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CHAPTER - I

INTRODUCTION, RESEARCH DESIGN AND REVIEW OF LITERATURE

1.1 INTRODUCTION

This opening Chapter of the Thesis titled “A Study of International Monetary System in relation to International Liquidity” introduces the topic of this investigation and also presents its methodological aspects. The work has mainly attempted to evaluate the role of the International Monetary Fund (IMF) in maintaining the international liquidity within the framework of the international monetary system.

The Chapter begins with brief explanations of such CONCEPTS as ‘international monetary system’, ‘international liquidity’, ‘balance of payments’, ‘International Monetary Fund’ (IMF), ‘Special Drawing Rights’ (SDRs), etc., which have been repeatedly used in the subsequent text.

1.2 INTERNATIONAL MONETARY SYSTEM

The ‘international monetary system’ refers to that framework under which international monetary relations are regulated. This structure enables residents of one country to make payments to the residents of other countries. In the words of Solomon, the international monetary system “is concerned not only with the supply of international money, but also with the relationships among the hundred or so currencies of individual countries and the pattern of balance of payments relationships and the manner in which these are adjusted and settled”. Such a system is generally identified by three key features, namely, (i) organization of foreign exchange market, (ii) types of assets used for financing or settling payment imbalances, (iii) mechanisms for adjustments of payment imbalances.

Over the 20th century, the international monetary system has evolved from its primary reliance on gold to reliance on national moneys, to meet the demand for international reserve assets, moneys which provide the basis of international payments. This development has not occurred in any accidental way but as a response to both monetary and structural economic disturbances. Changes in political relationships among major countries also had a bearing on the evolution of the international monetary system.

International monetary relations are a study of those rules, regulations, conventions and norms which govern the financial conduct of nations with other nations. In such a study, both economics and politics are inextricably intermingled. As Monroe says, “International monetary matters had always been and will continue to be a complex blend of economic and political considerations”. Further, international monetary relations
incorporate elements of both cooperation and competition. The element of cooperation stems from the common policy interest that all countries have in promoting the highest possible level of technical efficiency and economic welfare; the element of competition stems from the divergent policy interests that all countries have in influencing the distribution of economic welfare, political prestige and the burden or privilege of decision-making.\(^4\)

The main objective of the international monetary system is to facilitate the growth of world trade and investment. This goal can be attained only when the following major requirements are met:

(1) Minimization of restrictions and controls over world trade, commensurate with the domestic economic objectives of a high level of employment and price stability;

(2) Establishment of a system of multi-lateral payments which, in turn, requires convertibility of currencies into one another.

The latter aspect may be succinctly expressed in the following words: “The settlement of payment among countries should be multi-lateral, so that every country can offset its deficits with some countries by means of surpluses with others. To fulfill this condition, the system must provide (for some kind of convertibility), for the ultimate settlement of a generalized payments system makes a far higher level of internal trade and investment transactions that would be feasible if each country had to balance its payments bi-laterally with every other country in a network of barter relationships”.

(3) Stability in the monetary system and in the exchange value of the currencies so that individuals and businesses make rational plans for the future.

Stability should not mean rigidity but such flexibility as to enable the system to cope effectively with major or unforeseen changes in the world economy. As Jacobson states, “the international monetary system can never be a rigid system, with fixed and permanent arrangements. It must be such that it can develop with the varying growths of the individual national economies, and with the evolution of their financial and monetary needs and potentialities”.

These requirements of a properly functioning international monetary system are generally expressed as “the adjustment problem”, “the liquidity problem” and “the confidence problem”. Under the ‘adjustment problem’, it is seen whether the international monetary system is capable of providing a sufficiently prompt and effective mechanism for adjustment of payment imbalances, so that these imbalances do not persist and accumulate for any country. The ‘liquidity problem’ refers to the provisions of enough international liquidity and reserves to finance temporary differences between receipts and payments. The system should also be capable of increasing the liquidity and reserves according to the needs. It must operate in a way so as to create and maintain confidence in its continued viability and in the value of the international reserve assets associated with it.
1.3 International Liquidity

International liquidity from the point of view of an individual country can be summed up in the term “reserves”. Reserves are those assets of a country’s monetary authorities that can be used to finance a balance of payment deficit.

Thus, international liquidity is defined to include all the assets and currencies that are freely and unconditionally available and usable in meeting the balance of payments deficits and other international obligations of countries. A country, therefore, having a balance of payments deficit has to settle it by transferring generally acceptable means of international payments. Thus, international liquidity encompasses international reserves and the facilities for international borrowing for financing balance of payments deficit. International reserves, therefore, include official holdings of gold, foreign exchange, SDRs and the reserve position in the IMF of a country.

There exists a large body of studies concerning the optimum level of reserves that an individual country should seek to maintain. However, if the total international liquidity was to mean the sum of the reserves held by all countries, in the same manner as ‘world trade’ is the sum of imports or exports of all countries, the adequacy of total international liquidity would not be an issue. That issue existed as long as there was a limit on the total amount of the assets in the system that could serve as countries reserves.

Official holdings of foreign reserves derive from attempts by the national authorities to maintain fixed rates of exchange between domestic and foreign currencies. In a world where all currencies were backed cent percent by a single commodity such as gold or where all exchange rates were freely flexible, every national currency could be used to discharge trading debts in any country. However, where rates of exchange are fixed by government fiat or where fiduciary issues are pegged in relation to other currencies or gold, different currencies are substitutable as media of exchange only as long as each currency is freely obtainable at prevailing rates in all countries. The latter condition can be satisfied continuously only if national authorities assume major responsibility for the purchase, sale and holding of foreign currencies and simultaneously pursue policies of economic control that enable them to maintain reserves at levels that permit all demands to be met.

The question of international liquidity has to be studied in the context of the international monetary system. It is based on the following considerations:

(1) Each country is jealously insistent on its sovereign right to regulate internal demand for the purpose of maintaining suitable economic conditions at home in terms of employment and in the internal price levels;

(2) Free international movement of goods and of capital as a means of achieving efficient use of resources is a generally accepted goal and substantial progress has been made in this direction. In particular, since the advent of general currency convertibility in 1985, controls over the international flow of capital have been relaxed and investors have become increasingly inclined to shift funds internationally in response to differential changes in expected rates of return;
(3) Generally, trade is conducted under a system of fixed exchange parities at any particular time, with actual exchange rates fluctuating only within very narrow limits round these parities. The maintenance of fixed parities is a highly prized objective; nevertheless, provision is made for parity adjustments under the rules of the IMF as a means of dealing with the fundamental balance of payments disequilibria.

