INTERNATIONAL MONETARY FUND

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Background

The most distinguishing feature of the new international currency system built round the Bretton Woods Agreement is that, unlike the other international monetary standards, it has been established after serious deliberations and protracted negotiations among the representatives of a large group of leading sovereign nations. The negotiations for, an 'improved system of international currency' were carried on from 1942 to 1944, mainly between the representatives of the British Exchequer, and United States Treasury, and finally culminated in the Bretton Woods Agreement which led to the establishment of the twine institutions *viz.*, the International Monetary Fund and the International Bank for Development and Reconstruction.

The world uptill now has had the experience of three monetary systems. While the first, *i.e.*, the gold standard was adopted by practically every trading country by the latter part of the nineteenth century, and successfully operated until the outbreak of the First World War, the other two systems, namely the inconvertible paper currency standard with fluctuating exchange rates, and exchange control with the authoritarian manipulation of exchange rates, were largely the result of monetary chaos and disturbances of the inter-war period. These latter two systems, were rather the desperate remedies adopted by the various countries suffering from serious maladjustments and which caught upon various expedients to get out of their difficulties.

There is one particular feature attached to every one of the above-mentioned three, standards. Under the gold standard, the external value of the currency was kept stable, and the relative stability of the exchange rates between the countries was to a very great extent responsible for the tremendous increase in the volume of international trade during its period of operation. But the price which the country had to pay for this external stability was heavy. They had to sacrifice their internal stability in the volume of employment, production and trade, in order to keep the external stability. After the World War I, when attention was paid to objectives other than exchange stability, and countries hesitated to sacrifice their internal stability, they no longer practised the ‘rules of the game’ of the gold standards which, eventually brought its downfall. Soon after the gold standard, a free paper standard with freely fluctuating exchange rates, came into being. By making the exchange rates fluctuate, the countries hoped to insulate their economy against the inflationary or deflationary movements of the other parts of the world. The freely fluctuating exchange rates, however, tended to go to their extremes, some times with serious fluctuations in the domestic economy, and the fact dawned upon every nation that it cannot simply leave the exchange rates to their own fate. The re-action against excessive fluctuating exchange rates soon manifested itself in the introduction of exchange management of varying degrees in many of the countries. The extreme example in this respect at that time was provided by Germany. It must be mentioned, however, that before the outbreak of World War II in 1939, exchange control was not resorted to any great extent by many of the important countries.

The disadvantages of excessive fluctuating exchange rates were soon realized and in September 1936, the so-called Tripartite Monetary Agreement was signed by the important countries namely U. K., U. S. A. and France. It was a modest attempt to bring about some sort of Orders and stability between the exchange rates of key currency countries, and consequently many other nations of Western Europe adhered to this Agreement.

During the war it was felt that some sort of international monetary standard must be evolved, if the grim international currency experience of the inter-war period was to be avoided. None of the three standards mentioned above was acceptable in it entirety, to the countries. The British were particularly against the international gold standard, which they thought was mainly responsible for severe deflation in the country. The free paper standard, on the other hand, was in the minds of many associated with excessive fluctuations in the exchange rates; exchange rate movements were often thought of as disrupting and unstabilizing rather than equilibrating. Exchange Control, however, was the most criticized of all, because it was thought of as leading to discriminatory trade practices and thereby to the contraction of international trade.

The I.M.F. was, therefore, adopted, as an alternative to the adoption of any one of the three standards. It may be called a ‘mixed standard’, in so far as an attempt has been made to blend in it the distinctive features of all the three standards, with of course, some structural details peculiar to itself. The manner in which it embodies exchange stability, flexibility and under exceptional and presumably rare circumstances, a certain degree of exchange management, is the most important fact regarding I.M.F.

Submitting his plan, to the Bretton Woods Conference, Lord Keynes outlined three basic conditions for the establishment of a sound international currency system.

Firstly, in a new system gold should be used only as a convenient common denominator by means of which the relative values of national currencies — these being free to change — are expressed from time to time. The idea of Keynes was that there should be a new international medium of payment, which unlike gold should not be subject to natural factors, but capable of being manipulated to the needs of the countries.

