later countries «... the restoration of equilibrium of balance of payments in any meaningful sense calls for structural shifts that can be achieved only in the process of development»[2]. This is not to say that monetary and fiscal balances are not important. Rather, they are preconditions for healthy functioning of any economy, but viewing them as prior to other objectives in BOP adjustment is described as a too narrow view of BOP adjustment in developing countries[3].

The objectives of this article are: **First**, to shed light on the special nature of BOP disequilibrium in LDCs; **Second**, to show the deficiency of the conventional approaches to touch the original sources of BOP difficulties in these countries and thus to cure them; **Third**, this article aims at introducing the guideline of what can be called a development-oriented approach to the BOP in LDCs which combines and extends the general ideas that have been introduced by some economists during the last three decades.

(1) Mary Lereto, *The International Monetary Fund and the Third World Countries* (Damascus: Tallas for Studies, 1993), p. 135.

(2) Sidney Dell and Roger Lawrence, *The Balance of Payments Adjustment Process in Developing Countries*, Pergamon Policy Studies on Socio-economic Development (New York: Pergamon Press, 1980), p. 101.

(3) Ibid.

2. Why BOP difficulties in LDCs differ?

The nature of the BOP difficulties in LDCs, particularly the poorest ones, is totally different from those of developed countries. Usually, BOP problems in developed economies are temporary and are not reflections of structural problems in the composition of these economies. In fact, they reflect unfavorable changes in some economic aspects such as, the fiscal and monetary imbalances, inappropriate exchange rate policies, and the effect of commercial cycles. However, the BOP difficulties of the LDCs are structural in the sense that they reflect the original imbalances, bottlenecks, and obstacles in the composition of these economies. These structural obstacles include: the dominance of subsistence and commercial activities; a narrow productive base, particularly industrial base, with weak inter-sectoral linkages and ill-adapted technology and so, low levels of income, savings, and investment; fast growth of population; small and fragmented economies; openness and external overdependence; weak institutions; poor physical infrastructure; rudimentary money and capital markets; fragile political structures.

In taking the reflections of some of these structural imbalances upon the BOP, it would be easy to note that these countries generally have weak structures of foreign trade (imports and exports) in the form of limited number of primary commodities and low value added manufactures dominating the structure of exports with, at the same time, innumerous and diversified base of imports (consumer, intermediate, and capital goods). Furthermore, the low levels of income and saving make the overseas investment income that received by these countries insignificant against high levels of investment income commitments for bridging saving - investment gap. In the capital and financial account, many of these countries are not competitors in attracting foreign investment, either direct or portfolio investment. Meanwhile, the phenomenon of domestic capital flight is exacerbating. Moreover, the economic and political environment is discouraging, the needed infrastructure is lacked, the institutions dealing with investors suffer from corruption and old methods of management and the financial systems are simple and inefficient in playing the presumed role in financing economic activities.

3. Conventional approaches to BOP and LDCs

The elasticities approach, pioneered by Robinson[4], focuses on how changes in relative prices of both domestic and foreign goods can improve the balance of trade. In other words, it views the BOP difficulties as a result of the absence or weakness of a country’s price competitiveness. The absorption approach, intro-

(4) Joan Robinson, *The Foreign Exchanges: Essays in the Theory of Employment*, 2nd ed. (London: Basil Blackwell, 1947).

duced by Alexander[5], provides a simple interpretation to the nature of the BOP disequilibrium. It considers the BOP deficit or surplus as the difference between what a country produces and absorbs (spends). So, BOP deficit stems from excess expenditure over income. As a more recent approach, the monetary approach connects the BOP disequilibrium with the imbalance in money market through international reserves[6]. The BOP disequilibrium, accordingly, is looked upon as a monetary phenomenon reflecting the stock disequilibrium between supply of and demand for money. An excess supply of money leads to a loss of international reserves (a deficit BOP) and vice-versa in case of excess demand of money.

