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The Internationalization of the Financial System and the Developing Countries

The Evolving Relationship

T. M. Rybczynski

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FOREWORD

This paper is one in a special series of World Bank Staff Working Papers on international capital and economic development. Prepared as background papers for World Development Report 1985, the series provides more detailed treatment and documentation of the issues dealt with in the Report. The papers cover a range of topics including a historical perspective on international capital and economic development; the effects of policies in industrial and developing countries on international capital flows, external debt, and economic development; and the role of official assistance, commercial bank lending, securities markets, and private direct investment in developing countries. Several studies of individual developing countries are also included in the series.

The background papers draw on a large number of published and unpublished studies of individual researchers, on World Bank policy analysis and research, and on reports of other organizations working on these issues. The papers are the work of individuals and the views and interpretations expressed in them do not necessarily coincide with the views and interpretations of the Report itself.

I hope these detailed studies will supplement World Development Report 1985 in furthering understanding of the relationship between international capital and economic development. A complete list of the papers appears on the overleaf.

Francis X. Colaço
Staff Director
World Development Report 1985

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Abstract

The evolution of the international financial system is determined to a large extent by the development of the financial system in the dominant country or countries. Domestic financial systems pass through three different stages: the bank-oriented phase, the market-oriented phase, an the strongly-market-oriented phase. In the bank-oriented phase the bulk of savings an economy generates is transferred to those wishing to use them through banks. They channel the savings they collect mostly in the form of short-term loans to business. Risk capital is obtained from retained profits and direct recourse to savers, who are few in number. The market-oriented phase is characterized by the increasing reliance of firms on external funds, including risk capital raised from ultimate savers through the capital markets rather than through financial intermediaries. In the strongly-market-oriented phase the financial intermediaries also rely increasingly on the funds raised through the financial and capital markets and there come into existence new financial-risk-hedging markets.

The world financial system is now in the bank-oriented phase but is moving into a strongly market-oriented phase now beginning to characterize the United States and the United Kingdom, while the major European countries and Japan are entering the market-oriented phase. The bank-oriented phase began in the interwar period but did not start to dominate the international system until the 1960s and 1970s. This was due to the rapid growth in international liquidity, financial innovations, and the emergence of the OPEC.

Until the 1930s developing countries raised the bulk of their external funds on capital markets in Britain and the other industrial countries. Since then they have come increasingly to rely on bank funds. They can benefit most from the now changing international system by acquiring a full knowledge of the way it functions and applying its principles to their own fund raising operations. By so doing they will strengthen the financial links between the developing countries and the rest of the world as well as promote the economic integration of the world economy at large.

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I. Introduction

National and international financial arrangements throughout the world today are undergoing unusually rapid change. This is evident everywhere --in the size and character of the international movement of funds, in the scope and nature of the operation of financial institutions and financial markets, even in the regulatory framework within which such transactions are undertaken. As a result, the financial links between developed and developing countries have been greatly altered.

To understand how the place of developing countries within the world financial framework, has changed, we have to look at a number of important factors: the dynamics of the financial systems in the industrial countries; the overall changes in international monetary arrangements and in the domestic financial system in the framework of economic growth; the changing relationship between the advanced and developing countries under these new arrangements; the main elements that affect the flow of funds between mature and developing countries; and, finally, the present and the prospective position of developing countries in the network of world financial flows. This discussion is organized around these topics.

II. The Evolution of Domestic Financial Systems

(a) Basic Functions and Scope

The domestic financial system of any country can be defined as a set of institutional and other arrangements that transfer savings from those who generate them to those who ultimately use them for investment or

consumption. More specifically, the system consists of a mechanism for organizing and managing the payments for current and capital transactions; a mechanism for the collection and transfer of savings by banks and other depository institutions; arrangements covering the activities of capital markets with respect to the issue and trading of marketable and transferable long-term securities; arrangements covering the workings of money and credit markets dealing with short-term financial instruments; and arrangements covering the activities of financial markets complementary to the capital, credit, and money markets, which in essence provide hedging (or risk insurance) facilities, such as the new futures markets.

(b) Three Stages

As the economy of a country changes, so do the role, character, and scope of the domestic financial system. At the risk of over-simplification, we can say that as an economy grows, the financial system passes through three stages: the bank-oriented phase, the market-oriented phase, and the strongly market-oriented phase.

In a low-income, subsistence, or underdeveloped economy where savings are scarce, the arrangements for making payments are primitive. They usually involve barter and some rudimentary means of exchange. Arrangements for transferring savings are virtually nonexistent, however. Those wishing to invest--excluding the state (or royalty), which has the coercive powers of taxation--have to generate their own savings by abstaining from consumption, by borrowing from family and friends, or by borrowing from money-lenders who, on the whole, are few and have limited resources.

Bank-oriented System. As an economy grows, savings increase and barter is replaced by the use of currencies. At the same time, financial

intermediaries emerge to collect the savings and transfer them to those wishing to use them at essentially market-determined prices intended to provide an adequate return (allowing for the risk they incur). In the early stage of economic development, such financial intermediaries are generally banks (which also provide and operate a payment mechanism), but there may also be some specialized savings-collecting institutions, such as life assurance companies, building and loan associations, mutual societies, and the like.

Banks and other depository institutions provide facilities in which individuals, firms, and collective bodies can place their savings (in a liquid or semi-liquid form) by way of demand or time deposits; and large, the liquid savings consist of transaction balances. Banks use such deposits to make nonmarketable loans, predominantly short-term loans, to firms to finance their working capital (stocks and work-in-progress and debtors) on a secured basis. They supplement such lending by also holding easily encashable short-term securities--which are converted into cash if deposits are withdrawn--as well as small amounts of cash.

Banks employ deposits to lend for longer terms than the terms on which the deposits are accepted, and thus maturity transformation is involved in this arrangement. In addition, banks incur a risk (that is, commercial risk) that the borrower may not be able to repay his loan. Individual banks contain the risk arising from maturity transformation by limiting the proportion of deposits invested in the form of commercial and industrial loans. They limit the risk of default by diversifying the loan portfolio. In doing so, they must exercise some judgment concerning the relative importance of individual loans and the creditworthiness of borrowers. Their decisions are based on knowledge of the borrowers financial position and are backed by

security. The degree of risk undertaken is limited by the size of capital and is determined from capital ratios.

The liquidity risk for the system as a whole can be limited by creating a lender of last resort. Under this arrangement, which came into existence as a result of uncontrolled financial panics, the lender of last resort provides liquid funds if the public's demand for cash increases. Furthermore, fiscal and money supply policies can be designed to reduce the risk of default by reducing the impact of fluctuations in economic activity.