Secondly, Keynes maintained that under the new system, countries should not be allowed to resort to competitive exchange depreciation as they did during the inter-war period. While he conceded that exchange flexibility should be the aim in view rather than exchange rigidity, it is essential that any adjustment in the relative value of currencies should be carried out by mutual consultation and if possible by agreements. The establishment of the new system should therefore impose some legal or moral bindings on the nations in matters of exchange rate adjustments.

Thirdly, Keynes thought that the new international reserve system should be established with the aim of serving as a common pool so that nations may not be compelled to resort to discriminatory and restrictive measures when faced with balance of payment difficulties.

These are the three main principles which Keynes outlined in his Plan as a basis of Bretton Woods Agreement, and as a, guide to the realization of an ‘improved system of international currency’. Although his Plan did not find favour at the conference, yet these principles in the main have been embodied in the Bretton Woods Agreement.

Exchange Rates

Let us now first turn to the theoretical basis on which exchange rates are determined under the Fund. The Fund requires that the par values of member-countries’ currencies should be expressed “in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944.” These par values, member-countries were asked to declare at the inception of Fund, This provision, however, does not mean that the external value of currencies are tied to a fixed amount of gold, as under the gold standard. As Keynes pointed out at that time, gold has been kept only as a common denominator for accounting purposes without being “rigidly tied to a fixed quantity of gold or involving a financial policy which compels the internal value of the domestic currency to conform to this external value as fixed in terms of gold."

In order to promote multilateral trade, the Fund contains provisions which forbid the member-countries to resort to competitive exchange depreciation. It requires every member country to keep orderly exchange arrangements with the others. Between the excessive fluctuating exchange rates, under the free paper standard and rigid exchanges under the gold standard, the Fund has adopted a via media, that is it has aimed at a managed exchange stability. The exchange rates have been flexible in so far as the Fund permits a member country to adjust its currency value by 10 per cent upward or downward, without the prior approval of the Fund. A country wishing to adjust its currency value by more than 10 per cent must get the consent of Fund. These adjustments, however, could be made only when there has developed a fundamental disequilibrium in a country's balance of payments.

The Fund requires a member-country to devalue its currency only when it is suffering from a persistent adverse balance of payments. This concept of 'fundamental disequilibrium' as a criterion of devaluation many prove a source of conflicting interpretation.

Devaluation, as a means of combating depression, involves either a beggar-my-neighbour policy or a buffer policy. The case of the beggar-my-neighbour policy arises when a country that is suffering from a depression inside the country due to domestic reasons, devaluates its currency to gain an export advantage; this measure will in fact amount to securing for its national output a larger share of world total demand at the expense of other countries. It is likely, that such a 'country even without devaluation would secure a favourable balance of payments as her export prices fall and the domestic demand for imports is reduced. In these circumstances, a country cannot be allowed to devaluate her currency, since the depressed conditions inside the country have already given her a favourable balance of payments. But any country suffering a depression in its domestic market might claim that such depression constitutes a fundamental disequilibrium justifying exchange depreciation. And as long as the term is not defined, it may not be easy to reject such a claim.

As a measure of protection against a depression origination abroad, devaluation has, however, a justification. If a country is faced with a depression in one of its foreign markets, this depression will tend to spread to its economy through an adverse balance of payment as a result of a fall in its exports, and if prices are reduced abroad, a rise in the volume of its imports.

The deficit in the balance of payments would in this case justify a certain measure of devaluation.

It is devaluation under such circumstances only that the Fund appears to have allowed. But though devaluation for buffer purposes may be defensible, it should not be in- general necessary. The most desirable method of facing a depression from abroad, is to resort to ‘offsetting’ coupled with the use of international currency reserves to meet the cyclical discrepancies in the balance of payments. Another possible method for insulating against an outside depression would be the apportionment of scarce currencies, contemplated under the Fund, which would tend to have the effect of discriminating against the exports of a country which allows its national income and hence its income demand for foreign commodities, to decline below the full employment level. The Fund rightly regards exchange adjustment as a third line of defence. The Fund clearly forbids devaluation for meeting cyclical deficits in the balance of payments. It should be the function of international currency reserves to meet short-term and cyclical discrepancies in the balance of payments. The Fund considers exchange rate devaluation appropriate only for chronic or structural disequilibria in the balance of payments, and it has provisions allowing exchange adjustments only as a last resort.