The underlying theoretical basis of stabilization programs of the IMF is mixture of these three conventional approaches[7] to the BOP. The absorption and monetary approaches were invented inside the IMF in the first ten years of its age by Alexander and Polack. The elasticities approach is being used as a ground to advise countries to devalue their currencies so as to improve the competitiveness of exports, check imports, and thus improve the BOP position. Nonetheless, the generalization of devaluation as a major device in almost all stabilization programs, irrespective of the existence of the required elasticities for it to be effective, refers to the cut-short exploitation of the elasticities approach. The absorption approach considers BOP, more specifically current account, as the difference between output (income) and expenditures (absorption) and hence the interpretation of the cause of BOP deficits in LDCs countries is that these countries live beyond their means. Moreover, the analysis of Alexander[8] regarding the effects of devaluation on absorption and output provided the theoretical underpinning of devising devaluation as expenditure-reducing instrument. It should be noted that although the absorption approach reveals three options for correcting BOP deficit (reducing absorption, expanding output, or both simultaneously), stabilization and structural adjustment policies focus upon absorption reduction since «...it is generally easier to reduce absorption than to increase production»[9]. The monetary approach to the BOP connects BOP deficit with monetary imbalance (excess money supply), accordingly the

(5) Sidney Alexander, «Effects of a Devaluation on a Trade Balance,» *International Monetary Fund*, vol. 2, no. 2 (April 1952), pp. 263-278.

(6) This approach pioneered and developed by: Jacques J. Polack, «Monetary Analysis of Income and Payments Problems,» *International Monetary Fund*, vol. 6 (November 1957), pp. 1-50; Robert A. Mundell, *International Economics* (New York: Macmillan, 1968), and Harry G. Johnson, «The Monetary Approach to the Balance of Payments: A Non Technical Guide,» *Journal of Financial and Quantitative Analysis*, vol. 7 (1972), pp. 1551-1572.

(7) The IMF also uses the neoclassical theories as theoretical grounds for its structural adjustment programs.

(8) Alexander, Ibid.

(9) «Theoretical Aspects of the Design of Fund-Supported Adjustment Programs,» International Monetary Fund, Occasional Paper; 55 (1987), p. 7.

IMF recommends credit contraction as an important policy for curing BOP deficit. Furthermore, the monetary approach with its initial model still constitutes the logical ground for financial programming process which specifies the exact changes and criterion of macro variables to be achieved by the country requesting IMF support[10].

The suggested devaluation in the elasticities approach as a therapy to BOP deficit has been criticized on grounds of its unreal assumptions, limited coverage, and partial nature. An important fact is that the applicability of elasticities approach to LDCs has been questioned on some grounds**. First**, the condition of an elastic demand for exports and imports is not met. World prices of primary products are determined in foreign currencies and thus devaluation of domestic currency fails to reduce the foreign currency prices (world prices) of exports. So, as Bird[11] contends, «export elasticity of demand is largely irrelevant». **Second**, the assumed infinite elastic supply of exports is doubtful in LDCs as the productive capacities of these countries are mostly inflexible and economic sectors confront many bottlenecks. Moreover, the uncompetitive position of these countries is not the product of overvalued currencies, but it is the outcome of many factors such as the non advanced technologies and institutions which result in a low and uncompetitive quality, packaging, marketing, and maintenance services. This analysis of weak competitiveness causes was applied to some developed countries too. Thirlwall[12] views the UK BOP difficulties as a structural problem related to the capacity to produce, and the characteristics of goods produced and exported which are not amendable to price changes.

In addition to criticisms[13] directed to the absorption approach on the grounds of its assumptions, coverage, and inferring causation from identity, the cause behind BOP deficit might be an autonomous fall in exports, autonomous increase of imports, or by autonomous deterioration of terms of trade[14]. On the other hand, due to the long span of time needed to increase output particularly in LDCs, if any,

(10) See: Jacques J. Polack, «The IMF Monetary Model: A Hardy Perennial,» *Finance and Development*, vol. 34, no. 4 (1997), pp. 16-19.

(11) Graham Bird, «Balance of Payments Policy in Developing Countries,» in: Tony Killick, ed., *The Quest for Economic Stabilization: The IMF and the Third World* (New Hampshire: Heinman Educational Books Inc., 1984), p. 100.

(12) Anthony P. Thirlwall, *Balance of Payments Theory and the United Kingdom Experience* (London: Macmillan, 1980).

(13) For detailed discussion of criticisms and shortcomings addressed to the absorption approach, See: Mark P. Taylor, «A History of Thought in the Balance of Payments,» in: Mehmet Ugur, ed., *An Open Economy Macroeconomics Reader* (London: Routledge, 2002), pp. 60-92.

