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In Perspective—
THE INTERNATIONAL
MONETARY FUND

by Roderick F. McDonald

Foreign cars and other imports have suddenly become considerably more expensive in the United States, and Americans abroad find their dollars less valuable. These facts, which represent relatively minor misfortunes to most Americans, serve as a reminder that without the self-discipline in monetary matters accepted by many nations back in 1944, we might have been suffering disaster rather than misfortune, and in this period there could have been many such disasters.

Most business people are aware of the existence of the International Monetary Fund and are to some extent appreciative of the important role it plays in international monetary affairs. It may be useful to readers of *Tempo* to review the objectives and activities of the IMF and place it in proper perspective as a key institution exerting powerful effects on the fortunes of all of us who live in countries belonging to the Fund.

This review will highlight the things the IMF is intended

to do as well as some of the things it is not. It will also indicate the philosophy of international monetary policy on which the IMF is based. Such a review is timely because some of the basic premises on which the Fund operates are now being challenged in the light of problems that have been developing for some time in the foreign-exchange markets and have reached the point where important decisions are being made.

Background. As World War II approached its end, the world was badly in need of a revitalization of world trade and monetary management. The war would leave a legacy of dislocated national economies and international trade, extensive artificial controls of foreign exchange and international investment markets, a number of major nations near bankruptcy and, of course, shattered industrial plants over wide areas.

Free-world planners were convinced it was a prime necessity to set up a postwar system of stable international currencies and an organization within which nations could assist one another in maintaining that stability. This was seen as essential for the revival of international trade, without which the prospects for economic recovery and world-wide prosperity after the war would be dim indeed. For this purpose the IMF was created through the Bretton Woods international conference in 1944 and began operations officially in March 1947. There are now 120 member nations. This compares with 131 members in the United Nations currently. Yugoslavia is the only Eastern European communist country with IMF membership.

As indicated in the IMF Articles of Agreement, the essence of the Fund's purpose is to facilitate expansion and balanced growth of international trade as a vital element in promotion of a high level of employment and real income in all member nations and to this end facilitate the development of their productive resources. The major premises incorporated into the Fund's organization and operating philosophy as essential to achieve this purpose are:

1. A system of fixed exchange rates under an international gold-exchange standard, for avoidance of the competitive-exchange depreciation that could lead to monetary chaos.
2. A substantial fund of gold and other monetary reserves, contributed by the members and used for mutual assistance in helping correct temporary maladjustments in their international-payment balances, in order to shorten the duration and lessen the degree of imbalances.

3. Free foreign-exchange markets, without government restrictions that would hamper the growth of world trade.
4. A multilateral system of international payments.
5. Machinery for international monetary consultation and cooperation.

The Gold Exchange Standard. The IMF was founded to support and strengthen the workings of the international gold exchange standard, which has evolved from the traditional gold standard during the twentieth century. The international gold standard is based on the premise that gold is the ultimate value for settling international balances and, in fact, is the only final instrument for measuring and protecting the value of money on which human beings, regardless of nationality, can depend indefinitely and unconditionally against all uncertainties. Under this premise, gold is the only basis for money value that can be counted on always to be completely acceptable, anywhere in the world. It is the only safeguard against the fact that public powers cannot be depended upon to live up to their obligations or promises to maintain the value of money. History contains many examples that demonstrate this proposition.

Under a gold-exchange standard, a country establishes its monetary unit to represent a specified weight of gold and undertakes to redeem its paper money on demand, either in gold or in a "reserve currency," which is itself redeemable in gold and is expected to be always universally accepted as being "as good as gold." The U.S. dollar has been the generally used reserve currency.

A key point is that the gold-exchange standard imposes a strict discipline on a national administration. It must not create so much money, relative to the strength of its monetary reserves, that domestically it loses the confidence of its citizens against inflation, which causes them to demand and hoard gold or its equivalent. Internationally, the country must succeed in balancing its payments. Otherwise, gold or the reserve currency will be demanded in settlement of foreign claims, although temporarily, borrowing from outside sources may tide the administration over a short-term problem situation.