(4) Countries hold a limited supply of monetary reserves in the form of gold, dollar balances and (to a lesser extent) sterling balances. In addition, lines of credit are available at the IMF; portions of these credit lines can be available virtually automatically and are practically the equivalent of ‘owned’ reserves, while the remaining portions are available on conditions that become increasingly stringent as the amount borrowed increases. The reserves available, and potentially obtainable, set a limit, though somewhat elastic one, on the cumulative size of a country’s balance of payments deficit. Thus, each country operates, subject to a ‘balance of payments constraint’.

It is important to note that there is no corresponding limit for surpluses. Surplus countries are not constrained to adjust to their payments imbalances while adjustments in the deficit countries will always be painful and hence, avoided if possible.

Few remarks remain to be added concerning the goal of ‘internal stability’. It is often said that countries seek the twin goals of “full employment” and “price stability”. However, a more accurate description of the situation is as follows. There is in each country a ‘trade off’ between employment (or unemployment) and price stability, that is, the more the unemployment is reduced by policies to expand the aggregate demand, the higher is the price that must be paid in terms of inflation. This relationship holds primarily because of the tendency of money wage increases outstrip increase in productivity even under conditions of substantial unemployment. The trade off varies from country to country, depending on the organization, traditions and also, from time to time, depending upon the attendant circumstances.

Price stability is often given a high priority in the list of objectives of economic policy, not only for individual countries, but for the world, as a whole. It seems, however, that evidence is overwhelmingly in favour of under-employment and under-utilization of economic resources and that is both politically unacceptable as well as socially undesirable in most countries. The achievement of an acceptable rate of utilization of economic resources requires that the world is willing to accept and, indeed, underwrite a mild upward drift in the general level of prices, unless, of course, some as yet undiscovered means can be used to dampen the tendency towards price and wage increases without reducing the overall level of demand. The increased demand generated by economic policy objectives has to be supported by the adequacy of international liquidity.

There are three grave difficulties inherent in the existing international monetary system, which may be discussed as under:
(1) The first, and in many ways, the most fundamental difficulty is that the system contains no mechanism that can be depended upon to eliminate a balance of payments disequilibrium brought about by such disruptive forces as changes in tastes or technology. There are three possible ways of correcting a deficit or surplus by adjustment of the current account: (i) through the use of trade or exchange control, (ii) through an adjustment of exchange rates, and (iii) through internal price and income changes. Since all these violate the principles of the system, they are ruled out. Consequently, when a country experiences a deficit, there is no assurance that the deficit will be eliminated before its limited supply of reserves is used up;

(2) The system, as it is now constituted, is subject to an extreme degree of destabilizing speculative tendencies, which greatly complicate the problems of the balance of payments adjustment. Although fixed exchange rates appear to be one of the generally accepted goals of the economic policy, we do not yet have a viable system for fixing exchange rates. Indeed, the present arrangements by which rates are fixed within very narrow limits and are later subject to adjustment from time to time, so as to correct the disequilibria in the national balances of payment seem ideally suited to encourage speculation. Since opportunities for the investment of capital, viewed broadly, do not ordinarily vary widely as between major countries, there has been a mild suspicion that a country may devalue its currency and can cause a speculative outflow of capital from that country, and, as more and more investors become familiar with the possibility of transferring capital abroad, it seems probable that the potential size of speculative capital flows may become even larger, and consequently, there is always the possibility that speculation will exhaust the country’s reserves and force a devaluation upon it, a step which speculators are hoping for.

(3) The third difficulty, the least serious, because it is the easiest one to solve, is that the present system contains no orderly arrangement for generating in a predictable way the increased quantities of international monetary reserves which are needed to meet the growing demands of world economy. The world’s monetary reserves are increased primarily by gold production (less the amount of gold that is absorbed in consumption and in hoards) and by the additional Dollars that are pumped into official reserves by US deficits. Gold production is generally agreed to be capable of producing only a relatively small fraction of the additions to reserves which are needed.

1.3.1 Adequacy of Reserves

There are several reasons why a country’s central bank might want to hold assets which are internationally liquid. One is the transactions motive. Even if receipts and payments were to balance in the long run, there is little reason to expect them to be balanced everyday or every month. To bridge the gap between payments and receipts, a country needs reserves. When the volume of trade grows, the necessity for increased reserves also grows. The demand for transaction cash is most certainly sensitive to price changes and to conditions in the credit market. Much of the reserves needed for transaction
purposes is held by commercial banks. The percentage of total reserves held by commercial banks could, therefore, hint at how large a share of the total reserves are needed for transaction purposes.

Other reasons for the demand of international liquidity could be termed as ‘speculative’ and ‘policy’. The role of the speculative motive for the composition of liquidity is obvious. If a reserve currency is under speculation, that is, if there is a risk that it will be devalued, there is a strong reason for other countries to shift out of a currency and into gold or stronger currencies instead. Thus, the demand for international liquidity is analogous to the Keynesian analysis of holdings of cash.

The policy motive can also play a role for the total amount of reserves which a country wishes to hold. Some countries with a nationalist outlook want a free hand in determining their foreign policy and hence, strive to pursue an economic policy that will ensure the country having large reserves. Other countries which value economic growth highly, could be inclined to decrease their reserves and pursue expansionist policies at the risk of crises caused by too low an amount of international liquidity. Besides this analytical approach to international liquidity and factors affecting adequacy, the problem is often dealt within simple quantitative terms.

On the other hand, there are many people who argue that there is not enough international liquidity. As world trade grows, more liquidity is needed. Secondly, the persistent disequilibria in the balance of payments of the LDCs (Less Developed Countries) reinforce the need for greater liquidity. Thirdly, the most important reason for adequate liquidity is to enable a country to weather speculative storms. The net increase in the gold stock is inadequate as it is only about 2 percent per year and the increase in liquidity has to be larger if the international monetary system is to function efficiently. This is the most important argument. The only way in which international liquidity can grow under the present set up is by effecting an increase in Dollar holdings. But that presupposes deficits in the US balance of payments. There is another important reason for it. And it is irrational for the central banks to hold stockpiles of gold, as thereby they forsake interest earnings on Dollar holdings. At a 3 percent interest rate on Dollar holdings, a 3 percent devaluation of the Dollar every ten years would be necessary for gold to be as profitable a source of reserves as Dollars.

The dilemma in which the present international monetary system is caught is that more international liquidity is needed, but more liquidity cannot be created without impairing the confidence in the key currency, the Dollar.

1.3.2 Sources of International Liquidity

During the period of classical gold standard (i.e. pre-1914 era), it was the gold standard itself that “provided for an expansion of liquidity as the newly produced gold was distributed to various countries, spreading out fan-wise from the London Gold Market. Some of the new gold was taken up by industrial users and some was hoarded (mostly in the East), but the greater part became available for monetary purposes. Some of it went into circulation as coins, but the rest found its way to the vaults of the central banks, which thereby increased their gold reserves held as backing for their liabilities in notes
and deposits. The commercial banks through which the gold usually passed to the central banks to increase their cash and thus, they were able in their turn to expand credit". The supply of new gold available for monetary purposes served as the determinative factor in deciding the trend of credit expansion all around the world. Thus, the role of gold in directing the trend of world liquidity during that period has been decisive.