During this stage of economic and financial development, other savings-collecting financial intermediaries use the funds they collect to finance specific activities; for example, building associations finance house acquisitions and life assurance associations invest in government securities, either because of legal requirements or because of the security they offer. At this stage, their involvement in providing financing to industry tends to be negligible or nonexistent.

At this point in the evolution of the domestic financial system, banks, other depositary bodies, and other financial intermediaries collecting savings do not provide the <u>risk capital</u> needed by firms. Risk capital must be raised by owners from their own savings, from the savings of friends or acquaintances, or from retained profits.

As well as creating money and managing the payment system, banks are involved in transforming maturities and diversifying the risk associated with the provision of short-term working capital. And, as was the case in Continental Europe and indeed in the United States prior to the reform of the early 1930s, banks at this point are involved in taking up equity participations. In performing this function, banks may well induce a larger

volume of savings than a community without banks would wish to supply and they also undertake a greater degree of risk than a community would wish to incur in the absence of banks. They are wiling to do so because of the insurance principle inherent in the pooling and sharing of risks.

During this bank-oriented phase of economic development, the domestic financial system depends largely on financial intermediaries, especially banks. The ability of industry to raise external funds for expansion, involving risk taking--which is at the heart of economic growth--is determined by the profitability of existing firms and consequently the retention of profits, by the money-creating power of banks and its positive impact on the savings rate (as determined by legal requirements and financial innovation), and finally by the perception of risk in lending to industry.

Market-Oriented System. As an economy expands, changes occur in the character and scope of the financial system. The payments mechanism improves and, more important, capital markets and market and other financial intermediaries emerge alongside the financial intermediaries outlined above. Capital markets perform two functions. First, through market intermediaries, they bring together the ultimate providers and the ultimate users of savings. Second, they allow savers to take different degrees of risk by taking up different types of securities.

Capital markets consist of primary markets, where new capital is raised, and secondary markets, where existing securities are traded. Secondary markets also facilitate the transfer of ownership and control to different individuals and groups by way of mergers and amalgamations, as well as the phasing out of real and financial assets. In addition, primary and

secondary markets enable savings-collecting financial intermediaries--banks and other institutions--to acquire and trade various financial assets in accordance with their preferences for different degrees of liquidity and risk.

During this market-oriented phase of economic growth, savings-collecting financial intermediaries as a rule obtain their funds from ultimate savers and, not from other financial intermediaries. In short, in this phase, the domestic financial system consists of financial intermediaries (that is, savings-collecting bodies) and capital markets and market intermediaries. The function of the financial intermediaries is to carry out maturity transformation and to diversify risk, but they also use the facility of the capital markets. The capital markets and market intermediaries provide direct access to savings providers by way of transferable and tradable securities with different degrees of risk. Savers can place their funds either with financial intermediaries or directly with users of savings (incurring directly the desired degree of risk) whereas financial intermediaries raise their funds almost entirely by recourse to the ultimate saver.

As the activities of market intermediaries involved in the operation of capital markets enlarge the opportunities to savers and users of savings, the flexibility of the system increases. That is to say, the range of options available to nonfinancial firms for financing existing and prospective investment projects expands, and more resources are transferred from existing owners and managers to those who claim to make better use of them in the same or other industries.

The Strongly Market-Oriented System. As economic growth proceeds, the financial system changes again, this time from a market-oriented system to a strongly market-oriented system. Now the number and size of the existing components of the system increase, and there come into existence new financial markets (futures) with a new type of specialized market intermediary. Furthermore, savings-collecting financial intermediaries--especially the banks--tend rely to more and more on funds bought from other financial intermediaries rather than on the ultimate providers of funds.

The new futures markets provide nonfinancial firms, banks, and nonbank financial intermediaries with facilities for hedging financial (that is to say, interest rate and exchange rate) risk. Such risks are either new or may not have been insured before because, under previous institutional arrangements (such as those associated with an adjustable system of pegged exchange rates), such risks were borne by the community at large.

We cannot say to what extent the risk-hedging markets offer the opportunity of hedging new risk or risk that was previously uninsurable. Nor do we know to what extent their existence reflects market response to the abandonment of risk previously shared by the whole community by way of certain policies. There is reason to believe, however, that risk hedging markets grew in part to provide for activities that were previously uninsurable. In part, they also provide for the transfer, to business and allied firms, or risk-pooling arrangements previously undertaken by the community at large through governments. It is indeed a paradox that the new risk-hedging market facilities were established with a view to restore at least some of the stability that existed under a fixed, but adjustable, exchange rates system.

The shift toward a strongly market-oriented system also gives rise to what in the United States is described as "securitization." This term refers to the increasing use of capital markets by financial intermediaries, banks, and nonbanks, which sell some of their loans in a "packaged" form through the medium of capital markets.

The development of the bank-oriented phase can be associated with and does not preclude the emergence of a market-oriented phase. The degree to which market-oriented forces exert their influence and the time at which they do so depend on the regulatory framework and the involvement of the state.

The British financial system in the nineteenth century, for example, was bank-oriented, although capital markets grew quite rapidly, in response to foreign demands. Nonetheless, banks preferred to restrict the degree of risk and to concentrate on the provision of working capital in view of the high profitability of British industry and its reliance on retained profits. In Europe, banks depended on the involvement of the state in creating and expanding the financial system and regulatory framework. They also provided, as in the case of Germany, risk capital by taking equity and involving a rather limited use of capital markets.

The increasing reliance on savings-collecting financial intermediaries, primarily banks, and the increasing number of financial institutions financed from other financial intermediaries reflect to a large extent the important financial innovation of "liability" management. Here the liability side of the balance sheet is adjusted to the desired optimum size of the assets side, rather than vice versa. Thus, flexibility of the financial system increases in response to the demands made upon it; at the same time, the ability to exploit new opportunities is increased--subject, however, to

increased risk, which might arise from excessive optimism of financial intermediaries, particularly banks. This is discussed later.

III. Evolution of Financial Systems in the Main Industrial Countries

With certain qualifications, the present U.S. and the U.K. financial systems can be said to have entered a strongly market-oriented phase, that the French, German, Swedish, and Dutch systems are entering or are about to enter the market-oriented phase, and that the Japanese system, though still displaying many features of a bank-oriented system, appears to be developing a few of the characteristics of a market-oriented and strongly market-oriented system. In Japan, nearly two-thirds of the funds at the disposal of nonfinancial enterprises represent bank loans and only about one-fifth is raised through capital markets. However, an increasing, though still low, proportion of bank funds is being raised through the financial markets rather than from ultimate savings providers.

