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# The IMF – A Success Story?

by Hans-Eckart Scharrer, Hamburg\*

**Is the International Monetary Fund (IMF) the mainstay of the international monetary system? Or is it an insignificant sideshow? Might its actions, or its very existence, even be harmful? The fortieth anniversary of the Bretton Woods Agreement, which was signed by 44 states on 22 July 1944, affords an opportunity to assess the activities of the Fund and to outline its possible contribution to coping with future tasks in the world economy.**

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The Bretton Woods Agreement was part of a comprehensive attempt to re-establish orderly economic relations after the disintegration of the world economy in the thirties and the destruction of Europe during the second world war. The governments were unanimous in believing that exchange controls and competitive currency devaluations ("beggar-thy-neighbour" policies) were incompatible with the objective of a steady, prosperity-fostering growth in world trade. They were also fundamentally prepared to accept certain constraints on their exchange rate policies in the interests of stable monetary relations. However, the United Kingdom and the United States held diametrically opposed views on fundamental issues concerning the concrete shape of the monetary order and the role of the IMF.

## Negotiating Positions at Bretton Woods

The United Kingdom, as a potential deficit country without notable gold reserves, put forward the Keynes Plan, which advocated the creation of a new international liquidity and reserve instrument linked only nominally to gold ("Bancor") and the granting of substantial automatic credit lines ("drawing rights"). It also strove to give countries a large degree of autonomy in domestic economic policy: deflationary policies to safeguard external equilibrium under a system of fixed exchange rates no longer seemed acceptable in a democratic mass society. Instead, the most important instrument of balance-of-payments adjustment was to be the exchange rate.

By contrast, the policy of the United States, as a putative surplus country with large gold reserves and intact production capacities, was directed towards limiting the transfer of resources abroad unless real consideration was received in return. The White Plan submitted by the US Government set out the model of a monetary order based on gold – and hence equally on the gold-convertible dollar – with restricted drawing facilities subject to economic policy conditions and with essentially fixed exchange rates.

The controversy seems astonishingly topical. Of course, the debate no longer revolves so strongly around the question of exchange rate policy and the battle-lines are no longer drawn between the United Kingdom and the USA, but differences of opinion remain between debtor and creditor countries, between poor and rich economies on the automaticity or conditionality of finance and in general on the relative importance of financing and adjustment and the role of the IMF in this respect. In 1944 this conflict appeared to have been resolved by a compromise; the United Kingdom accepted restrictions on drawing rights and the United States withdrew its insistence that the deficit countries' obligation to adjust their domestic economic policies be embodied in the Agreement. It was not to be the final compromise on this issue.

## The Tasks of the IMF

The signatory states defined the aims and responsibilities of the IMF as follows in Article I of the Fund Agreement:

- "To promote international monetary cooperation" – the Fund is not a supranational authority.

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□ “To facilitate the expansion and balanced growth of international trade” – employment, growth and development are the ultimate objectives of economic policy, but not the direct concern of IMF activities.

□ “To promote exchange stability”: under Article IV, member states were obliged to maintain fixed exchange parities against gold or against the US dollar. There was provision for parity changes only in the event of otherwise undefined “fundamental disequilibrium” and they required the approval of the Fund.

□ “To assist in the establishment of a multilateral system of payments in respect of current transactions ... and in the elimination of foreign exchange restrictions which hamper the growth of world trade.” This constitutes rejection of the bilateralism of the thirties and foreign exchange restrictions in trade in goods and services. At the same time member countries are given responsibility for regulating capital movements. Furthermore, Article VI prohibits member states from using Fund resources to cover a substantial or lasting outflow of capital.

□ “To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with an opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity”.

□ “To shorten the duration and lessen the degree of disequilibrium in the international balances of payments.”

To what extent has the IMF been able to realise these aims?

### **In the Shadow of the Marshall Plan**

On 6th May 1946 the Fund began its activities with the first meeting of the Executive Board – and led a twilight existence for the next ten years. True, the Executive Board did take significant steps that paved the way for the Fund’s future activities. The practice of annual consultations with member states was developed and, with good economic logic, gradually extended to domestic monetary and fiscal policy. As far as lending operations were concerned, in 1952 it was decided, under strong American influence, to divide drawings into tranches with increasing economic policy conditionality and to give loans maturities of three to five years. The *standby arrangement* was created.