Today, the liquidity is provided in a variety of ways, namely,

(i) Owned Reserves, for instances, gold, holding of reserve currencies (Dollars, Pound Sterling, Yen, Deutsche Marks, Swiss Francs) reserve position of SDR in the IMF;

(ii) Ready access to official sources of finance such as low conditionality IMF credit, inter-governmental swaps and credit lines, etc., and

(iii) Credit facilities from commercial banks, for the commercially creditworthy, upto certain limits.

Owned Reserves are under direct voluntary control, so they provide a firmer basis for domestic policy management than international credit facilities can do. A country’s overall potential liquidity comprises of IMF credit offered on conditional terms, conditional credits from international agencies, governments and other resources. Since the potential credit is conditional, it is not fast-disbursing nor does it provide actual liquidity in the same sense as owned reserves of low conditionality credit.

1.3.3 Changing Role of Monetary Reserves

The international and national monetary and banking systems have undergone radical changes which have fundamentally altered the role of monetary reserves and capital movements in balance of payments adjustments from what they used to be during the period of the gold standard.

Reserves are needed in the cushioning of balance of payments deficits. The adequacy of reserves is measured in terms of the ratio of a country’s overall reserves to annual imports. Such a use of reserves was almost foreign to the writers of the classical gold standard, as this role of reserves was explicitly recognized towards the end of the World War-II only. The writers of 19th century discussed the role of monetary reserves in the context of avoidance of excessive currency issues, but never referred to a country’s imports or exports. For this purpose, they suggested either an overall ceiling on such issues or a limitation of fiduciary issues. This resulted in extremely disproportionate ratios between the central bank reserves and the level of the country’s imports.

The World War-I and the Great Depression thereafter radically changed the monetary institutions and policies worldwide and completely revolutionized the role of monetary reserves and consequently brought about fundamentally different views as to their measurement and adequacy. Here, the three most important changes must be noted:

(1) Gold coins completely disappeared from active monetary circulation, leading to a modification in the significance of the central bank liquidity. There was no more need to keep reserves by the central bank to convert bank deposits and
paper currency into legal gold tender for the purpose of domestic circulation; these were exclusively required in the context of deficits in the balance of payments of the country.

(2) International flows of private capital were no longer relied upon as a major source of cushion for current account disequilibrium in the balance of payments. Fears of currency depreciation and exchange restrictions spur private capital to flow from deficit countries to surplus countries, which aggravates, rather than cushions, the impact of current account imbalance. During the inter-War period, these movements of private capital (also known as ‘hot money’) created havoc in the international monetary system. (Even today, these movements foil a country’s exchange control legislation).

(3) Another development of the post-Worl War-II period is that official loans and grants have grown on an unprecedented scale. These now provide vast amounts of cushioning capital and have partly substituted the private capital flows of the gold standard era. To facilitate the flow of such loans and grants, a number of international institutions have been set up, such as International Monetary Fund, (IMF), International Bank for Reconstruction and Development (IBRD - the World Bank), the European Payments Union (EPU), the European Fund, the European Investment Bank, the Colombo Plan and such like.

In Robert Triffin’s opinion, official grants and loans should not be regarded as a normal and dependable source of financing temporary deficits in the balance of payments. Reasons may be sought in long and uncertain negotiations, unacceptable political or economic conditions, etc.

Monetary reserves are needed primarily to finance short-term deficits in the balance of payments and not, as earlier, to preserve the overall liquidity of individual banks. Besides temporary deficits, a country may face more fundamental disequilibria too, needing corrective action. In both cases, an insufficient level of reserves will force the deficit country to resort to otherwise unnecessary measures of definition, devaluation or restrictions to keep its payments in closer and more continuous balance with its receipts than would be called for by the need to preserve the long-term equilibrium in its international transactions. This, of course, points to the need for maintaining adequate international liquidity.

1.3.4 Evolution of International Reserve Standards

In order to settle international indebtedness, countries need some standard asset which could be placed in the reserves or taken out from reserves as required. Gold had been the traditional international reserve. J.M.Keynes made a proposal to create another standard, independent of gold and called it ‘Bancor’ (Banker’s Gold). This proposal was not accepted at the Bretton Woods and gold continued to be the means of top-level international settlement.

Though gold coinage had stopped and the evolution of development banking system had made the use of monetary gold unnecessary within a country, for international
settlements, affluent countries kept their reserves primarily in gold, while smaller nations tied themselves to the currency of the ‘great’ neighbour. The Pound Sterling performed the function of reserve assets in the 19th century and the US Dollar did so after the World War-II. In fact, all countries have kept a variety of foreign exchange assets in the present Bretton Woods era, because the volume of the gold available is small relative to international trade that has to be financed. The more important reserve currencies today are the US Dollar, Pound Sterling, Swiss Franc, Deutsche Mark and the Japanese Yen.

1.4 Balance of Payments

The ‘balance of payments’ of a country is generally defined as a “systematic record of all economic transactions between the residents of a particular country and the residents of foreign countries”. Thus, the balance of payments includes both visible and invisible transactions. The items usually included in balance of payments of any country are payments for merchandise imports and receipts for merchandise exports, loans to and investment in foreign countries and enterprises, foreign investments in domestic enterprises, borrowings from foreign countries, tourists expenditures - both by domestic tourists abroad and foreign tourists in the reporting country, money paid to foreign carriers and receipts for foreign goods carried in national carriers, cable and telegraph payments to foreign communication agencies, insurance premia paid to foreign insurance companies and those received by national insurance companies, commission received by domestic banks and paid to foreign banks, expenses of foreign establishments outside the home country and expenses on foreign embassies established in the home country, interests and divided payments and similar items.

The two sides of a balance of payments must always balance, i.e. payments to be made to outsiders must equal the receipt from outsiders. The reason is to be found in the simple fact that for everything one gets, one has to pay something in return.

The study of balance of payments of a country reveals its financial position vis-à-vis foreign countries. In fact, it is so important that balance of payments is considered to be an economic barometer of a country’s health. It can furnish a key to an understanding of a country’s economic problems. A country’s balance of payments reveals its ability to buy foreign goods or its ability to meet its foreign obligations. If a country is having a deficit in balance of payments, it may resort to import controls, exchange controls or may even devalue its currency. Thus, a study of balance of payments helps in the formulation of trade and fiscal policies. It may be useful even to those who are involved in domestic affairs only, since they too are affected by fluctuations in foreign exchange rates and by changes in price levels abroad. It is of great value in forecasting its business and economic conditions. The more accurate the material in the balance of payments, the more valuable it becomes as a basis for the study of economic and business conditions of a country. Balance of payments can also be used to evaluate a country’s international solvency and to determine the appropriateness of the external value of its currency.