In Germany, France, the Netherlands, and Sweden, between 45 and 60 percent of the funds of the nonfinancial corporations represent bank loans and less than one-fifth is obtained through capital markets. Recently, however, the proportion obtained through capital markets (including international capital markets) has been increasing. Banks, but not yet other financial institutions, in these countries, are now obtaining an increasing proportion of funds from other financial intermediaries, and nonfinancial and financial corporations are beginning to use the services of futures markets.

In the United States, 30-40 percent of the funds of nonfinancial corporations represent bank loans and around 40 percent are funds raised through capital markets. Banks and many other financial intermediaries rely on funds "bought" from the market rather than those obtained in the retail markets from providers of savings in the personal sector. Finally, more and more nonfinancial corporations are using the hedging market.

(a) The Financial System and Economic Growth

The United States and the United Kingdom are now moving into the strongly market-oriented phase. These two countries are among the richest in the world, have high total and per capita wealth, and a large accumulation of assets. Equally significant is the fact that their financial systems emerged in the process of industrialization and economic advance without the help of the State.

In much of Europe, however, the state was instrumental in helping to create and structure the financial systems, particularly the banks and other savings-collecting financial intermediaries. These countries believed that state support would help to promote economic growth. This was also true in Japan, which originally attempted to model its financial system on that of the United States, but later moved toward the British model.

State involvement in these countries had an important effect on the timing and duration of the different stages in the evolution of their financial systems. Countries that became industrialized after the United Kingdom and the United States did required investment banks and similar financial institutions to provide long-term lending for, and also take up equity stakes in, new industrial enterprises. Insofar as funds collected by banks and other savings-collecting institutions consisted mainly of genuine

savings--rather than transaction balances held in currency--the original character of activities undertaken by banks had to be different, as was the relationship between banks and nonbank financial intermediaries in capital markets.

(b) Recent Developments

All the industrial countries are now attempting to facilitate and speed up the transition from a bank-oriented system toward a market-oriented system or from a market-oriented system toward a strongly market-oriented system. The deregulation now under way in the United States, for example, which until recently had been gathering strength but is now slowing down, is nevertheless transforming the U.S. financial system into a strongly market-oriented system. As is characteristic of this process, concentration and conglomeration have become more prevalent, although the separation between deposit-banking and underwriting introduced by the Glass-Steagall legislation of 1933 is still being maintained.

The United Kingdom, meanwhile, is restructuring the securities industry with a view to improving the functioning of the capital markets. It is also deregulating the entire financial system. The countries of Europe, too, are adopting measures designed to improve and extend the operation of capital markets, in accordance with official and semi-offical recommendation from individual countries as well as from various regional bodies such as the European Commission (EC) and the Organisation for Economic Co-operation and Development (OECD). Similar steps are being taken in Japan (where the U.S.-Japanese Accord on liberalization in the financial area is leading to important functional and organizational changes), Australia, Canada, and other smaller industrial countries such as Sweden and Finland. All these policies

are designed to increase the efficiency of the financial system with a view to improving its contribution to economic growth.

IV. Criteria for Evaluating the Structure and Operation of the Domestic Financial System

(a) The Criteria

The criteria by which the structure and operation of the domestic financial system should be assessed are well known to students of finance. They are the stability of the system, its efficiency, its competitive nature, its flexibility, and the degree to which it is balanced. These criteria all overlap and are closely interconnected.

There must be continuing and unquestionable confidence in the system if it is to be stable. Institutional arrangements must therefore provide adequate liquidity, especially in the face of external shock. Furthermore, prudential rules and regulations have to be such that they impose adequate market discipline on financial intermediaries and ensure that those operating in the capital and other financial markets have enough information to assess the degree of risk. The central banks provide this liquidity. Their use for this purpose is controlled by the prudential regulations that govern the behavior of savings-collecting financial intermediaries.

The question of how to differentiate between a liquidity crisis and a solvency crisis has not been resolved satisfactorily, however, in the case of financial intermediaries posing a "moral hazard". There are financial intermediaries, notably large banks, that in their search for growth and profits may accept excessive risk precisely because they assume that if things

go wrong they will be rescued in an effort to prevent the social and economic consequences of their collapse. The proper mix between prudential regulation and liquidity support has yet to be clarified.

The efficiency of a financial system, as is well establish is judged by its allocative, operational, and dynamic efficiency. Allocative efficiency refers to the degree of success in directing savings, new and old, into the highest-yielding investments, consistent with the risk-taking proclivity and liquidity preferences of the savers and with the stability of the system as a whole. Operational efficiency has to do with the extent to which the real resources of a country are used to transfer savings (as reflected in the gap between the supply price of and the demand price for savings). Dynamic efficiency refers to the ability of the system to adapt to the changing needs of the providers and users of new and old savings in a way conducive to the efficient functioning and growth of the economy.

The flexibility of a system consists in its ability to adjust to disturbance by changing its techniques and practices and producing financial instruments that facilitate adjustments, while at the same time protecting the interests of the fund-providers to the degree consistent with their willingness to accept risk.

Finally, the balance of a system depends on the mix of financial instruments and practices and the extent to which some of its elements can absorb large shocks without adversely affecting the functioning of the system as a whole. The greater the ability of the system to contain a shock arising in one sector and prevent it from affecting other parts of the system, the greater its stability.

(b) The Three Types of Financial System in the Light of the Basic Criteria

On the basis of these criteria we can suggest which of the three basic types of financial system as it evolves is likely to contribute most to economic growth. The strongly market-oriented system appears to display the greatest degree of stability, efficiency, and competitiveness, subject to the adequate resolution of the "moral hazard" problems on the one hand and the prudential regulation of financial institutions and markets on the other. A strongly market-oriented system is also likely to be balanced in the sense that it provides the users of funds and the providers of savings with a wide choice of financial instruments offering a different combination of risk, return, and liquidity. Such a system is also more flexible in that it is better able to absorb shock while also promoting the process of adjustment.

V. The World Financial System

(a) Special Features

The world financial system, like any domestic financial system, consists of a set of institutional and other arrangements governing the transfer of savings from those generating them to those wishing to use them, but in this case the arrangements apply across national frontiers. In addition, the international system has controls on transactions relating to the transfer of savings (new and old). These are mostly in the form of exchange controls but can also be specific tax imposts, such as an interest equalization tax, or special discriminating tests applicable to inward and outward direct investment. Other special arrangements may also apply,

particularly to export or import credits. The second distinctive characteristics of the international system is that the transfer of savings here carries special risks--namely, the exchange-rate risk and country risk. The degree of exchange-rate risk will vary according to the international monetary arrangements in existence, whereas country risk largely depends on subjective factors.

