LIQUIDITY PREFERENCE IN INTERNATIONAL FINANCE: THE CASE OF DEVELOPING COUNTRIES

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1.1. INTRODUCTION

Keynes's monetary theory is based on the view that money is fundamentally nonneutral. Money is an institution integral to the capitalist process, and monetary developments are part of the process that determines output and employment. Keynes's theory has been developed to apply to modern conditions by Post-Keynesian monetary theory (see Davidson, 1972; Minsky, 1985; and Wray, 1990).

According to this theory, the supply of money is determined significantly by the banking system (albeit influenced by the monetary authorities). The banking system supplies credit according to its state of liquidity preference, while borrowers demand credit according to their liquidity preference; *liquidity preference* is here being interpreted broadly to refer to the portfolio choices of banks and financial borrowers and the choices of nonfinancial firms with respect to purchasing capital goods and the form of financing this purchase. Liquidity preference is thus determined by the state of confidence in the prices of the full range of assets, financial and nonfinancial. Shifting liquidity preference influences the supply of and demand for credit, as well as output and employment.

It is the purpose of this chapter to explore this representation of Post-Keynesian monetary theory in an international context. In general terms, if money is nonneutral internationally, then international monetary develop-
ments can have real international consequences. In addition to the general question of nonneutrality, the international dimension poses further questions (parallel to those in regional economics) about the implications of financial integration among different economies. In other words, if money is nonneutral, is its effect on output and employment different in different types of economy, and how is this affected by different international institutional arrangements? There are two contexts in which this discussion has particular relevance. The first is the European Monetary Union, where a series of measures is planned to ensure financial integration; this is discussed in terms of Post-Keynesian monetary theory in Chick (1991) and Dow (1994). Here the focus rather will be on the other context of developing countries and international financial markets.

In the next section, Post-Keynesian monetary theory is outlined in more detail with a general formulation in the international context. The following sections outline the case of developing countries with respect to international financial markets. First their situation is couched in terms of center-periphery analysis and then in terms of credit demand and availability, and finally capital flight is analyzed in terms of liquidity preference theory. Reference is made to the Bank for International Settlements (BIS) data on international borrowing and lending. The international liquid assets of developing countries will be considered alongside their borrowing; the liquid portfolio position of many low-income developing countries can be seen to reflect not only credit availability constraints but also a high degree of liquidity preference, which discourages the demand for credit.

1.2. POST-KEYNESIAN MONETARY THEORY IN AN INTERNATIONAL CONTEXT

Quite apart from the logical and doctrinal shortcomings of such a polarization (see Dow and Dow, 1989), neither approach adapts well to the international context. In the context of a partial analysis of a closed economy, it could be argued either that the domestic money supply may be taken as given or that the demand for credit is fully accommodated. But in an open economy context it is hard to justify abstraction from the fact that international credit flows not only endogenize the supply of credit, but also from the fact that there are availability constraints on the supply of credit in international markets. Given that the amount of international borrowing and lending and the choice of instruments employed reflects the choice of to how much liquidity to preserve or to forgo, it seems clear that a Post-