The Fund’s actual influence on exchange rate and foreign exchange policies and its contribution to trade

liberalisation in Europe and in the broader Atlantic economic area remained slight, however:

□ It played a passive role in the devaluation of the pound sterling by 30.5 % on September 18, 1949 and the consequent devaluation of thirteen further currencies. It was unable to prevent the floating of the Canadian dollar.

□ Despite the evident need for finance on the part of member countries, drawings fell to a minimum from mid-1948 onwards; the American-inspired decision not to grant IMF loans to countries receiving aid under the Marshall Plan meant that the Fund had disqualified its own “customers”.

The driving forces behind the reintegration of the world economy were primarily the Marshall Plan and the efforts within the OEEC and the European Payments Union (EPU) to liberalise trade and overcome bilateralism in Western Europe. In the monetary field the EPU and its agent, the Bank for International Settlements (BIS), performed functions that made the IMF dispensable. As a clearing system, the EPU ensured the multilateral settlement of balances arising in intra-European payments. As a credit system, it provided automatic credit for a portion of balance-of-payments deficits; the remainder was settled through transfers of gold or dollar holdings. Surplus countries acquired corresponding claims on the EPU.

By the end of the first decade of the IMF’s existence the aims of the Bretton Woods Agreement had been largely achieved: international monetary cooperation was functioning; trade was steadily expanding; exchange rates were stable; a multilateral clearing system ensured smooth payment transactions; exchange controls on international trade had been largely dismantled; the financing of temporary balance-of-payments deficits was assured. And yet the Fund had played practically no part in these achievements. Deprived of any important function, its dissolution was an obvious possibility.

### **The Fund’s Heyday: 1956-68**

With the heyday of the Bretton Woods system in the sixties, the IMF also blossomed. The period was marked by a high degree of freedom in foreign trade (including capital transactions), stable exchange rates and close collaboration among monetary authorities on external monetary policy. The IMF played a significant role as an organ of cooperation and deficit financing. Research and negotiations on expanding the liquidity base of the system were begun, terminating in the agreement on

special drawing rights in March 1968. Nevertheless, the disregard of the rules relating to balance-of-payments adjustment by both deficit and surplus countries, the unchecked expansion of international (dollar) liquidity and the insistence on autonomy in domestic economic policy were already sowing the seeds of the subsequent crisis in the system.

On 27 December 1958 fifteen Western European countries made their currencies convertible for foreigners. Two years later, on 15 February 1961, most of them accepted the obligations of Article VIII of the IMF Articles of Agreement, whereby they agreed to dispense with any autonomous restriction on commercial payments. Their action became an example to others: by the end of the sixties thirty-four countries, including all the industrialised countries, had lifted restrictions of this kind. Curbs on capital movements were also gradually eased and, by some countries, removed, to a large extent owing to the liberalisation initiatives within the OECD. The IMF took account of this development in 1961, when it permitted the financing of balance-of-payments deficits attributable to capital movements. Indeed, the sixties constituted a transitional period, in that capital flows reached proportions that made it difficult for some countries to maintain fixed exchange rates under a regime of convertibility; on the other hand, the international financial markets had not yet developed to the point where large-scale balance-of-

payments financing could be carried out without the involvement of the IMF.

### Strong Demand for IMF Loans

The demand for IMF loans set in with the Suez crisis. France and especially the United Kingdom concluded standby arrangements with the Fund in 1956-57 and made substantial drawings. The volume of drawings consequently shot up to \$ 1.1 billion and the Fund's commitments under standby arrangements to just under \$ 1 billion. This was more than in all previous years together. The quotas had proved sufficient for a decade, but now a general increase of 50 % appeared to be necessary and was implemented in the autumn of 1958. A further increase in quotas followed in 1966, bringing the overall total to more than \$ 21 billion. By then the Fund had become firmly established as a special credit institution for medium-term balance-of-payments finance. The largest borrower was the United Kingdom, which repeatedly made large drawings on the IMF during the sixties and up to 1977, but other industrial countries and a growing number of developing countries were now also making use of the drawing facilities.