The world financial system is, in essence, an outcome of the interaction of domestic financial systems, primarily those in the major economies of the world, and of the international exchange arrangements relating to the freedom of capital movements.

(b) Three Phases in the Evolution of the World Financial System

The international financial system has passed through three phases over the past 200 years or so. The first, which lasted up to World War I, can be described as the capital-market oriented phase. The second, which covers the period between World War I and the early 1960s was still capital market-oriented, but bank financing was becomingly important. The third phase, from about the mid-1960s to the present, can be described as the bank-oriented phase since bank financing has dominated the international transfer of savings, and capital market finance has played a diminishing role (but government-sponsored and assisted transfers have been of overwhelming significance).

Capital-Market-Oriented Phase and Factors Behind It. This phase in the evolution of the world financial system lasted from about 1800 until World War I. Most transfers of savings across the national frontiers during this period assumed the form of long-term loan and equity (or risk) capital raised on the capital markets of the rapidly industrializing and capital-exporting

countries of Western Europe, principally Great Britain, and on a smaller scale, France and Germany. Savings were also transferred internationally by way of bank and bank-related financing over the short term, for example, through acceptance credits, but such flows were small in relation to funds raised in capital markets. The predominance of capital markets at this time can be attributed largely to the fact that Britain, the main capital-exporting country and manager of the gold-backed sterling standard, had a market-oriented financial system open to and used by non-residents wishing to avail themselves of the savings that Britain was generating.

Other rapidly industrializing countries merely emulated Britain in this respect, although their domestic financial systems were bank-oriented. Furthermore, demand for savings from other industrializing countries, such as the United States and Canada--which were recently settled, or were within the British Empire--and from the smaller industrializing countries of Europe was mainly for infrastructure (railways, docks, harbors, and so on). This demand came from sovereign states, various states in the United States, and from municipalities and other types of local authorities. These fund-raisers wished to obtain external funds, mainly in the form of long-term loans (and to a smaller extent, risk capital) on the capital markets rather than through banks and other savings-collecting financial intermediaries, whose lending at that time tended to be concentrated on relatively safe short-term loans for working capital.

The Rise of Bank Financing and the Non-Commercial Flow of Funds. Between World War I and the early 1960s--with some interruption between 1931 and the early 1950s--more and more banking funds began to flow across national frontiers. Such funds essentially had a short life and included government-

sponsored and subsidized loans. Although governments also provided grants and longer-term loans, their relative importance as well as that of long-term funds raised in capital markets in capital-exporting countries was declining. At the same time, capital-exporting countries began to place discriminatory restrictions on access to their capital markets and on the use of such funds.

We need not dwell on the history of the interwar period, which was dominated in the 1920s by fund-raising operations on capital markets (principally in the United States, but also in the United Kingdom and France) as well as the use of banking credits up to the Great Crash. Nor is it necessary to recount the details involved in the creation of the sterling area, which provided preferential access to the British capital market for its members. Similar development occurred in France. Thus, these years witnessed the gradual emergence of financial arrangements designed to assist exports. With temporary exceptions, the only major country that refrained from imposing limitations on exports of capital during this period and during the fifteen years or so following world War II was the United States.

The important point here is that, following World War II, the restrictions on the transfer of savings in countries other than the United States (where there were none) were gradually removed, and after the late 1950s an increasing proportion of funds moved internationally represented short-term (but with gradually increasing life) banking loans, including an increasing proportion of government-subsidized, medium-term loans and government-supported and sponsored long-term loans and grants, as well as small amounts raised on the capital markets and direct investments (that is, risk funds) often enjoying official guarantees.

By and large, the funds (that is, savings) involving subsidies and straight grants flowed from the capital-exporting to the developing countries. Banking funds and funds raised through capital markets were used mainly in the transfer of savings among industrial countries, and only to a modest degree in the flows from the industrial to the developing countries.

Furthermore, the gold-backed sterling standard was replaced by a gold-backed dollar standard and an adjustable peg system of exchange rates was adopted under the Bretton Woods agreement of 1944. Although the decision to continue using a single-currency reserve preserved the hegemonial system that had prevailed under the sterling standard, it changed the character of the international flow of nongovernment-assisted funds. Such funds increasingly resembled some of the domestic flows in the United States. Most notably, more and more medium-term banking loans were adopted in the international area from the late 1960s onward.

Bank-Oriented Phase Since the Early 1960s. With increasing use of medium-term loans by banks and governments after the early 1960s, the relative importance of capital markets continued to decline until recently, and risk capital tended to be provided mainly through direct investment. This change in the international flow of funds, it should be stressed, became noticeable before the OPEC countries first raised the price of oil in 1973. It then gathered strength and received additional stimulus following the second rise in the world price of oil in 1979. The rapid increased in the use of funds channeled by banks can be attributed on the one hand to financial innovation and changes in technology and on the other to the rapid rise in world liquidity associated with the ample supply of dollars in the second half of

the 1960s, especially in the years following the breakdown of the Bretton Woods System.

The most notable innovation was the creation of the Euro-markets (comprising Euro-bonds and Euro-credit markets), the adoption by banks and similar depositary institutions of "liability management", and the creation of a large number of new financial instruments by depositary institutions and those operating in the capital markets.

The Euro-markets, particularly the Euro-credit markets, began expanding in the 1960s, their main function being to channel funds internationally. Although the power of Euro-banking operations to create credit has not been clearly established (a great deal depends on the nature of transactions at any particular time), there is no denying that these operations have had a positive credit multiplier. That the growth of Euro-credit until 1982 has proceeded at an extraordinarily fast pace is well documented and will not be explained here.

The adoption of "liability management" has made it possible for depositary institutions to raise additional funds from other depositary organizations when they believe there are opportunities for the profitable employment of such funds. "Liability management" as a basic principle governing the rechanneling of funds (that is, savings) by depositary institutions has replaced the "assets management" principle under which the volume of a single bank's assets was governed to a large extent by the size of deposits (savings) raised in retail markets from ultimate generators of savings. (This approach appears now to be complemented by what can be described as "capital management", whereby banking authorities insist on minimum capital ratios.)

Other financial innovations that have helped to accelerate the growth of bank lending in the international financial system have been the provision of medium-term credits with an increasingly longer initial life and increasing flexibility in the terms surrounding interest rates, such as floating rate notes. Technological advances and the general trend toward the internationalization of business have also played a role in expanding bank credit, as they have in expanding international financing itself. Technological developments have enabled financial and nonfinancial institutions to control their assets and liabilities more effectively and to assess what adjustments are needed for their optimum utilization. The growing internationalization of business by expanding the scope for the application of new technologies and financial innovation has had a similar effect.

