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The IMF and Its Operation till the Breakdown in the 1970s: Implications for International Liquidity and Adjustment

Manmohan Agarwal[*]

Abstract: The Fund played a very limited role in meeting the balance of payments (BOP) deficits accompanying European reconstruction at the conclusion of the Second World War (SWW). Only later did the Fund become a source of BOP financing after restoration of some economic normality and members' acceptance of condition for the use of Fund resources. The operations revealed some special problems leading to the initiation of standby agreements and the creation of the compensatory financing facility for developing countries. Fund conditionality was based on the idea that deficits were a reflection of excess demand calling for contractionary monetary and fiscal policies. The Fund was concerned with the potential for a crisis caused by the reliance on the dollar as an international currency. A number of measures were undertaken to prevent a crisis. Gold convertibility of the dollar was eliminated and an alternate reserve currency the Special Drawing Right (SDR) was created. The system ultimately collapsed as balance of payments especially of the US ballooned. The system continued reliance on dollars as an international currency and lack of appropriate adjustment policies continue to be weaknesses of the system.

Keywords: IMF, collapse of IMF, international liquidity, adjustment.

JEL Codes: F32, F33, F51, F55.

I. Introduction

The Fund had hardly any role in financing the balance of payments (BOP) deficits accompanying European reconstruction after the conclusion of the Second World War (SWW). Only later when some semblance of economic normality had been restored and members had accepted

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attaching condition to the use of Fund resources did the Fund become a source of BOP financing for developed and developing countries. We discuss the evolution of the Fund's operation in these years in Section 2. These operations revealed some special problems. The Fund reacted with two innovations in particular. One was the initiation of standby agreements. The other was the creation of the compensatory financing facility (CFF) for developing countries. Developing countries depended very largely on primary exports and often ran into BOP problems because of adverse movements of the terms of trade over which they had no control. The CFF was to deal with BOP problems arising from adverse movement in the terms of trade. In Section 3 we discuss the theoretical basis for Fund conditionality. A major concern of the Fund was the implication of the reliance on the dollar as an international currency, what came to be known as the 'Triffin paradox'. The choice seemed to lie between a shortage of reserves, a slowdown of exports and of GDP growth, and a crisis as countries sought to convert US dollars into gold, US dollars created by the US running current account deficits. In Section 4 we discuss the steps undertaken to tackle the Triffin paradox. To prevent a run from the dollar to gold, changes were made in the system's reliance on gold. The final step was the creation of an alternate reserve currency, the Special Drawing Right (SDR). Fearful of inadequate resources to meet demand the Fund shored up its resources by the General Agreement to Borrow (GAB). In Section 5 we discuss why the system ultimately collapsed. In Section 6 we discuss the implications about international liquidity and the adjustment mechanism from the history of the Fund's operations.

II. The Fund and the reconstruction of Europe

The large deficits accompanying the reconstruction of Europe after the SWW were not anticipated. The deficits were actually a reflection of the success of the reconstruction effort (Milward, 1984) as reconstruction and recovery resulted in increased demand for imports including of consumer goods as people's incomes increased and rationing restrictions

were relaxed. The management of the IMF restricted the use of Fund's resources. This was the outcome partly of the very conservative approach adopted by the leadership of the IMF and partly the push by the US to get the Fund membership to accept that conditions should be placed on the loans granted by the Fund. The issue had come up at the negotiations in Atlanta in 1944. But the US proposal for conditionality had been rejected and the members thought that the issue had been settled. The issue had not come up during the final negotiations at Bretton woods. But the US used its veto power at the Fund to stymie the working of the Fund till the membership accepted the need for conditionality.