(14) Anthony P. Thirlwall, *Trade, the Balance of Payments and Exchange Rate Policy in Developing Countries* (London: Edward Elgar Pub., 2003), p. 93.

demand deflation appears to be more probable. But the already mentioned adverse effects of this choice will further worsen the BOP position. Over and above, the BOP disequilibrium is usually coupled with weak record of growth which therefore asserts the need for growth-oriented policies, not the opposite.

As for the monetary approach, it is criticized on the grounds of its assumptions, broadness and narrowness[15] at the same time, and its negligence to the composition of the BOP. In LDCs' case, monetary imbalance usually exists but it is also the product or reflection of the inflexibility and impediments facing real sectors.

4. A development - oriented approach to BOP for LDCs

The already discussed structural interpretation of BOP disequilibrium in LDCs means that unless structural impediments in these economies are overcome, BOP disequilibrium would continue. Despite the ascendancy of the neoclassical doctrine, particularly after the 1970s, there existed some writings that challenged it and insisted the necessitation of structural transformation for BOP disequilibrium in LDCs to be cured. The report of the BOP adjustment in developing countries during the 1970s, by Dell and Lawrence[16], is touching in this respect. It underlines the need to address BOP adjustment in these countries in the course of the development process and thus warns the dangers of the dependency on the short-run aggregate demand reduction, which may disrupt the episodes of economic development. In addition, it claims that aggregate demand reduction may restore balance provisionally but «... the obstacles will probably persist unless dealt with them explicitly and directly and the pressures will emerge once more as soon as the development process is resumed»[17]. Therefore, the report suggests that BOP adjustment in the long-run must be an episode of development strategy. The essential conclusion of this remarkable study was that the inflexibility of supply side and the difficulty of resources mobility, as the core cause of BOP in these countries, can be overcome via a process of industrialization[18].

The study of Killick et al.[19] tried to introduce an alternative approach to the

(15) Bird, «Balance of Payments Policy in Developing Countries,» p. 88, Mentioned that the monetary approach is broad in the level of aggregation used and narrow in its identification of the causes of BOP disequilibrium.

(16) Dell and Lawrence, *The Balance of Payments Adjustment Process in Developing Countries*.

(17) Ibid., p. 101.

(18) Ibid., chap. 4.

(19) Tony Killick [et al.], «Towards a Real Economy Approach,» in: Killick, ed., *The Quest for Economic Stabilization: The IMF and the Third World*.

BOP adjustment and called it real economy approach or a strategy of adjustment with growth. This attempt copes with BOP disequilibrium in LDCs depending generally on expanding supply side and restructuring demand. Despite their recognition to the difficulty of the generalization of an elaborated prescription to countries with different situations and potentials, Killick et al.[20] went ahead and introduced a detailed policy prescription.

Thirlwall[21] placed emphasis on the need to rectify BOP problems in a growth context through structural transformation towards producing and exporting products of high income and price elasticities within what he called it a structural approach. However, he has not given accurate and elaborated policies or procedures of this approach.

Consequently, the development-oriented approach proposed here is a general framework or an outline to the BOP adjustment. This means that it comprises no standardized prescription of policies to solve payments disequilibrium in LDCs. It is believed that the value of the development-oriented approach lies in its call to structural changes as a general solution to the BOP problems of developing countries. Under this outline the required structural changes certainly differ from country to another depending on situations and potentials. Thus, the detailed policies should be left to the peculiarities of every economy to determine what is needed. What will be introduced here are some general outline which may support Dell and Lawrence's[22] calls, extend Thirlwall's[23] general idea, and outline the key elements of the real approach of Killick et al.[24] as follows:

* The main aim of the development-oriented approach is to restore the BOP equilibrium in LDCs through bringing about a structural transformation process which boosts the productive capacity and improves productivity and thus affects the structure of external trade and payments. This structural transformation process depends mainly on a well-designed and implemented strategy of industrialization. Attention should be placed on industrial activities that have potentials, especially for exportation, and concur with the available advantages to the under study country. It follows that a critical role should be played by state to support and facilitate the process of industrialization. The successful experiences of the new industrialized countries have proved that the role of state was crucial. In fact institutionalized interaction between state and private actors is a necessary condition to realize the required changes. Nevertheless, changing the patterns of production to-

(20) Ibid.