Of course, there are some limitations of balance of payment data. There may be a gap between the dates when transactions take place and when they are settled. Balance of payments is usually prepared in the national currency. But transactions are often made
in different currencies. This may lead to exchange gains or losses. India prepares its balance of payments in Indian Rupees as also in US Dollars.

1.4.1 Nature of Balance of Payments

Balance of payments measures flows rather than stocks. It records only changes in assets holdings and liabilities abroad, not the levels of these items. This way, it resembles more a ‘sources and uses of funds statement’ and not a balance sheet. Balance of payments is prepared on the principle of ‘Double Entry System’ of book-keeping. Uses of funds are shown as debits and sources of funds are treated as credits.

The following could be the sources which increase the external purchasing power of a country:

(1) When a country decreases (sells) its tangible and intangible assets, including goods and services;

(2) When a country increases its liabilities to foreigners, i.e. it obtains loans from foreign countries, which could be official loans from foreign governments or from international institutions like the IMF or the World Bank or from foreign financial institutions, foreign companies or from non-resident nationals;

All these represent sources of external purchasing power and appear on the credit side.

The following could be the uses which decrease the external purchasing power of a country:

(1) When the country buys tangible or intangible assets, i.e. import of goods and services, or increases its holdings of foreign financial assets;

(2) When the country decreases its previous liabilities to foreigners.

These transactions represent uses of a country’s external purchasing power and appear on the debit side.

1.4.2 Deficit in Balance of Payments

The transactions appearing in a balance of payments can be divided into two categories, namely, (i) autonomous transactions, and (ii) induced or compensatory transactions. Autonomous transactions are those that take place because traders find it profitable to trade, the travellers find it necessary to travel for business or pleasure, banks provide their services for profit, insurance companies operate for profit and so on. In other words, no inducement is needed for such transactions and these are self-motivated.

A deficit in balance of payments exists when payments for autonomous transactions exceed receipts therefor. In case, there is a deficit or surplus, there have to be some compensatory transactions to balance the deficit or surplus. These transactions are called compensatory or induced because they are undertaken by the State or foreign exchange authorities to balance the country’s balance of payments. The examples of such transactions are official borrowings, grants received from abroad, and changes in the
country’s foreign exchange reserves. There may be some speculative transactions to take advantage of changes in exchange rates as well. Similarly, some persons may take money out of the country to earn higher rates of interest or to take advantage of what are called ‘safe havens’. The Government controls and subsidies also affect the volume and direction of these transactions.

1.4.3 Format of Balance of Payments

Balance of payments can be considered as having three major sections:

1) **Current Account**, which records flows of goods, services and unilateral transfers;

2) **Capital Account**, which shows public and private investment and lending activity. These may include foreign direct investment in India and Indian joint ventures abroad, portfolio investment in the form of global depository receipts and investment by foreign institutional investors in Indian shares, loans (official and private) net of repayments and private short term capital movements. Capital account transactions affect a nation’s wealth and net creditor position;

3) **Official Reserves Account**, which consists of (i) IMF position (a country’s contribution to IMF in the form of gold), (ii) foreign exchange reserves, and (iii) Special Drawing Rights (SDRs) allocated to the country. A change in the official reserves of a country measures its surplus or deficit on its current or capital account transaction. A surplus will lead to an increase in the foreign exchange reserves and a deficit will lead to a decline in these reserves.

The difference in (1) and (2) is also termed as the ‘basic balance’. The Reserve Bank of India refers to it as ‘overall balance’. Depending on the purpose for which it is needed, we can talk of a number of balances. The balance of goods is also referred to as ‘trade balance’. These classifications enable the policy-makers to take appropriate action in the relevant areas. If the two sides of the balance of payments do not agree, the difference is treated as ‘errors and omissions’, which may be rectified in the course of time.

The balance of payments is usually prepared for a year but may be divided into quarters as well. It can also be prepared region-wise or even country-wise. The IMF has prepared a balance of payments manual and publishes a Balance of Payments Year Book.

Changes in the underlying conditions which determine the flow of a country’s exports, imports, services or foreign investments will, of course, affect the composition of its balance of payments. The balance will be preserved but the altered composition of accounts may either be adverse or favourable to the country. For example, a temporary disturbance like a bad domestic harvest will require the import of additional foodgrains to supplement the inadequate domestic food supplies. Payments on current transactions will consequently increase and if they were previously equal to current receipts, they now exceed them. The country is said to have a deficit in its balance of payments, because it is forced to draw upon its international reserves. Had the disturbance arisen from increasing popularity abroad of its exports or from the reduction of tariffs in the importing countries, its current receipts might exceed current payments. There would be surplus in
its balance of payments causing its international reserves to rise.

Whether a disturbance in a country’s balance of payments, which causes a surplus or deficit, is favourable or unfavourable depends upon circumstances. Favourableness or unfavourableness is a relative matter. Therefore, it is better not to use these terms when referring to balance of payments but to use instead more neutral terms such as deficit or surplus.

1.5 **INTERNATIONAL MONETARY FUND (IMF)**

The representatives of 44 countries that gathered for the United Nations Monetary and Financial Conference in the little resort town of Bretton Wood in New Hampshire in the USA in July, 1944, reached two important agreements: one recommended the establishment of an International Monetary Fund (IMF) and the other called for the establishment of an International Bank for Reconstruction and Development (IBRD - the World Bank). Both the agreements have been recorded in history as important milestones in international economic cooperation.

As stated in the Articles of Agreement of the IMF, its aims are:

1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems;
2. To facilitate the expansion and balanced growth of international trade and thereby help to promote and maintain high levels of employment and real income;
3. To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation;
4. To assist in the establishment of a multi-lateral system of payments in respect of current transactions, that is, in respect of current exports and imports of goods and services;
5. To give confidence to member countries by making the IMF’s resources available to them under adequate safeguards, thus providing them with an opportunity to correct maladjustment in their balance of payments without resorting to measures of national or international stringency;
6. In accordance with the above, to shorten the duration and lessen the degree of disequilibria in the international balance of payments of members.

The IMF is the central institution of the international monetary system - the system of international payments and exchange rates among national currencies that enables business to take place among countries.