The main factors behind the changes in world liquidity since the early 1960s are (a) the United States balance of payments deficits and breakdown in the Bretton Woods arrangements and the associated shift from a single-currency reserve system to a multicurrency reserve system; and (b) the emergence of OPEC, particularly the "low-absorbing" members of OPEC, as the principal capital-exporters to the rest of the world.

There is little doubt that the ample additions to world liquidity since the late 1960s resulting from the U.S. balance of payments deficits have enabled banks based in the United States and elsewhere, including those involved in Euro-market operations to expand rapidly. Further large additions to liquidity after the breakdown of the Bretton Woods system in the early 1970s gave a further boost to the international banking system (as well as to domestic systems).

The emergence of OPEC was important in that OPEC--faced with a large increase in external income in U.S. dollars (because oil is priced in dollars) and with a rather underdeveloped, small, and domestically oriented financial system and strong liquidity preference--placed much of the additional dollar receipts in dollar deposits (some of them went into sterling deposits) with banks operating in the Euro-market, and less so with banks in the United States and the United Kingdom.

VI. Evolution of Domestic Financial Systems and the International Financial System

(a) Main Features

From the past events mentioned earlier, we can see that in the past 200 years or so the world financial system and the financial systems in the important industrial countries appear to have been evolving in opposite directions. Whereas domestic financial systems have been moving away from a bank-oriented system toward a strongly market-oriented system, the international financial system has been moving from a market-oriented system toward a more bank-oriented system.

It should be added, however, that in the United States and the United Kingdom in recent years, the significance of nonfinancial corporations with respect to external funds raised through capital markets has decreased slightly and the dependence on loans raised from banks in these countries has tended to increase somewhat, absolutely and relatively. Specifically, there has been some reduction in the relative importance of debt raised from banks. In other words, one form of debt has been replaced by another type of

debt with different characteristics. However, there has been no change in the relative importance of risk capital, which has continued to be raised through capital markets (and retentions).

The main forces responsible for this development have been inflation and an aggressive and innovative approach to lending adopted by the depositary institutions in the United States and the United Kingdom. (Whether or not the developments in these countries will prove to be temporary or are likely to be reversed, is too early to say.)

(b) Factors Responsible for the Differences in the Evolution of Domestic and International Financial Systems

At the risk of oversimplification, one can say that the international financial system and domestic financial systems in the major industrial countries, have evolved differently because of three main factors. First, as noted earlier, changes in the international monetary system, tended to reflect and, indeed, to follow changes in the financial system of the country at the centre of world finance. It is through the financial system of the pivotal country that most of the world's savings are redistributed internationally, especially to developing countries. Other principal capital exporting countries usually follow the practices adopted by the pivotal country, which then become familiar to both the users and providers of funds.

In fact, a small shift toward raising funds for medium-term debt from banks by nonfinancial corporations occurred both in the United States and the United Kingdom during the 1960s and 1970s. With the growth of Euro-markets, the domestically based banks in these countries increasingly used their ingenuity to develop new financial instruments for this purpose.

The second important factor to account for the different patterns of evolution is the gradual shift toward a multicurrency reserve system in the 1970s. Its impact was greater in the international area than in the domestic field in the United States and the United Kingdom. This was so because, with their market-oriented financial system moving in the direction of the strongly market-oriented system, their banks which dominated the Euro-credit sector, perceived that new and unexploited opportunities were to be found internationally, especially in developing countries registering rapid rates of growth. The increase in exports in these countries provided room for servicing foreign debt.

The third factor, also mentioned earlier, was the emergence of OPEC (especially the low-absorbing members), which lacked an internationally oriented financial system and displayed marked liquidity preference. The OPEC countries placed most of their increased world savings with depositary institutions in the West, forcing them to look for new outlets for employing funds. It was believed that these outlets could be found mainly in the international area, particularly in the developing countries.

VII. The Position of Developing Countries in the International Financial System

(a) Before the 1930s

The place of the developing countries in the world financial system and the world economy has been well documented, so only the few basic points need to be mentioned here. First, the transfer of savings to developing countries in the market-oriented stage of the evolution of the world financial

system and during the first half of the transitional interwar period was affected mainly by the use of capital markets (portfolio investment), especially the raising of long-term debt. Depositary institutions, including banks, played only a limited role, as did direct investment involving the transfer of retained profits by companies operating in different countries.

The use of capital markets in Britain, Germany, France, Switzerland, and Holland, and in the United States during the 1920s is well known. Working capital for the finance of imports was provided by banks in the United States, Britain and a number of European countries. Virtually no information is available, however, on the size and importance of redistribution between countries of retained profits by multinational companies (as distinct from the retention of profits in countries where they had been earned), on new direct investment, or on the use of banking credit (for purposes other than financing foreign trade).

Access to capital markets in the industrial countries was open to all those who were considered creditworthy. The system worked reasonably well for several reasons: First, the major industrial countries maintained confidence in the system through their observance--until the early 1930s--of the rules of the "gold-backed sterling standard." Second, the system was buoyed by the political conditions in a large number of countries that were then part of the empires ruled from Europe. Third, the arrangements in force tended to ensure that sovereign countries restored their creditworthiness after a temporary economic setback. In such situations, foreign debt service was suspended and the countries concerned adopted economic policies regarded as conducive to servicing external debt and profitability of direct investments.

These arrangements enforced a disciplinary code that made clear the degree of risk accompanying the transfer of savings overseas, including the possibility of default. Unfortunately, there are no reliable statistics concerning the relationship of defaults to sums provided. However, such evidence as is available shows that the number of defaults by U.S. utilities, states, and companies before 1914 had been quite large and that as a result of World War I all further investment in Russia and in Germany ceased, and the bulk of their foreign investment was lost.

It is important to mention here that in the closing decades of the nineteenth century a precedent was established by the Bank of England, whereby it agreed to come to the aid of a bank involved in foreign lending in order to preserve the financial system and absorb any "excessive shock." It did so again after the Great Crash, for example, when it organized rescue operations needed to cover the defaults of borrowers of short-term banking credits as well as the long-term loans and risk capital raised on capital markets.

The economic development of industrial and subsequently developing countries was not governed by any macroeconomic policies, but was left to natural economic forces. As the experience of recently settled countries (Australia, Argentina, and Canada) indicates, however, economic growth in those and other countries was quite satisfactory despite the criticism of the center-periphery relationship in the 1950s and 1960s.