Nevertheless, the IMF was not the only forum for monetary cooperation in the sixties, and probably not even the most important one. The Group of Ten leading industrial countries distinguished itself by its close

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cooperation in monetary affairs, which found visible expression in actions such as the creation of a number of regional financing facilities. In the medium-term credit sphere, the Group of Ten granted the IMF additional credit lines totalling initially \$ 6 billion in 1962 under the General Arrangements to Borrow (GAB), which were intended to supplement the Fund's resources should a participating country have a substantial financing requirement. The IMF made repeated use of this facility in lending to the United Kingdom. In the short-term area, the Basle Agreement created a credit line of \$ 1 billion at the BIS; this supplemented the swap arrangements, then totalling \$ 6.8 billion, that had been agreed between the Federal Reserve Bank of New York on the one hand and the central banks of the Group of Ten and a number of other countries on the other.

### **A World Central Bank?**

The Group of Ten was also the context in which most of the consultations on reform of the liquidity base of the international monetary system took place. In 1960 Robert Triffin had warned that the growth in gold and dollar reserves might not keep pace with the growing demand for international liquidity; three years later the Group of Ten began to consider the creation of a new, composite reserve instrument, the volume of which would be set according to objective criteria and which would be used in transactions among the Group of Ten, the main trading nations of the world. The IMF was only marginally involved in the discussions and negotiations, even though consensus gradually developed within the Group of Ten that the new liquidity instrument – the special drawing right (SDR) – should be issued and administered by the IMF and made available to all member states. The Rio Agreement of 1967 and the amendment of the Fund's Articles of Agreement were therefore based largely on the work of the Group of Ten and reflected the conflicts of interest within the Group – primarily between France and the USA – and the compromise formulae devised to resolve them. The amendment of the Articles nevertheless meant a considerable upgrading of the IMF from the point of view of monetary policy. Many already saw it as a future world central bank that would manage the growth in international liquidity according to rational criteria oriented towards stability and growth in the world economy.

This expectation was in marked contrast to the Fund's real capabilities. In fact, the record of the Fund's activity in this "golden age" of the Bretton Woods system demonstrates its fundamental weaknesses. It is true that since 1956 it had established itself as a significant

provider of medium-term balance-of-payments credit, so that its right to exist would stand up to scrutiny. Through its lending and regular consultations it also probably helped prevent the introduction of new trade restrictions in defence of exchange rates. On the other hand, it could not be overlooked that member states, and in particular the larger ones, were not prepared to allow the Fund to interfere in their exchange rate and foreign exchange policies, let alone their domestic monetary, fiscal and economic policies. It was therefore unable to prevent the unnecessarily long defence of unrealistic exchange parities – indeed, it may even have contributed through the granting of substantial credit lines. The conditionality of its loans did not in any case prove to be an effective instrument for inducing necessary exchange rate adjustments; this always remained the prerogative of the market.

### **Bystander at the Smithsonian Agreement**

The weakness of the IMF's influence on the exchange rate policies of member states became clear when the Bretton Woods system of parities ran into serious difficulties at the end of the sixties and finally collapsed in the spring of 1973. The Fund could only watch when in the spring of 1971 the Federal Republic of Germany and other European countries set the exchange rates of their currencies free to float in contravention of the rules of the IMF Agreement and when President Nixon and his Treasury Secretary Connally officially "suspended" the gold convertibility of the dollar on 15 August 1971. The Fund did submit a number of sample calculations at the consultations on the Smithsonian Agreement in December 1971 on a multilateral realignment of exchange rates, but the political negotiations on the new parity grid were ultimately conducted within the Group of Ten, and here essentially between the five largest countries – the USA, Germany, France, the United Kingdom and Japan. Nor did the Fund have any effective say in the final move away from the parity system and the changeover to floating in March 1973.