The IMF’s statutory purposes include facilitating the balanced expansion of world trade, promoting the stability of exchange rates, avoiding competitive currency devaluations, and helping in the orderly correction of a country’s balance of payments problems. To achieve these goals, the IMF:
• Monitors economic and financial developments and policies in member countries and at the global level and gives policy advice to its members based on its six decades of experience;

• Lends to member countries with balance of payments problems, to provide temporary financing in support of adjustment and reform policies aimed at correcting the underlying problems;

• Provides the governments and central banks of its member countries with technical assistance and training in its areas of expertise.

By working to strengthen the international monetary system and to accelerate progress towards reducing poverty as well as promoting sound economic policies among all its member countries, the IMF is making globalization work for the benefit of all.

The membership of the IMF originally comprised of 44 attending countries. Since then, it has increased to 185 countries in January 2007. Each member appoints one Governor-Member to the Board of Governors, the highest rung in this hierarchical organization. Below the Board of Governors in the hierarchy are the executive directors who are concerned with the real day-to-day management. There must be at least 12 such executive directors. The five largest contributing member countries appoint one director each and the rest are elected by the remaining countries.

Each member of the IMF is allocated a quota, the size of which varies according to the importance of that country. The sum of all quotas was established at US$ 88.8 billion in 1944. This can be compared with the figure for the total world liquidity, which at that time amounted to approximately US$ 38 billion. It should be noted that each country’s quota determines its voting rights and thereby, the influence of that country. In the beginning, the USA was dominant as its quota amounted to 56 percent of the total holdings of the IMF. This American quota has since then decreased to 22 percent, but the United States, together with UK and some other Western European countries, still retains a controlling interest in the IMF. The general quotas have since then increased twice, by 50 percent in 1959, and by 25 percent in 1966. Including the new members, the second increase brought the total IMF quotas to US$ 21 billion.

A country’s quota thus has three important functions : (i) it specifies how much the country must subscribe to the IMF in terms of gold and its own currency - of this subscription, 25 percent must be paid in gold and the rest in the currency; (ii) the quota defines a country’s drawing rights, i.e. how much a country can borrow from the IMF; and (iii) it indicates the country’s voting power.

The most important aspect is the drawing rights. Each country’s drawing right is divided into five parts. The first part is called the ‘gold tranche’ (portion), because it corresponds to the country’s subscription in gold. The remaining four parts are called the ‘first’, the ‘second’, the ‘third’ and the ‘fourth’ credit tranches. The importance of the drawing rights lies in the fact that a country can draw on the IMF and use the currency it obtains to cover deficits in its balance of payments. Under the IMF practice, a country can automatically make the use of its gold tranche. Also, it can usually use its first credit
tranche without much difficulty. Further drawings, however, depend upon the approval of the IMF. The conditions of approval become more and more stringent as a country applies to go beyond its first credit tranche. Usually, a country must repay the funds within three to five years and there is an increasing scale of interest on drawings that go beyond the gold tranche.

Thus, the IMF has a discretionary power which it uses to ensure that a country drawing upon its resources will use the breathing space thus acquired to correct its balance of payments position. Its object is to help the countries to meet temporary deficits and give them time to correct deep-seated maladjustment. In case of persistent disequilibria, the country itself is free, under the provisions of the IMF, to depreciate its currency up to 10 percent, but after that limit, it has to seek the approval of the IMF.

Instead of devaluation, the IMF stresses on the importance of internal measures, such as reduction of expenditure to keep the balance of payments equilibrium. Of the three types of reduction, i.e. expenditure reduction, expenditure switching and provision of liquidity, only the first one is generally relied upon.

On the whole, it can be said that the IMF has been playing a conservative role in maintaining the international liquidity and reserves. However, the nature of assets and, therefore, of reserves changed. Before 1914, the critical limit to reserves was the amount of gold held by central banks and the limit to the growth in the stock of gold over time. The latter was the function of gold mine production and absorption of gold in the industry and arts. In fact, by 1930, an imminent shortage of gold compared to the amount required to support the monetary demand for it at the prevailing price level, and assuming a growing world economy, was felt. Soon after that, the standard began to crumble with sterling moving off gold in 1931, followed by other industrial countries between 1933 to 1936. This led to instability in the world economy. This was aggravated by the outbreak of World War-II.

For 15 years after the end of the War (1945), concern about the liquidity remained subdued as the balance of payments deficits of the United States enabled other countries to rebuild their reserves, both by accumulating US dollars and buying from a fairly large gold holdings of the US. This stretched the US economy and a need to create an international asset that (unlike gold or reserve currencies) would have no other function than to serve the need of the system for an adequate but not excessive quantity of reserves.

Thus, in order to provide extra liquidity, a new type of reserve asset was introduced by the IMF on 1st January, 1970, called ‘Special Drawing Rights’ (SDRs). These were allocated to various nations in proportion to their quotas in the IMF, to meet a long-term global need to supplement existing reserve assets. A member may use SDRs to obtain foreign exchange reserves from other members and also to make payments to the IMF. Such use does not constitute a loan; members are allocated SDRs unconditionally and may use them to meet a balance of payment financing need without undertaking economic policy measures or repayment obligations. However, a member that makes net use of its allocated SDRs pays the SDR interest rate, while a member that acquires SDRs in excess of its allocation receives interest. The SDR also serves as the unit of account for the
IMF and the SDR interest rate provides the basis for calculating the interest charges on regular IMF financing and the interest rate paid to members that are creditors to the IMF. The supply, valuation and interest-payable on the SDRs are all determined by the IMF. On 1st January, 1970, 3.5 billion of SDRs were created. By 1981, a total of SDR 21.4 billion were allocated to members in two allocations.

In January, 1970, one SDR was equivalent to one US Dollar. When all currencies began to float freely in 1973 and the value of the Dollar began to fall, it became desirable to establish an independent value for the SDR. Prior to 1981, the composition of the SDR was based on a basket of 16 currencies representing the world’s major trading currencies. Daily calculation of the values of all these currencies was a difficult task. Hence, it was decided to change over to a simpler system. From 1st January, 1981 onwards, the value of an SDR unit consisted of a basket of only five currencies (USA, West Germany, UK, France and Japan). These five currencies and the weights assigned to them under various revisions are shown in Table 1.1

Table 1.1
SDR Valuation Basket - Weights assigned to the Currencies

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>U.S. Dollar</td>
<td>4.2</td>
<td>4.2</td>
<td>4.0</td>
<td>3.9</td>
</tr>
<tr>
<td>2.</td>
<td>Deutsche Mark</td>
<td>1.9</td>
<td>1.9</td>
<td>2.1</td>
<td>2.1</td>
</tr>
<tr>
<td>3.</td>
<td>Japanese Yen</td>
<td>1.3</td>
<td>1.5</td>
<td>1.7</td>
<td>1.8</td>
</tr>
<tr>
<td>4.</td>
<td>French Franc</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
<td>1.1</td>
</tr>
<tr>
<td>5.</td>
<td>Pound-Sterling</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: IMF’s Annual Reports for the respective years.