It is impossible to gauge the extent of the transfer of net savings from the capital-exporting countries to the capital-importing countries in relation to GDP in either case, but rough estimates suggest that in the forty years preceding World War I, they were not significantly different from those

in the 1960s, but that they decreased significantly in the 1920s, and became very small indeed in the 1930s.

(b) The period after World War II

The period since the early 1960s, following the recovery of Europe and the adoption of convertibility on current account by most of the industrial countries, has been characterized by a rise in the absolute and relative volume of savings transferred to the developing countries and a marked change in their composition. According to available estimates, between 1960 and 1966 oil-importing developing countries had net capital imports of $5 billion per annum. This amount rose to around $7 billion per annum between 1967 and 1973, increased sharply to $26 billion per annum in the five years ending in 1978, and advanced rapidly again from 1979 to 1981, reaching some $60 billion per annum. In terms of GNP, the contribution to the domestic savings of all the developing countries, which amounted to 2.6 percent in the 1967-73 period, increased to 4.0 percent in the following five years, and rose to 5.4 percent in the three years ending in 1981. (In relative terms, these figures fall short of the net capital flows from Great Britain and France in the closing years of the nineteenth century and the first decade of the twentieth century.)

These overall figures conceal marked differences among the high-, middle-, and low-income countries and, among the least developed countries, as classified by the IMF, the World Bank, and other international organizations. In absolute terms, the transfer of savings to high-income developing countries has been largest, but the contribution of such flows to domestic savings was the most important for the least-developed countries and the middle-income countries.

When the flow of financial resources to all non-oil developing countries is taken into account, we find that there has also been a change in the composition of such flows. If we exclude funds with maturities of less than one year (which can be taken to represent the "normal" trade financing but which distort the picture somewhat in that some developing countries used such credit to refinance maturities falling due), we see there was a decline in funds obtained by all the developing countries from official sources and by way of official development assistance (inclusive of official or officially supported export credits and nonconcessional multilateral lending) plus private grants. We also see a rise in the relative importance of nonofficial and nonofficially sponsored funds. Official and allied funds amounted to 64 percent of the total in 1970 and fell to 62 percent by 1982, and nonofficial and allied funds rose from 36 to 38 percent during this same period.

However, more startling changes occurred in the composition of private funds transferred to the oil-importing developing countries. There we see a decrease in the funds transferred by way of direct investment and a marked rise in funds raised from financial intermediaries, along with a small increase in funds raised through capital markets. The share of direct investment in the total declined from percent 25 percent in 1970 to 14 percent in 1982; the share of bank funding increased greatly in the same period, whereas that obtained through capital markets (domestic and international) advanced only modestly in the twelve years ending in 1982.

Again, these aggregate figures conceal important differences between various groups of countries and their members. It is well known that most of the resources transferred to low-income oil-importing developing countries

represents official assistance and private grants, and that such funds cover virtually all of the savings transferred to the least-developed countries.

In contrast, high- and middle-income countries initially had a larger share of nonofficial funds that the average, and the rate of increase in that share was faster than the average; the financing obtained from depositary institutions and through capital markets was appreciably greater.

(c) Summary

Looking over the past 100 years, one can say that developing countries were fully integrated within the world financial system prior to World War I. They used capital markets in capital-exporting countries and were involved to some extent in direct investment. These links were weakened considerably between World War I and the early 1960s, but they were reestablished after about 1960, but in a different form.

Apart from the transfer to resources by governments, predominantly on a nonrepayable basis to low-income countries, a substantial part of savings transferred to developing countries through the world financial system today consists of government-supported and government-sponsored funds. As for nonofficial transfers, these consist mainly of funds raised from banks operating in the international credit market and covering medium-term debt. Some funds are also invested directly, including the transfer of profits earned in other countries. These funds are used by multinational companies to diversify risk and comprise both debt and risk capital (equity). In addition, they include funds raised on capital markets (domestic and international) that cover predominantly debt.

Again, we can see marked differences in the relative importance of the three main types of private funds obtained by developing countries--that

is, direct investment, funds raised from depositary institutions (banks), and those raised in capital markets. Broadly speaking, the higher the per capita income and the faster the rate of growth, the greater was the recourse to capital market, although this was still small.

In short, the participation of developing countries at present differs from that during the period before World War I in terms of size, number of participants, and the relative importance of different types of savings. The new elements are the result of political factors (as reflected in the flow of concessional funds and the extent of participation), the new international financial arrangements, and the changes in the financial system of the countries dominating the international scene.

VIII. The "Ideal" World Financial System

(a) The Attributes of the "Ideal" System

The ideal world financial system would meet the same standards we apply to domestic financial systems; it would be stable, efficient, competitive, flexible, and balanced. Thus, stability at the international level depends on maintaining confidence in the system, especially in times of financial panic. It must be able to absorb shocks arising from the greater-than-anticipated and allowed-for risks, and hence to contain a contractionary impact on activity, employment, and trade, as well as any inflationary effect on prices. The question of stability of the international financial system devolves around the lender of last resort and the terms on which assistance will be provided internationally. In a single-currency reserve system, this function is performed by the central bank of the pivotal country. By ensuring

that pressures on individual banks in the pivotal country are contained, and central banks in effect preserve the stability of the world system as a whole. Under a multiple currency reserve system, the close coordination and cooperation of the monetary authorities of the reserve currency countries is essential to ensure that banks and nonbank financial institutions do not collapse. Such cooperation may require the intermediation of a special institution such as the IMF or the World Bank, which can participate in the management of the international financial system. This type of arrangement will in no way reduce the responsibility of the central banks and governments of the countries whose currencies perform the basic (pivotal) function in the world system as a whole.

Another important aspect of stability at the international level is linked to the lender of last resort issue and has to do with the growth in the world supply of money and with liquidity. Ideally, the rate of growth in world money supply and liquidity should be neither excessive nor inadequate. How to achieve this goal through workable policies in the multicurrency reserve system containing the quasi-independent, extraterritorial Euro-credit market is an important issue and is commented upon later. What constitutes the world money supply and liquidity in a multicurrency system with fluctuating rates of exchange is subject to debate. This question centers on the role of the SDRs as well as on the coordination of economic policies in the pivotal currency countries.

An efficient financial system, whether at the international or domestic level directs savings to investments with the highest rate of return, allowing for risk. Efficiency in both cases consists of allocative, operating, and dynamic efficiency. The distinguishing feature of allocative

efficiency in the international context is that the risk assessment must take into account exchange risk and country risk. The operating efficiency will depend on the extent to which the benefits of technology and competition are used to reduce operating costs. The dynamic efficiency will depend on the impact of economic growth and the corresponding changes in the structure of both the real economy and the financial industry in the capital-exporting and capital-importing countries. (It should be added here that exchange risk and country risk may give rise to different social and private rates of return. To what extent they differ will vary from case to case, but if the difference is sizable, the gains in allocative efficiency will be limited.)