### **Changed Responsibilities**

The original function of the IMF, namely the financing of temporary balance-of-payments deficits under fixed exchange rates, disappeared with the dissolution of the system of parities and the dynamic rise of the Euro-currency markets. Nevertheless, the objectives set out in the IMF Agreement are still as topical as ever. World economic developments in the past decade have demonstrated the need for an internationally coordinated economic and monetary policy to safeguard and promote the international division of

labour, but also the requirement for balance-of-payments financing tailor-made for particular country groups or occasions.

The Fund therefore continues to be significant as a forum for institutionalised cooperation between industrial and developing countries and as an organisation competent to examine and advise on national economic and monetary policies. The intentions of the so-called Jamaica reform of 1978 went further. The new Article IV of the amended IMF Agreement not only legalised the system of floating but also empowered the Fund to "monitor" the exchange rate policies of member countries. This surveillance is not confined to exchange rate policy in the narrow sense; the analysis also relates to the overall economic development of the country in question and its domestic economic policy, thereby realising ideas that had played a part in the formulation of the IMF Agreement forty years earlier. The effectiveness of this provision is admittedly limited. The actual influence that the Fund can exert on the economic policies of member countries depends ultimately on the strength of its arguments and the readiness of members to accept and act upon the criticisms and suggestions of the IMF. The fact that there is considerable room for improvement in this respect has been demonstrated not only by the counterproductive economic policies pursued by many highly indebted newly industrialising countries.

Whereas both the industrialised countries and the newly industrialising nations have succeeded in freeing themselves from dependence on the IMF for balance-of-payments financing and hence also in avoiding its economic policy conditions for long periods of time, the reliance of the remaining developing countries on the Fund has increased further as a result of the two oil price explosions and the worldwide recession. The Fund performs an important task for these countries in cushioning external real shocks, especially those caused by fluctuations in export and import prices, and in lengthening the adjustment periods. The Compensatory Financing Facility, created in 1962 and "liberalised" at the end of 1975, the purpose of which is to finance temporary reductions in export earnings (and sudden increases in the cost of food imports) and hence to stabilise foreign exchange flows, therefore appears to be just as useful as the Extended Fund Facility with its lending terms of up to eight years. It remains unsatisfactory, however, that the Fund has only negligible power to complement adjustment efforts by deficit countries, in particular developing countries, by means of corresponding adjustment measures in creditor countries.

This also makes it more difficult to solve the debt problem, in which the IMF has become increasingly deeply involved since the Mexican crisis in August 1982. Its role in causing and resolving this problem is a matter of controversy. It cannot be ruled out that the considerable increase in the Fund's lending resources and the creation of more and more new facilities in the last decade simply made many developing and newly industrialising countries both prepared and able to overextend themselves in the international financial markets. Today the Fund is being vehemently criticised by these countries for its bitter adjustment medicine. It is often overlooked that in many cases serious economic errors had been made that would have had to be corrected in any event. There is therefore no alternative to an adjustment policy.

It is an open question whether the Fund has been able, by granting credit to highly indebted countries, to alleviate their adjustment burden and to provide more than temporary relief to the international debt problem. It rather appears that more often than not the fund has (unintentionally) financed capital flight or the transfer of interest to bank creditors. Moreover, the role of the Fund as a catalyst of "fresh" bank money is often overestimated. Apart from a few spectacular instances the IMF's contribution appears to have been negligible, and the amounts thus raised were largely unrelated to the Fund's own financial participation in the respective rescue operations.

Further quota increases and SDR allocations are therefore unlikely to be the best approach to meeting the challenge of the present debt crisis or to prevent the emergence of future crises. Quite the contrary: they may well discourage both debtor and creditor countries from taking the policy actions required to put the debtors back on a sound economic and financial footing. Given the size of drawing rights now available to member countries, a review of the Fund's lending policies is called for. Whereas the IMF should continue to assist members in meeting severe exogeneous shocks, it should be made clear that persistent economic mismanagement can no longer create a claim for financial support by the international community – whether it be to the benefit of borrowers or their lenders. Indeed, in a world of high capital mobility the Fund's comparative advantage lies no longer in the field of finance but in the unique potential of economic expertise it can offer to its members, and in its being a forum for international policy cooperation. The lesson of forty years of IMF activity is that members would be well-advised to draw more on these non-financial resources.