One of the great weaknesses of the Fund, is that in so far as exchange rate adjustments are concerned it plays only a passive role. While it is one of the great merits of the Fund, that it prevents member-countries from resorting to competitive exchange alterations, its weakness lies in the fact that it does not possess any power of taking the initiative for asking a surplus country to appreciate its currency or a deficit country to devaluate its currency. The danger, in the absence of such powers, is that a country by devaluating its currency may not be able to overcome the deficit in its balance of payments if the surplus country does not simultaneously appreciate its currency, or if it devalues its currency which it is allowed to do (to 10%) under the rules of the Fund. The disequilibrium would have been easily and quickly restored, had the Fund been invested with the powers to require the surplus country to appreciate its currency simultaneously with the depreciation of the deficit country’s currency. Another danger, which arises when a country devalues its currency, without appreciation of surplus country’s currency, is that under such circumstances balanced countries would be turned into deficit countries. As a devaluated country would be able to undersell not only to the surplus country but also to those countries who have had balanced accounts so far. This will throw these countries into deficits and compel them to resort to depreciation to the detriment of all. In case, there had been a simultaneous appreciation of surplus currency, both the devaluated and balanced countries would have been able to undersell to the surplus country.

Exchange Control

It is one of the aims of I.M.F. to restore a multilateral system of payments in respect of current transactions between members and to eliminate foreign exchange restrictions which hamper the growth of trade. The Fund's policy regarding exchange restrictions may be divided into (*a*) post-war transition measures, (*b*) permanent measures and (*c*) exception to the general rule.

It was realized at the time I.M.F. was established that countries whose economies were wrenched and distorted due to the war, might be facing balance of payment difficulties in the post-war period, and it might not therefore be possible for them to immediately dispense with the various exchange restrictions in force at the time. Hence it was decided that during a transition period of five years (1946-51) member-countries may be allowed to retain all forms of exchange controls including multiple exchange system, and other discriminatory currency practices. It must be mentioned here that it is only the current transactions that the Fund wants to be striped of all restrictions. With respect to capital movements, the Fund allows restrictions even after the transition period. The member-countries retaining exchange control under this provision are required to dispense with these restrictions as soon as they can see their way in setting their current account with other countries without unnecessarily drawing upon the resources of the Fund. In other words, when a country has acquired equilibrium in its balance of payments and a sufficient amount of international reserves it must do away with all forms of exchange control, except those which are designed to regulate the capital transactions.

This obligation of removing the exchange restrictions after a transition period, may, however, be subject to indefinite postponement. The main problem in this connection is that of the convertibility of sterling. By 1945, it had become clear that not only the realization of the Fund's objectives, but its very existence would be impossible unless some solution of the sterling problem was found. It was, felt, that if Britain could restore the convertibility of sterling with the help of United State's financial aid, it would greatly help to restore the pre-war system of payments since as much as 80% of the world trade is currently conducted in terms of dollar and sterling. Under the terms of Anglo-American financial agreement, therefore, Britain agreed to make currently acquired sterling freely convertible from July 15, 1947. On August 20, 1947, however, the British Government announced a temporary suspension of general convertibility of currently acquired sterling into dollars. The introduction of convertibility on July 15, 1947, for a brief period of one month had resulted in a serious drain on Britain’s dollar and gold resources. In the present circumstances, it is impossible for most of the countries to maintain convertibility of their currency with the dollar. This situation it appears would continue for a long period.

In general, the Fund’s policy in respect of exchange, control, excepting transitional arrangement, and a general scarcity of a particular currency, is that “no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfer for current international transactions.” The Fund prohibits exchange restrictions on all current payments, multiple exchange practices and making by country an inconvertible currency system. But the Fund permits the retention of exchange control on capital movements, *i.e.* to prevent capital flight from upsetting both exchange stability and the member’s balance of payments.

Since control on capital movements is permitted by the Fund, it is clear that members will not be required to restore free exchange markets within their borders. Moreover, in practice, it would be very difficult to distinguish between the transactions arising out of current payments and those related to capital movements. The danger therefore is that member-countries might retain strict exchange control even after the transition period.