(21) Thirlwall, *Trade, the Balance of Payments and Exchange Rate Policy in Developing Countries.*

(22) Dell and Lawrence, *The Balance of Payments Adjustment Process in Developing Countries.*

(23) Thirlwall, Ibid.

(24) Killick [et al.], «Towards a Real Economy Approach».

wards industrialization does not mean that other sectors are ignored. Rather, the distinguished characters of every economy such as resource endowments and the achieved level of economic and social development determine the promising sectors on which, besides industrial sector, concentration should be placed. Taylor[25] suggested that modernization of agriculture sector and non-traded goods sectors would be helpful in improving inter-industry linkages and may has a positive effect on equity if it implies land reforms and other social changes. Generally, comprehensive plans of exploiting the potentials of the promising sectors (agriculture, services, or any others) by the way of improving their output, productivity, and the inter-linkages would be fundamental to any strategy of structural transformation.

* Service sector development strategy should go hand in hand with that of goods production sectors to facilitate the development of the later and strengthen the export base of services.

* Putting into effect the approach is likely to depend heavily on supply-side policies either macro or microeconomic ones, as well as to focus on overcoming key bottlenecks and constraints encountering every sector.

* In the demand side, priority should be given to changing the composition of demand, more than reducing it, towards investment at the expense of consumption. Here, restructuring expenditures of the government budget towards investment of various kinds (human, physical) and away from luxurious and wasteful expenditures is crucial. If the demand reduction is unavoidable, the burden of reduction should be borne by consumption. But, because this approach is intended for LDCs where per capita income is low and an important part of the society lives under poverty line, policies of reducing consumption should be directed, as possible, away from the people of low income levels[26].

* Attention should be given to increasing and restructuring exports towards manufactured and high value added products by well designed and gradual subsidy policies. At the same time, effort should be made to lessen the dependence on imports by strengthening import substitution activities.

* Restructuring and modernizing the financial system is a major factor for the under study approach. However, policies of credit allocation would be a necessary condition for industrialization strategy or for promoting and modernizing any other promising sectors.

* Changing educational system towards vocational and applied sciences on the one hand and programs for promoting research and development on the other

(25) Cited in: Raghbendra Jha, *Macroeconomics for Developing Countries* (London: Routledge, 1994), p. 239.

(26) Killick [et al.], p. 274.

are essential pivots for initiating industrialization ambitions. The improvement of productivity in the long-run needs educated, healthy, and well paid population[27].

* Foreign capital and domestic capital abroad, especially direct investment are critical in terms of the acquisition of technology and bolstering BOP. Thus, for foreign capital to be attracted, legal, regulatory, and different institutional changes should come about.

* Implementing the structural approach would be of gradual and long-run nature. Therefore, accruing the expected outcomes would take a long time too. In the meantime, the BOP disequilibrium is expected to persist, which entails a necessary flow of finance until the BOP reach a viable position. That is to say that the success of the development-oriented approach would depend on the extent to which the country concerned has an access to international finance. For this reason, calls for different objectives and mechanisms of the international institutions are constant, particularly for transferring financial resources between countries and compelling surplus countries to bear responsibilities with regard to deficit countries. Consequently, providing the needed funds to LDCs for BOP adjustment purposes away from the disinflationary prescriptions is hoped to be provided by the IMF and World Bank in the context of a new international financial and economic arrangements.

5. Conclusion

The above discussion shows how BOP difficulties in LDCs are of structural nature in the sense that the weak structure of different BOP accounts echo several obstacles and bottlenecks in the composition of these economies. The conventional approaches to BOP appear not to touch the roots and the original causes of Bop difficulties in LDCs as they place emphasis on the symptoms such as the demand pressures and the resulted monetary imbalance. The proposed development-oriented approach focuses on the extension of supply side and at the same time gives due attention to demand restructuring. Institutions' building is stressed too. An inflow of funds during the unavoidable long-run period of adjustment is supposed to come from the BWIs which are concerned with BOP adjustment. In other words, it is hoped that the development-oriented approach would be adopted by the BWIs in supporting BOP adjustment programs in LDCs within a new international financial and economic arrangements.

(27) Lance Taylor, «Stabilization Adjustment and Reform,» in: Lance Taylor, ed., *The Rocky Road to Reform: Adjustment, Income Distribution, and Growth in Developing Countries* (Helsinki: United Nation University Press, 1993), p. 8.