Monetary or fiscal mismanagement which results in inflation of the money supply will generate a drain of monetary reserves, domestically or internationally or both. This will force a shrinkage in quantity of money and a deflation of prices, wages and other costs, in order to correct the situation which caused the inflation in the

first place. It is a hard discipline, usually accompanied by increased unemployment and other problems, but if defending the value of its money is a nation's primary goal, the gold-exchange standard will do the job.

It is a truism that, under the automatic workings of the gold-exchange standard, the surest way for a nation to get itself into monetary difficulties is to persist in running government expenditures well beyond the limit of its will or its capacity to levy taxes, creating deficits that are covered by inflating the money supply; also, over an extended period to buy or spend more abroad than it sells or otherwise has the resources for payment. Many devices have been developed to postpone the working of this disciplinary force, but a moment of truth has to be faced eventually.

At that point, the nation may default and reduce the value of its monetary unit in an attempt to avoid the sacrifices involved in maintaining its commitment. Since there is no fully effective sanction against such a default, experience has shown this to be perhaps the greatest weakness of the system. However, if a permanent decline takes place in the economic position of a nation notwithstanding its best efforts, devaluation would be logical and unavoidable in recognition of the decline.

A devaluation in such circumstances would not be inconsistent with the philosophy of the gold-exchange standard. Naturally, in case of devaluation of the reserve currency, the effects could be especially serious and would be shared by all nations to the extent they were holding the reserve currency as part of their monetary reserves.

Monetary Commitments of IMF Members. Members committed themselves to the international gold-exchange standard by fixing their monetary units at specified weights in gold or in relation to the U.S. dollar with its gold content of .888671 gram as of July 1, 1944—equivalent to a gold price of US\$35 per ounce. They agreed to maintain that parity in the foreign-exchange markets. This commitment does not necessarily include adherence to the gold-exchange standard domestically. The United States does not redeem its money for its citizens in gold and they are not free to buy and hold gold.

Members agreed to limit exchange fluctuations to no more than one percent up or down from official par. They also agreed to refrain from changing official parity unless forced to do so to correct a fundamental disequilibrium in the balance of payments. Thus the commitment to maintain parity is not absolute. But it does apply to situations that can be met by responsible mon-

etary and fiscal management and genuine effort by the member, supported by the assistance it can obtain from other members and the IMF.

When forced to change its official parity by development of a fundamental disequilibrium, a member may make any change up to ten percent without prior consultation with the IMF. The Articles of Agreement provide that the IMF will not raise any objection to a change within that range. Larger changes are not to be made without prior consultation with the IMF and the IMF will concur if it agrees that the change is needed to correct a fundamental disequilibrium. In that case, the resources of the IMF are used to assist the member to make a smooth transition. However, if a member changes its parity over the objections of the IMF, the support of the Fund's resources may not be made available and compulsory withdrawal by the member may result.

Member countries also pledged themselves to the ideal of free foreign exchange markets as quickly as their postwar economic conditions would permit. During the postwar period exchange controls were removed gradually, although in the developing countries this ideal is still some distance from full realization. The IMF publishes annual reports on exchange restrictions, use of multiple exchange rates and other control devices still in effect. It should be noted that under the IMF Articles of Agreement, an exception is made to this pledge and members may exercise exchange controls where exchange problems are due to capital movements.

The philosophy of the IMF is that fixed, free market exchange rates, with the minimum of government controls or other interference with the exchange markets will minimize exchange uncertainties which hamper trade and will encourage international trade, travel and investment to flourish—and they have.

The IMF system is designed to provide flexibility and aids to liquidity which will enable members to cope with reasonable payment imbalances without threatening their official parity. It also recognizes that exchange rates must be realistic and that fundamental economic developments may render changes necessary. The rates set originally in 1946 proved to be too high in some cases and revisions were made. In situations where fundamental adjustments later became necessary, the resources of the IMF have been a powerful support to members.