Lastly, we come to the Fund’s attitude towards exchange control under abnormal circumstances. If the demand for a particular currency becomes so great that the Fund has not enough resources for meeting that demand, it takes special measures to meet the situation. Suppose that the demand for dollars becomes so heavy on the Fund, that it cannot possibly meet those demands out of its existing resources. In such a situation, the Fund has two methods at its disposal, either it can purchase more dollars by offering its gold in exchange and thus make available dollars to countries needing them, or it can declare dollar a ‘scarce’ currency. The extent to which the first method can be resorted to depends upon the gold resources of the Fund and the degree of dollar demand by member-countries. In extreme cases, the Fund will resort to the second method, which authorizes the dollar needing countries, to impose exchange restrictions on transfers and payments relating to dollar. This constitutes an exception to the general rule mentioned above. Any deficit member-country is thereby “authorized to limit the demand for the scarce currency to the supply held by, or accruing to, the member in question” but is expressly required to remove such restrictions as soon as conditions permit (Article VII Section 3b).

The theory underlying the scarce currency provision is that there may develop a general disequilibrium resulting from a persistent favourable balance of a key-currency country or area. The Fund agreement provides that when the Fund finds this situation threatening to develop, it shall have to make a report together with recommendations designed to correct the conditions giving rise to the disequilibrium. A better way to bring about equilibrium under such circumstances, would have been to make the surplus country as much responsible for a disequilibrium as the deficit countries. Because ultimately, if a currency is declared scarce, the deficit countries would not stop at limiting only the demand for it but might resort to other measures like import restrictions, 'beggar-my-neighbour' policies etc. and worst of all to deflationary internal measures.

It may, however, be mentioned, that the very provision allowing a country to apply exchange restrictions on 'scarce' currency, constitutes a discrimination against the surplus country's trade and to that extent at least puts pressure on the creditor country to allow other countries to acquire more of its currency by means of tariff reductions, short-term loans, long-term international investments.

Lending Operations

The main purpose of I.M.F. is to provide the member-countries with international liquidity in the event of balance of payment discrepancies of a short-term character. It was the object of the Fund to maintain international equilibrium in general, and a high level of employment and real income in the member countries in particular. In order to achieve these objects, therefore, the Fund makes its resources available to the member-countries in case they are faced with a deficit in their balance of payments, provided of course the deficit is of a cyclical or temporary nature.

In a world, where economic activity is subject to violent fluctuation and there is a growing demand for stability, the main function of international currency reserves is insulate a country against the economic fluctuations of the outside word, and to act as a "buffer" thus enabling a country to pursue policies of full employment and high real income.

In such a situation, the country must endeavour to offset the fall in foreign expenditure on its exports by an increase in domestic expenditure. While this will tend to maintain total expenditure in the country, which will result in domestic stability, it does nothing to remove the deficit in the balance of payment arising from a fall in exports. The country pursuing this offsetting policy, must therefore be prepared to use up temporarily some of its international currency resources also, in order to fill this gap. Only with a sufficient amount of international reserves will a country in such a situation be able to avoid exchange depreciation of import restrictions.

The main function of the I.M.F. will be therefore to create substantial addition to international liquidity. Let us see how the I.M.F. proposes to do it.

The resources of the Fund consist of the contributions made to it according to a specified quota assigned to each country, according to the relative financial and trade positions of the respective countries. Thus the amount of quotas ranges from a high figure of United State's initial contribution of $ 2750 million to a small sum of $ 5 Million assigned to Liberia and Panama. The Fund began its exchange transactions with $ 8800 million.

Suppose that a member-country is faced with a deficit in its current account. It may approach the Fund and purchase from it that particular currency upto 25% of its original quota in any year, in exchange for an equivalent amount of its own currency. Thus the Fund has accumulated the deficit country's currency, to the amount that was originally paid by that country as her contribution plus that country's currency equal to the amount of foreign exchange sold to it. If now the deficit country has come to achieve equilibrium in its balance of payments, it is required, under, the Fund's rules, to repurchase her 'additional' currency in exchange for gold or 'convertible' currencies which it has subsequently accumulated. Through the repurchase, therefore, the Fund's resources come to what they were before. In order to safeguard its resources of a particular currency from quick exhaustion, the Fund not only limits the amount to 25% of a member-country's contribution, but also imposes heavy graduated interest and other charges on the amount drawn. These interest charges are payable in gold. In case there is an excessive purchase of a particular currency on the part of a member-country, the Fund may impose penal interest rates. In short, the Fund has made the member-countries to apply to the Fund only in the last resort.