If the international financial system is to be competitive, it must have an adequate number of participants. And if it is to be flexible, the instruments employed and the methods of operation must be able to adapt to changes in the economic and financial structure of the capital-exporting and capital-importing countries. A balanced system requires that there should be an optimal mix of various types of financing with respect to both the international transfer of current savings and the stock of past savings. The optimal mix would be such that changes in any one component could be absorbed by changes in another without having excessive impact on the providers and users of savings, while allowing both an adequate period of adjustment. These basic attributes of the ideal system are closely interconnected. Their ideal combination, as already mentioned, will change as the process of economic growth proceeds.

(b) <u>The Present System in Relation to the Ideal System</u>

The main features of the present world financial system can be summed up as follows: (1) It is gradually moving toward a multicurrency reserve

system; (2) the financial system, particularly the banking system and capital markets in the major countries and the Euro-credit and Euro-capital markets (that is, international financial markets), are now an integral part of the world system alongside official institutions; (3) as exemplified by the Basle Concordat and arrangements between the Federal Reserve of the United States and central banks of the major countries, there now exists a network of international monetary support agreements, which, although created ad hoc, are designed to contain possible shocks; (4) there are not well-defined arrangements for increasing world money supply and liquidity (they change in response to the policies pursued by major countries and the evolution of the domestic financial systems in such countries, as well as to the evolution of the international credit and capital market countries); (5) OPEC, especially its low-absorbing members, have ceased to be important capital exporters in the 1980s (that role has now been assumed by the industrial countries, notably Japan); (6) four major industrial countries--the United States, the United Kingdom, Germany, and Japan--now have no restrictions on capital exports; and (7) the gross and net flow of savings to developing countries forms only a part, though an important part, of total international capital movements.

Despite current international debt problems, it appears that the present international system is basically a stable one, and will remain so as long as the world money supply does not grow at an excessively rapid rate. There are, of course, important issues connected with the function of a lender of last resort that still have to be resolved in the international context. In particular, arrangements should be such that financial intermediaries, notably banks, will not incur excessive risk in the knowledge that they will be bailed out. The United States and United Kingdom have already introduced

mandatory, though limited, deposit insurance schemes to banks and similar bodies. In addition, prudential rules and regulations are now being extended by national authorities to include more exacting capital and liquidity ratios.

It is not easy to assess the efficiency of the present international system in comparison with that of earlier periods. Whether or not the existing arrangements are efficient in the allocative function depends on the cost of funds and on the perception of prospective return (allowing for risk). The returns offered by the various types of investment in different countries are difficult to predict, particularly because creditworthiness as well as country and exchange rate risk must be taken into account. One important feature of the present system is that financial intermediaries (banks and other depositary institutions) have to carry the funding risk (that is, they have to replenish deposits whose life is not fully matched with that of assets), the cost of which they try to pass on to the ultimate users of funds. Under these circumstances, nonfinancial corporations endeavor to hedge exchange rate risk and interest rate risk, with the result that their cost of funds is increased.

As for operational efficiency, one can say that although the flow of banking funds and the flow of funds through capital markets are dominated by a small number of firms, the degree of competition appears to be adequate at present. It could, however, be strengthened by more information.

Dynamic efficiency, which is closely linked to flexibility, can be evaluated only in relation to changes in the economic structure, particularly with respect to the adaptation of capital stock and the transfer of resources from declining to emerging industries. All one can say is that the international and domestic systems, particularly in the advanced countries,

appear to be converging, and that this development can be expected to lead to improvements in dynamic efficiency and flexibility of the world system.

Finally, we must ask to what extent the present system is a balanced one. It could be argued that a dynamic financial system (and for that matter any other social system) can never be balanced. Thus, the only relevant question is whether the degree of imbalances is such that the system is excessively vulnerable. The present level of imbalance is probably close to being excessive because of the dominance of bank financing without adequate safeguards. However, the building of ad hoc safeguards together with natural changes in the system can be expected to reduce the degree of vulnerability to an acceptable level.

(c) The Developing Countries in Relation to the "Ideal" World System

There is little doubt that since the reintegration of the developing countries, the present world system has moved further away from the ideal in certain respects. For one thing, allocative efficiency has declined because of less reliable risk assessment, and the degree of imbalance is greater now in that there is more concentration on particular forms of lending (bank lending). Allocative efficiency of the system may well have been impaired because of new elements in risk assessment, which have not as yet been mastered. The degree of imbalance has increased because of too rapid an increase in one type of transfer. At the same time, the reintegration of developing countries has probably increased competitive pressures, improved the flexibility of the system, and also added to its operational efficiency.

IX. The Developing Countries and the Present World System

(a) The Problems

The problems faced by the international financial system as a result of the large foreign debt incurred by developing countries need not be reviewed here. Rather, we are concerned with the measures that can be adopted to contain the pressure on the international system so as to improve its functioning, while assisting the developing countries.

On one hand, measures could be taken to increase world liquidity by creating SDRs and allocating them fully to the developing countries. Whatever the merits of such proposals, they are unlikely to find enough support at present. The point is that, although temporary finance is needed to implement the process of adjustment, it can be provided by "new money" that developing countries can obtain within the context of IMF-assisted stabilization programs.

In addition, specific measures can be taken to introduce "bridging finance," which has to do with the attitude of bank supervisors and access to the various sources of finance. That the general approach and practices adopted by bank supervisors can have an important impact on the provision of the bridging finance is quite clear. Similarly, with better information, existing users of foreign funds and their providers can help to substitute the present types of external finance for other types.

Considerable advances have been made in both these areas. The IMF Fund-assisted programs designed to lengthen the life of existing debt has helped to promote stabilization. At the same time, the strengthening of prudential regulation is reinforcing the financial system, while the trading

of existing debt among banks, though small compared with the stock, is helping to diversify risks. Provided the pace of activity in industrial countries is maintained and world trade continues to increase, the threat of a shock from the inability of developing countries to service foreign debt can be contained.

(b) How Developing Countries Can Use the International Financial System

To avail themselves of the funds that could be obtained through the international financial system, developing countries use a number of financial instruments developed for use among the industrial countries. In addition, some new instruments could be created to the requirements of fund-providers and fund-users and at the same time increase the flow of funds to the developing countries, especially is they are used in conjunction with some hedging instruments that have come into existence in the recent past.