This outline indicates the extent to which IMF members have voluntarily surrendered a significant part of their sovereign freedom to manipulate the international value of their currencies and have pledged to observe a code

of behavior for common benefit, based on free foreign-exchange markets and fixed rates of exchange.

IMF Organization and Resources. The IMF is directed by a Board of Governors and a group of Executive Directors. These are chosen and exercise their powers on behalf of the member countries under a rather complex voting system which, in effect, gives weight to the votes of members in relation to their contributions to the resources of the IMF. These contributions are made in accordance with assigned quotas, which are based on the amount of each member's national income and its share of world trade.

Quotas are reviewed and adjusted at intervals not exceeding five years. The latest review was in 1969 and the total of all quotas was increased to US\$28.5 billion from the previous total of US\$21.3 billion. There are seven members with quotas of US\$1 billion or more:

U.S.A.	\$6.7
United Kingdom	2.8
Germany	1.6
France	1.4
Japan	1.2
Canada	1.1
Italy	1.0

These seven provide 55 percent of the total. Other quotas range downward to US\$5 million.

A quota may also be adjusted at any time on request of the member and concurrence by a prescribed majority of the membership, as provided in the Articles of Agreement. Consent of the member country is required before any change in its quota can become effective.

Each member contributes 25 percent of its quota in gold and 75 percent in its own currency. In a very real sense, these funds are a central international reserve behind the currency values of the members. When it needs other currencies for settling payment balances, a member may borrow them from the Fund in exchange for its own, for periods of from three to five years. This period is designed to give the member time to solve temporary problems. The time limit emphasizes that it

is not intended to maintain an unrealistic exchange rate indefinitely.

Lending by the IMF is automatic up to the amount of a member's gold contribution (25 percent of quota). Loans beyond that amount are available and may exceed the member's total quota by special arrangement. The IMF derives revenues from charges on its loans. If the amount of a member's currency held by the Fund as a result of borrowing remains in excess of its quota for a period of more than three months, a special charge is levied. All loan charges are payable in gold. Since gold cannot earn income while held in its vaults, the IMF transferred some of its gold holdings to the U.S. Treasury with right of repurchase, in exchange for interest-bearing Treasury obligations, thereby supplementing its income. The total of these transfers was US\$800 million, reduced to US\$400 million by repurchase during 1970.

Special Drawing Rights. With the substantial growth of world trade during the past two decades, some concern arose in international monetary circles as to whether total world monetary reserves, including the resources and lending capacity of the IMF, might prove inadequate for all members to maintain enough liquidity for continued growth. To guard against the danger of problems arising from inadequate reserves, the IMF put into effect on January 1, 1970, a system of Special Drawing Rights (SDRs). The total number SDRs created now stands at 9.3 billion. These have been allotted to members pro rata in accordance with their individual quota contributions to the IMF.

The SDRs are defined as having the same value as an equal number of U.S. dollars in gold. Members have agreed to accept them in settlement of international balances, with the limitation that no member is required to accept SDRs beyond a total amount equal to three times its IMF quota contribution. Interest is earned by members on SDRs received in settlements and held. At present, members are expected to leave on deposit with the IMF an average of 30 percent of the SDRs allotted to them—an international compensating balance. If at any time a member's drawings of SDRs exceed 70 percent of its allotment, such excess must be redeposited and the 30 percent average restored. Because of the members' commitment to accept them in settlement of claims, SDRs are a new addition to each member's international monetary reserves.

Creation of reserve assets is an important extension of the international monetary system and is only possible because of the cooperative participation of trading

nations through the IMF. The universal acceptance of SDRs means that they supplement a member's gold and dollar exchange holdings as reserves supporting the official parity of its currency. In its 1971 Annual Report, the IMF announced that the SDRs have now become established as usable and acceptable reserve assets; that participants have been willing to acquire and hold them and have been able to use them readily to obtain needed foreign exchange.