As the consolidated financial statements of the IMF are expressed in SDRs, it would be prudent to briefly discuss this tool of international liquidity at the disposal of the IMF and its member countries. The SDR is an international type of monetary reserve currency, created by the IMF in 1969, which operates as a supplement to the existing reserves of member countries. The SDR was created in response to concerns about the limitations of gold and dollars as the sole means of settling international accounts. The SDRs are designed to augment international liquidity by supplementing the standard reserve currencies.

The SDRs can be regarded as an artificial currency used by the IMF and described as a “basket of currencies”. The IMF uses SDRs for internal accounting purposes. The SDRs are allocated by the IMF to its member countries and are backed by the full faith in and credit of the member countries’ governments.

Initially, the “basket of currencies” used to determine the value of the SDR included (a) US Dollar, (b) German Deutsche Mark, (c) Japanese Yen, (d) French Franc, and (e) British Pound-Sterling.
1.6 SELECTION OF RESEARCH TOPIC AND AUSPICES

Alike other social scientists, economists also have evolved certain investigative methods for adding to the knowledge base of their discipline. These methods are both deductive and inductive.

For the purpose of the present research work, the researcher has mainly used the historical method (as distinct from historiography), one of the inductive methods, for broadly evaluating the IMF’s role in maintaining the international liquidity within the framework of the international monetary system, with particular reference to the IMF and the international financial system, the IMF’s surveillance activities and the IMF’s financial operations, for the period of seven years from FY 2001 to 2007.

Given the new politico-economic world order that has emerged after the fall of the Soviet Bloc in the 1990’s, it has become incumbent on the IMF to pay particular attention to the above stated areas of the international monetary system. It is also felt that the historical research method of Economics is the most appropriate one for the purpose of the present work. Accordingly, the work has been carried out under the auspices of the Economics.

1.7 STATEMENT OF THE PROBLEM

In view of the foregoing discussion, the statement of the problem has been formulated as: “A STUDY OF INTERNATIONAL MONETARY SYSTEM IN RELATION TO INTERNATIONAL LIQUIDITY”.

1.8 OBJECTIVES OF THE STUDY

The following have been set out as the objectives of the study:

1. To take a historic review of the IMF’s role in strengthening international monetary system during the period from 2001 to 2007;
2. To review the IMF’s surveillance activities during the period from 2001 to 2007;
3. To review the IMF’s role in maintaining international liquidity during the period from 2001 to 2007; and
4. To derive such meaningful conclusions as may be appropriate.

1.9 HYPOTHESES OF THE STUDY

A cursory scrutiny of the primary data statistics gleaned from the IMF’s annual reports for the study period revealed that the following five hypotheses could be taken up for testing under this work:

(1) Over the study period (FY 2001 to 2007), the global official holdings of reserve assets of the developing countries increased significantly compared to the industrial countries;
(2) Over the study period, the global official holdings of gold of the developing countries increased significantly compared to the industrial countries;

(3) Over the study period, the share of US Dollar in the global official holdings as foreign exchange reserves has decreased, the share of Euro has increased.

(4) Over the study period:
   (a) the share of US Dollar in global official holdings as foreign exchange reserves increased significantly in the developing countries as compared to the industrial countries;
   (b) the share of Euro in global official holdings as foreign exchange reserves increased significantly in the developing countries as compared to the industrial countries;

(5) Over the study period, the total reserves of IMF-related assets held by the member countries have gone on decreasing.

1.10 Data Collection

The Indian literature available on the IMF is mostly in the textbook format for the students of international economics. On the other hand, the IMF itself annually publishes a plethora of reports, country reports, working papers and books, both in printed and video formats and also on the Internet, and it is rather difficult to precisely classify these sources into primary and secondary categories. Nonetheless, the IMF’s annual reports for the years 2001 to 2007 have been considered as the primary sources and all the remaining literature has been treated as the secondary sources.

The primary sources included the following:

(1) IMF’s Annual Report for FY 2001,
(2) IMF’s Annual Report for FY 2002,
(3) IMF’s Annual Report for FY 2003,
(4) IMF’s Annual Report for FY 2004,
(5) IMF’s Annual Report for FY 2005,
(6) IMF’s Annual Report for FY 2006, and

The selected contents of the above primary sources were taken up for a detailed analysis against the concepts of IMF’s Role in Strengthening International Monetary System (Chapter-3), IMF’s Surveillance in Action (Chapter-4) and IMF’s Role in Maintaining International Liquidity (Chapter-5) of the Thesis.

A detailed list of the secondary sources used for analyzing the primary data has been presented in the Bibliography part of the Thesis.
Both the primary and secondary sources have been compiled by visiting the Gokhale Institute of Politics and Economics (GIPE), Pune, being the IMF’s authorized library in Western India. Some other books that were not available with the GIPE were purchased from the IMF’s authorized stockists in Mumbai. The IMF’s annual reports for the relevant years were downloaded from its website on the Internet (http://www.imf.org). The books and periodicals in the public/academic libraries or personal collections that could not be borrowed were xeroxed or hand-copied. Particularly useful were:

1. Barr.Khardekar Library, Shivaji University, Kolhapur,
2. Chh.Shahu Central Institute of Business Education & Research, Kolhapur,
3. Barr.M.R.Jaykar Library, Pune University, Pune,
4. Gokhale Institute of Politics and Economics, Pune,
5. Jawaharlal Nehru Library, Mumbai University, Mumbai.
6. Reserve Bank of India Library, Mumbai.

1.11 DATA ANALYSIS AND INTERPRETATION

After collecting the needed data/information, it was neatly organized both topically and chronologically. The information of the primary significance was interpreted by juxtaposing it against the secondary data to derive meaningful observations.

1.12 SCOPE OF THE STUDY

The IMF is a truly international colossus organization. Its policies have far-reaching implications for every country in the world - whether an IMF member or not. Especially, after the globalization of the world economy consequent to the emergence of the WTO (World Trade Organization), the IMF’s role and responsibility in maintaining a balance in the international economy has increased multi-fold.

However, within the resource constraints of the present work, its scope has been confined only to reviewing select areas of IMF’s operations.

1.13 CHAPTER SCHEME

The Thesis is divided into Five Chapters as under:

Chapter-1 : Introduction and Research Design,
Chapter-2 : IMF’s Role in Strengthening International Monetary System (2001-2007),
Chapter-3 : IMF’s Surveillance in Action (2001-2007),
Chapter-4 : IMF’s Role in Maintaining International Liquidity (2001-2007),
Chapter-5 : Epilogue.