It is beyond the scope of this discussion to outline the opportunities available. Suffice it to say that there is room to create instruments involving geographic risk diversification and maturity transformation, and also to increase their liquidity. By varying the risk-reward ratio, we can increase the choice of fund-providers while also raising the degree of flexibility (in terms of the burden of servicing such funds) to the fund-users.

Developing countries, acting collectively or individually, must try to master the technicalities of financial markets and must persuade the prospective fund-providers that the new instruments enhance the scope for satisfying their requirements while providing them with increased scope for adjustment. Such an approach would be in line with the lessons from experience. That is to say, the best way that the developing countries can

use the international financial system will be determined largely--though not entirely--by the character of the financial system in the dominant country or countries.

The developing countries should also encourage and assist their fund-raisers in evaluating risk by providing adequate information and helping to spread methods that will reduce the risk attached to fund-raising overseas. Furthermore, they should follow policies that will help to reduce the "man-made" risks (that is, those arising from the policies they pursue) rather than "natural" risk. By so doing, they will be able to reduce the risk that fund-raisers in their countries and fund-providers overseas incur.

Once developing countries are able to master the technicalities of financial markets, they will have considerable room for maneuver in that the mix of funds they raise overseas will, to a considerable extent, be within their own control. Indeed, they are in a position to restructure both the mix of such flows and the stock. This aspect of financing the process of development in the developing countries does not appear to have received sufficient attention from researchers, financial practitioners, policymakers, or, indeed, those in the international institutions concerned with development of these countries.

X. The Financial Links Between Developing Countries and Developed Countries and the World Economy

The extent to which developing countries are at present integrated into the world financial system and the world economy can be assessed by examining the nature of financial links between them and the world financial

system and the world economy. From a strictly abstract theoretical point of view, developing countries would be fully integrated into the world economy if their were no obstacles to capital movement. Under such conditions, the rate of return (adjusted for risk and other qualities) would tend to be equal in all the countries and developing countries would be fully integrated into the world financial system. It should, of course, be mentioned that, in an equilibrium, trade is a substitute for factor movement and ceteris paribus would also lead to equalization of factor prices--that is, the prices of labor, capital, and land.

From a historical perspective, developing countries were fully integrated into the world economy prior to World War I, when the world was on the gold-backed sterling standard and there were no obstacles to capital movements and few obstacles to free trade. The developing countries at that time had no control whatsoever over their monetary policy--which was determined, in principle, by the rules of the gold standard (capital flows would occur if risk-adjusted rates of return differed between different countries). Economic development depended mainly on the rate of growth of external markets, price elasticities for exports and imports, and the pace and character of capital accumulation.

When capital movements between the developing countries and the rest of the world are not free (especially with respect to the outflow of capital) and when governments in some countries endeavor to follow independent money supply and fiscal and exchange rate policies, the financial integration of such countries within the world economy is limited. This has been the case since the end of World War I. From the 1920s onward, the world has experienced the spread of controls on capital movements, especially since the

countries now classified as the "developing countries" achieved their independence. Some of these countries, however, have adopted "growth" policies relying on independent money supply and fiscal policies and on the control of outward (as well as inward) capital movements. Under these conditions, the financial integration of developing countries into the world economy will be limited, and implies large differences in the risk-adjusted rate of return.

These differences can be attributed to the uncertainties resulting from high risk premium attached to transfer of savings to the developing countries. Once risk premium rises beyond a generally acceptable figure, capital flows stop altogether. Risk premium tends to go up when difficulties arise in repatriating capital (whether in the form of debt or risk capital) or in servicing such capital, or when the actual rate of return resulting from the policies pursued differs greatly from the expected rate and requires a high threshold rate of return compared with other countries.

Although under the present conditions the developing countries are financially linked to the world economy, they are not fully integrated into it, because obstacles to capital movement are high and fund-providers attach a very high risk premium to such capital transfers. The financial linkage between individual developing countries and the world economy varies with the specific economic policy pursued, however, particularly the mix of fiscal and monetary and exchange rate policies adopted by each developing country, the degree of success of such policies, and the consequent risk premium fund-providers attach to capital transfer.

The greater the consistency of policies pursued by a developing country in relation to policies pursued by the developed world, the lower will

be the risk premium attached to various types of prospective inflows of capital. Lower risk premium is likely to help increase the inflow of capital and reduce the gap between the rate of return in a developing country and in a developed country, and in turn will assist in the accumulation of capital, physical as well as human.

XI. Future Prospects of the World Financial System and the Developing Countries

At the present time, the domestic financial systems of the developing countries appear to be converging and the emphasis is shifting toward a market-oriented system. It is also clear that developing countries are being reintegrated into the world financial system, but the relationship is different from the one that existed prior to World War I.

The domestic financial system in the main capital-exporting countries and the international financial system are likely to continue to follow a converging path in the shift toward a market-oriented system. The reintegration of the developing countries into the world financial system is also likely to continue, with an increasing (gross and net) movement of capital between them and the industrial countries. If these trends do continue, funds are likely to consist of more long-term debt and risk capital. Both the developing and developed countries should try to adopt the regulatory framework and introduce the measures needed to ensure integration into the international financial system.

XII. Concluding Observations

The central points raised in this discussion are that the character of the international financial system is determined to a large extent by the nature of the financial system in the dominant countries; that the international financial system evolves more or less in accordance with the changes in the financial system in the dominant country or countries; that the world financial system is now assuming characteristics of the market-oriented and strongly-market-oriented systems now present in the United States, the United Kingdom, the large countries of Europe, and Japan; that the developing countries have little scope for changing the nature of the international financial system; that the way they can benefit most from the international financial system is to acquire full knowledge of its "modus operandi", to apply its principles to their own capital-raising operations, and to initiate and support measures that improve its proper functioning; that the degree of financial linkages joining the developing countries with the world economy can be improved by adopting policies conducive to the working of the world financial system; that strengthening the financial links between developing countries and the rest of the world can be expected to promote the economic integration of the developing countries in the world economy at large.

At first glance, these tentative conclusions may appear to resemble the center-periphery view that prevailed in 1950s and 1960. Such a comparison does not, however, take into account the fact the developing countries can benefit by trying to participate in the world financial flows, by structuring their policies accordingly, and by making the system function better than it would otherwise.

In the longer historical perspective, the developing countries are being reintegrated into the changing world financial system. Because reintegration does not proceed at a smooth pace some imbalances in the system are to be expected. Efforts are now being made to correct a number of these. As a result, we can expect increasing financial integration of developing countries into the changing world system. But that will bring with it changes in the methods that developing countries use to import capital. These changes will no doubt be a reflection of changes in the domestic financial system in the capital-exporting countries and the international financial system.

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The Internationalization of the Financial System and the Developing Countries The Evolving Relationship

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