The successful operation of the new international monetary system requires that countries maintain domestic stability. The extent to which countries may be able to maintain domestic stability, as we have seen, depends on the amount of international currency reserves which are at their disposal to meet the cyclical discrepancies in their balance of payments. This 'buffer' function of international liquidity is important to any international monetary system, though it is hardly possible for this buffer, mechanism to withstand any severe slump in a major trading nation. Obviously, it is the volume of international currency reserves which determines the degree to which a strain can be tolerated in a system.

Under the present circumstances, however, the resources at the disposal of I.M.F. are far from adequate for this purpose. Ultimately, therefore, the success of I.M.F. closely depends on the maintenance of full-employment conditions above all in major industrial states. Unless this condition is met, it is most likely that countries would resort to restrictive commercial policies, and thus defeat the very purpose for which the Fund is established.

In the end it may be said that the 'noble experiment' which was made with the founding of I.M.F. has more or less failed. There are not much chances that it will succeed in future either. Its failure may partly be explained by its weaknesses mentioned above and partly by the fact that the economic dislocations were greater than contemplated at the time of its inception. More important, however, is that no real peace has been established. Another important reason for the failure of I.M.F. in reconstructing a freer multilateral trade is the inability of the governments of most countries to end inflation and to restore international monetary equilibrium and order.

By 1948 it became apparent that the governments were bent upon maintaining their freedom of action with regard to exchange rates. Accordingly, they were prepared to inform the Fund of changes, in some situations to consult it, but not to seek its permission. Thus late in 1947 France consulted the Fund concerning proposed changes in its rate of exchange from approximately 119 francs to the dollar to 214 francs to a dollar, and also to create a special rate for certain currencies. The Fund opposed to special rates, but the French did not agree with the Fund, ignored the Fund's proposals, and adopted the new rates. For its part, the Fund considered these rates unauthorized and withdrew from France its privilege of using the Fund's resources.

Another important event, which reflects the failure of the Fund, is that of the sterling devaluation of September 1949. In the fall of 1949, U. K. engaged in lengthy financial negotiations with the United States concerning the British economic crisis. Several United States Officials had urged that the pound sterling be lowered from its current rate. The Fund had recognized the need for some changes in the exchange rate in order to stimulate the British exports. In September 1949, United Kingdom announced the devaluation of the pound by 30 per cent. This was followed by a series of devaluations on the part of many countries. There was no indication that the Fund had been consulted, that it had objected to or agreed in these decisions of devaluations before they were announced. Obviously, within the short time that these countries devalued their currencies, they could not have secured the Fund's, permission. Moreover, to the extent such devaluations frustrated Britain's attempt to secure an export advantage and thus attain equilibrium in her balance of payments, they amounted to ‘Competitive exchange depreciations’ the prevention of which was one of the cherished aims of the Fund.

During its initial operations, it became evident that the Fund played a merely passive role in the alternations of exchange rates. Some governments feared that prior consultation with the Fund would result in ‘leaks’, with disastrous consequences for their money market. There were others who regarded the exchange rate matters as a sacred concern of a sovereign nation, with Fund having nothing to do with it. In the face of these attitudes and in the absence of any effective power in the hands of the fund, there is no wonder if it was unable during its brief period of operation to assure the fulfillment of one of its fundamental objectives, *i.e.*, the assurance of stable exchange rates and orderly adjustments.

The most important cause of the Fund’s failure, however, arises from the basic assumption on which it was built. The framers of the Fund thought that after a brief period of post-war recovery, the world would return to ‘normalcy’ with no chronic debtor or creditor countries. This was clearly an underestimation of the complexity of the problem to be solved. However, subsequent political conditions are also responsible for the Fund’s failure. It would be interesting to recall that while after world war I countries were eager to return to normal condition and adopt the same mechanisms of trade and currency as were before the war, after the World War II nations were determined more than ever to retain all the restrictive and discriminatory practices which were adopted during the war period.

In the end, one may conclude that it is too much to ask the Fund to solve the present international monetary problems. This is not the world in which it was supposed to operate. It is obvious, therefore, since that world is no more a real hope, the Fund agreement should be modified to meet the present situation.