A Select Bibliography concludes the Thesis.
1.14 **Review of Literature**

Fritz Machlup (1966), writing about the reform of the **International Monetary System**, in his book titled “International Monetary System” has devoted a whole chapter of 85 pages to the topic. In the course, he has touched on such issues as foreign reserves, their growth, composition and distribution; the International Monetary Fund; difficulties with the balance of payments; inadequacy of international reserves; and the danger of the collapse of the system. Then, he has progressed on to extensively elaborate on various reform measures such as extension of the gold exchange standard, mutual assistance among central banks, centralization of monetary reserves and reserve creation, increase in the price of gold, and freely flexible exchange rates. In conclusion, he observes that an intelligent choice among these measures would have to depend on many conditions, and one cannot ascertain whether and to what extent they are fulfilled. What under certain circumstances would appear as the best solution may under other circumstances be hopelessly wrong. In economic policy decisions, much depends on how they fit in with other measures adopted and objectives accepted. Monetary policy, credit and fiscal policy, commercial policy, wage policy, investment policy, growth policy, employment policy, counter-cyclical policy etc. are so closely related to one another that it would not be possible to formulate a rational policy concerning the international monetary system, irrespective of all other areas of economic policy.

Policies regarding the international monetary system must take account of the measures and intentions of the governments of a multitude of nations. The theories entertained by influential monetary experts will, of course, be important, but what is really decisive in the relevant considerations are the notions, the beliefs, the courage, and the powers of persuasion of central bankers, ministers of finance, and other leaders of economic policy in the major countries. Consequently, one cannot possibly expect that there will be one particular plan among all plans for the international monetary system that may be singled out and proclaimed as “the best” under any set of conditions.

To say this is to not to make a virtue of indecision. Sooner or later, the reform of the present system will have to be taken up seriously. The stop-gap solution initiated at the Vienna meeting of the IMF and formalized in the ‘General Arrangements to Borrow’ and the bilateral credit swap arrangements between the United States and several other countries may tide us over the worst difficulties for some time, possibly even for several years. To be sure, we should never expect a solution that is really definitive, but perhaps we may hope for one that can dispel for a longer time the apprehensions, nervousness and fears of collapse. 8

H. Robert Heller (1977), writing about **International Monetary System**, in his book titled “International Monetary Economics”, explains that most international commercial and financial transactions are undertaken by individual economic units for the purpose of their own gains. It is seen that welfare maximization of households and profit maximization by firms serve as the motivating force behind international transactions. Gains from specialization and exchange may be identified. Free international exchange of goods and services leads to a more efficient resource allocation in the
production of commodities and increases the utility that can be derived from the commodity bundle produced during the current period. These international transactions are recorded in the goods-and-services account of the balance of payment. The capital account of the balance of payments records the transactions that involve the transfer of titles of ownership or financial assets. Capital account transactions lead under competitive conditions to an optimization of intertemporal production and consumption patterns. Individual economic nits may reap additional gains from intertemporal optimization made possible on a worldwide basis through capital movements. Most of the problems in the international monetary system are the problems of adjustments to new disturbances. If there were no new disturbances, the pure theory of international specialization and exchange would be adequate to handle most problems in analysis.

Then, Heller states that there remains the question whether it is possible to devise an institutional framework that will minimize the costs associated with international adjustments and thereby help to maximize the benefits to be derived from international transactions. Such an optimal international monetary system would consist of a set of institutions or rules that would bring about speedy adjustment at minimum cost. To devise such a system is no mean task, and history has shown that the various systems tried out did not survive severe crisis situations.

For example, the pre-World War-I gold standard broke down when the stresses imposed by wartime inflation could not be overcome by adjustments triggered by specie flows. The flexible exchange rate system tried during the interwar period fell victim to the nationalistic policies instituted by countries attempting to overcome Great Depression. The IMF-Dollar system of the post-World War-II is being subject to severe strains as a result of the deterioration of the dollar’s predominant position on the world scene.

Whether it is possible to devise a system that would have weathered all these crisis situations and still have provided smooth and efficient adjustment is highly questionable. Any system that is to be used effectively in the future must assure that a mix of various adjustment methods can be used to rectify international disequilibrium situations. The precise method to be used in any given set of circumstances will vary depending on the state of the economy of the countries affected. Flexibility to pursue optimal national economic policies tempered by the constraint that these policies should not impose any greater costs on other countries is one of the basic requirements for any such system. Devaluation to remedy domestic unemployment problems - to mention only one frequently cited example - should not be allowed if this merely shifts the unemployment to other countries. Yet, the same policy may be mutually advantageous if the developing country’s trading partners experience full employment and excess-demand inflation.

In recent years, it has been proposed to widen the margins within which exchange rates are free to fluctuate. This is a step in the right direction. While there is no magic about a band of permissible fluctuations of 1 percent versus 2.25 percent or 5 percent, it shows that under different circumstances, the optimal width of the band may change.
Similarly, countries are often willing to let the rate of inflation or unemployment increase by 1 or 2 percent if this will help to achieve external equilibrium. However, there is a strong reluctance against permitting high rates of inflation or unemployment for external reasons alone. This may well be an indication of official concern about the increased marginal costs of adjustment associated with the various adjustment methods. Flexible use of a variety of adjustment methods tailored to the specific circumstances under which they are used may help to reduce the burden of adjustment to international monetary disturbances and therewith contribute to an improvement in the welfare of the citizens of all the countries.  

Francis Cherunilam (1988) explains international liquidity in lucid terms. He states a country having a balance of payment deficit has to settle it by transferring some generally acceptable means of international payments to the creditors. International liquidity refers to such generally accepted means of international payments, available for the settlement of international payments. Thus, international liquidity encompasses international reserves and the facilities for international borrowing for financing the balance of payments deficit. International reserves are defined to include official holdings of gold, foreign exchange, SDRs and reserve position in the IMF. The international liquidity, however, does not include private holdings of gold and foreign exchange and long-term international financing.

An adequate stock of reserves is the one that is consistent with the smooth functioning of the international monetary system, an expansion of world trade and the absence of persistent inflation or deflation. An adequate level of resources may be larger or smaller than the desired holdings of reserves under a particular set of asset prices and economic conditions.

An appraisal of adequacy of international reserves must take into account both the factors affecting the demand for reserves and those determining the supply. The expected size and volatility of payments imbalances are the principal determinants of the demand for industrial relations. Of particular importance in this regard are a country’s exchange rate arrangements and the pace of its adjustments to external imbalances. Moreover, the variability of private capital flows and debt service charges experienced in recent years adds to the importance of holding adequate international reserves for the purpose of accommodating temporary payments imbalances and avoiding disruptive adjustments of the domestic economy. The supply of reserves depends primarily on the financial policies of the reserve currency countries, the state of international capital markets, and quantitatively on the policies determining the supply of fund related reserves assets.