Parity Problems. Throughout the years of its operations, the IMF has assisted with loans of foreign currencies when a member country found itself with a problem in maintaining the official parity of its currency. In some cases, devaluation nevertheless became necessary and smoother transition to a lower parity was facilitated by IMF assistance. Naturally, this assistance has been more vital to countries with the greatest problems of adverse payments balances. However, countries whose balances have been consistently favorable and currencies strong have also benefited indirectly from the general stability of exchange rates, under which their foreign trade has prospered.

During 1971 some serious international payment imbalances, accompanied by volatile international movements of short-term investment capital, resulted in difficulties in maintaining stability in the foreign-exchange markets. In May, Austria and Switzerland revalued their currencies upward by 5 percent and 7 percent respectively; also, Germany and The Netherlands decided to no longer maintain their currencies within one percent of official parity and to allow the values to float upward. This followed the path taken by Canada a year earlier. Subsequently, in August Japan also allowed its currency to float upward from official parity.

At the end of 1971, appreciation in currency values stood at 15.2 percent for Japan, 12.1 percent for Germany, 11.4 percent for The Netherlands and 8.0 percent for Canada. The IMF maintained consultations with these members in the expectation that they would resume maintenance of the one percent limits around new official par values as soon as permitted by circumstances.

Gold Convertibility. In recent years there have been some important developments in the area of gold convertibility. In March 1968 a departure from the discipline of the international gold-exchange standard occurred when the central banks of five major IMF member countries (U.S.A., U.K., Netherlands, Germany, Italy)

jointly agreed to discontinue supplying gold to the public gold markets, although they continued to buy and sell gold to central banks at the official parity of US\$35 per ounce. This reflected a situation where the public markets apparently had become convinced that the gold value of the U.S. dollar could not be maintained indefinitely at that level.

This was an important limitation on the convertibility of currencies into gold, especially serious because it related to the reserve currency—the U.S. dollar. Subsequently, in August 1971 the U.S. withdrew completely its commitment to redeem U.S. dollars in gold. From that time the system has no longer been in fact a gold-exchange standard.

New Developments. As a result of negotiations initiated late in 1971, some important monetary changes have been decided upon by the major IMF member countries. These include:

1. Devaluation of the U.S. dollar by an increase in gold price to \$38 per ounce, but without resumption of dollar convertibility into gold.
2. Prompt adoption of new higher official par values for most other major currencies.
3. Continued floating of the Canadian dollar until some future date when circumstances permit fixing a new official par value.
4. Widening of the range within which exchange rates may fluctuate to not more than 2.25 percent up or down from official par, instead of the previous limit of one percent up or down.

The Outlook. The resources of the IMF and its capacity for international monetary action have been a very real source of financial strength in modern management of international monetary affairs. The ability to create new resources under the SDRs program adds significantly to the Fund's potential for contribution to continued expansion of world trade.

The recent developments which are challenges to the basic premises of the IMF and the international monetary program for which it stands may be highlighted as follows:

1. Relaxing the commitment of major trading nations to maintain fixed exchange rates and limit fluctuations to a range of one percent up or down. The discipline of the policy of fixed exchange rates is onerous but it imparts a valuable stability to exchange dealings. With the broadening of the range

of fluctuations to 2.25 percent up or down, the question is whether the system can be managed in a manner that will avoid uncertainties which would hinder continued growth of world trade.

2. Abandonment of gold convertibility of the reserve currency. This removes another discipline which is basic to the IMF program for maintaining stability of exchange values. The question is whether the world any longer needs gold as a basis for the international monetary system.
3. Freedom of foreign-exchange markets from governmental restrictions which could hamper the continued expansion of world trade. The question is whether movement away from the two preceding basic premises will result in creation of insur-

mountable obstacles to the maintenance of this third essential.

The real meaning of these questions is whether the fundamentals of the system designed nearly 30 years ago at Bretton Woods are still essential for the continued growth of world trade, as a vital element toward the high purpose for which the experiment in international monetary cooperation was launched in 1944. Or, has the world finally reached the point where disciplines developed through the lessons of experience in an earlier monetary era are no longer applicable? This is what is being decided by world monetary leadership in the current developments, with important future consequences for everyone involved in international business.