The demand for international reserves is also influenced by the access many countries have to international financial markets. During 1970s and 1980s, a number of countries relied on borrowings in international capital markets as an alternative to owning reserves. This suggests that it might be more appropriate to consider the adequacy, not of reserves alone, but of the international liquidity also - a broader concept that takes into account the borrowing capacity of countries.
About the IMF and the international liquidity, he writes that a major function of the IMF is to provide international liquidity in accordance with the purpose specified in the Articles of Agreement. Part of the liquidity supplied takes the form of reserve assets that can be used for balance of payments financing (unconditional liquidity), while other takes the form of credit to members that is generally subject to conditions (conditional liquidity).

Conditional liquidity is provided by the IMF under its various lending facilities. Most of the IMF’s credit extended under these arrangements requires an adjustment programme for the member that is intended to promote a sustainable external position. In addition, it is often the case that when the member obtains fund financing under agreed conditions, its access to international capital market is enhanced. This catalytic role of the IMF has become more important in the recent period when private lending institutions have been less willing to engage in international lending.

Unconditional liquidity is supplied through the allocations of Special Drawing Rights (SDRs) and also in the form of reserve positions in the Fund, which are the claims corresponding to the resources that countries have made available to the Fund. Member countries holding SDRs and reserve positions in the Fund can use them to finance balance of payments deficits, without having to enter into policy commitments with the Fund.

The Fund makes its resources available to members, under agreed conditions, to help them overcome balance of payments problems in an orderly way, without undue disruption of the flow of international trade and payments. Several facilities are available for extending credit to members for varying periods of up to ten years and subject to different degrees of conditionality. For example, the extended fund facility, which was set up in 1974, is designed to assist members experiencing protracted payment difficulties, whose correction requires sustained effort through appropriate policies.

In credit arrangements that envisage policy actions to be taken by the member, the use of Fund’s resources is normally made conditional upon continued policy action in accordance with a programme agreed upon between the member and the Fund. However, no policy adjustment would normally be required when the need for balance of payments financing is of a temporary character, resulting solely from circumstances believed to be likely to reverse themselves in the near future, as under the compensatory financing facility designed to meet temporary shortfalls in export earnings.

The limits placed under present policies on a member’s use of Fund’s credit facilities are defined in terms of the member’s quota in the Fund. For example, to meet a shortfall in export earnings, a member may draw from the Fund up to 100 percent of its quota. On the other hand, in order to meet a protracted and structural balance of payments problem, a member may, subject to certain conditions, borrow Fund resources up to 150 percent of this quota in any year, up to 450 percent over three years, and, in some circumstances, up to a cumulative limit of 600 percent of its quota, apart from any amounts borrowed by the member under the compensatory financing and buffer stock facilities.

The number of countries using Fund resources has increased substantially over the years. During this period, while the amount of outstanding Fund credit has shown a
considerable cyclical variability, it has registered a substantial increase. The proportion of the outstanding Fund credit subject to high conditionality has also increased quite substantially during the last few years. This evolution has resulted mainly from the need for more active adjustment policies of members using Fund resources in present circumstances and in the light of the continuing requirements for safeguarding the revolving nature of the Fund’s resources.\textsuperscript{10}

A Critique of IMF Operations

The IMF has, in some respects, been a disappointment because:

(1) The resources at its disposal have been inadequate, partly because of the failure of the former Iron Countries (East European countries under USSR’s influence) to participate, and partly because global inflation, rises of income and the accompanying increase in trade.

(2) Because of the worldwide scramble for the US Dollars, most other currencies were not in great demand. Generally speaking, with quotas equal to about 10 percent of imports and borrowings limited in any one year to 25 percent of the quota, the members could obtain aid equal to only 2 to 3 percent of their import trade at the most in any one year. Obviously, greater resources are needed.

(3) Disappointment at the contributions made by the IMF is due to the failure of exchange adjustment to bring about equilibrium conditions. Behind the IMF is the theory that the exchange rates related to the requirements of the international balance would bring equilibrium, or at the very least, make an important contribution to it. Here, the unwillingness of some countries to adapt exchange rates to international situation is relevant. For example, the IMF had to accept the rates in effect at the end of 1946, even though these were clearly overvalued generally \textit{vis-a-vis} the US Dollar (the French refusal in 1948 and the British confrontation in 1949). Even when devaluation was resorted to, and frequently it was, its efficacy did not prove to be as great as was expected.

(3) Thirdly, the transitional problems were much more serious than had been anticipated. The disequilibrium was one that had to be treated with IMF’s vigorous policies to deal with structural maladjustments, both long- and short-term.

(4) Unfortunately, the IMF was distinctly limited in its competence of controlling domestic policies. Members are free to pursue policies based on their respective fundamental social and political objectives and the IMF cannot refuse a member’s proposal for a revision of exchange rates on grounds of disapproval of policies related to these objectives. Indeed, as a condition for the purchase of a country’s currency (generally for Dollars), the IMF might urge modification in domestic policies, but there is little evidence that the IMF wielded much influence in the past.

Yet, inspite of these critical comments, it is also true that throughout the history, the Bretton Woods system has served the world economy reasonably well. During the 1950’s, remarkable strides were made towards the reduction of trade barriers and payment
restrictions. Gottfried Haberler wrote in 1965 that, “broadly speaking and comparing the post-War performance with earlier periods, especially the inter-War period, it would seem that the present system has done very well indeed. The world economy has developed quite satisfactorily since the War-II. World trade has grown by leaps and bounds, not only in value but also in real volume (in terms of constant prices). The annual compound growth rate in real terms was something like 8 percent a year, which is very high. Historically speaking, even if we allow for the fact that the starting point at the end of the War-II was a very low one”.

However, in a sense, during this period, the system was operating on borrowed time. The ‘tearless deficits’ of the 1950’s left the USA, as well as the rest of the world, with a legacy in the form of the large ‘overhang’ of foreign Dollar holdings, which threatened a crisis of confidence. Direct arrangements, called the ‘swaps’ between the central banks of the leading industrial countries (the Group of 10) could not help the situation. Furthermore, the major source of expanding industrial liquidity had dried up. This occurred not by elimination of the US deficit, but rather by the diminution in the quality of the Dollar in the view of many foreign Dollar holders. The proliferation of the balance of payments controls imposed by the United States, beginning in the middle of the 1950’s, further testifies to the costliness of balance of payments adjustments when the exchange rate changes are ruled out. It is clear that Triffin has a considerable cause when he writes, “the gold-exchange standard is dead. The next question is, whether reforms within the existing system (as contemplated in the creation of SDRs by the IMF would suffice or a wholly new system will have to be introduced”.

References

4. Ibid., p.17.
6. See 1.3.2.