The other aspect of the approach of the management essentially meant that the Fund would play no role in the exceptional post-war situation. The management noted in the Annual Report for 1947 page 2 that "the Fund's objectives can be fully realised in a world in which the war damaged and war devastated economies have restored their productive efficiency to the point where they can achieve balance in their international payments with a level of trade conducive to their own and general well-being." This was partly because the view was adopted that the Fund's resources could not be used for reconstruction and no government was in a position to guarantee this. But it is unclear to what extent this decision was also the result of the banking mind set which began to prevail in the Fund. Gutt the managing director was a former finance minister and the US executive director was an investment banker. More than half of IMF top management appointed from 1946 through 1959 comprised financial experts from central banks, treasuries, finance ministries, etc. (Babb and Carruthers, 2007). Keynes and White were both sceptical of central bankers and had recommended the abolition of the Bank for International Settlements (BIS). Meetings of central bankers at the BIS pushed for strong anti inflationary policy and autonomy of central banks, which have now become the hallmark of conduct of monetary policy.

The problem posed by the large deficits because of the successful reconstruction effort was compounded by capital flight because of these

large deficits and political instability in many European countries.[1] The US Government stepped in with the Marshall Plan. The Marshall Plan grants amounted to about 1.1 per cent of US GDP for the four years that the programme lasted.

The members were committed by the articles of the Fund to ensure that their currency was convertible on the current account. This meant that exchange restrictions could not prevent trade transactions. The US granted a loan to the UK, the Anglo-American loan of US$3.75 billion in July 1946 to pay for imports after lend-lease came to an end. One of the conditions of the loan was that international sterling balances became convertible one year after the loan was ratified, on 15 July 1947 (Rosenson, 1947).[2] Within a month, nations with sterling balances had drawn almost a billion dollars from British dollar reserves, forcing the British government to suspend convertibility and to begin immediate drastic cuts in domestic and overseas expenditure. The rapid loss of dollar reserves also highlighted the weakness of sterling, which was duly devalued in 1949 from $4.02 to $2.80 (Kindleberger, 2006). This episode together with the reluctance of private capital to finance European reconstruction showed that the European economies were not yet ready for current account convertibility, and resulted in US acquiescence in the continuation of capital controls in European countries (Helleiner, 1994, Gardner, 1980). The currencies of the European countries became convertible only in 1958, and even then only on the current account.

The Fund engaged in only two transactions in the period 1946-47, a loan of $50 million to France and of 1.5 million pounds to the Netherlands (IMF, 1947).[3] In contrast, the European countries used almost $1.8 billion of gold and short-term loans to fund imports from the US. Consequently US gold holdings increased. US gold holdings which had been 14.6 billion at the end of 1938 were 20.1 billion at the end of the war, though at their peak they had been 22.8 billion. The gold holdings reached 22.4 billion at the end of June 1947.

Table 1: Credits granted by the IMFs

Year	Loans ($m)	Standbys ($m)	Year	Loans ($m)	Standbys ($m)
1948	606		1969		
1949	119.4		1970		
1950	51.8		1971		
1951	28.0		1972		
1952	46.2		1973		
1953	66.1	55.0	1974		
1954	231.3	112.5	1975		
1955	48.8	112.5	1976		
1956	38.8	97.5	1977		
1957	1114.0	1212.3	1978		
1958	665.7	1500.0			
Total	3016.2				
1959	263.5	1132.8			
1960	165.5	291.9			
1961	577.0	338.6			
1962	2243.2	1942.9			
1963	580.0	1287.2			
1964	625.9	1970.2			
1965	1897.4	546.2			
1966	2817.3	421.0			

Source Annual Reports of the IMF

Transactions increased subsequently (Table 1). Transactions were very large in the period July 1947 to April 1948, when the rest of the world had a deficit of 10 billion (IMF, 1948), a large part, 5.7 billion financed by loans from the US.[4] Nevertheless, 10 countries purchased foreign currencies from the IMF. Most of the amounts were purchased by European countries. For instance, of the total of $725.5 million purchased by 17 countries till April 1947, 125 million was purchased by France and 300 million by the UK.

Almost as many developing countries purchased foreign exchange from the IMF as developed countries. But their borrowings were relatively small. The large borrowings were by developed countries which had large quotas. After 1948 purchases from the Fund decreased as Europe financed imports through the Marshall Plan. The large purchases in 1957 and 1958 were mainly by the UK and France.

Purchases after 1958 were mainly by the developed countries. The UK was a major purchaser. It bought 1500 million in 1962, 1000 million in 1965 and 1.4 billion in 1966. The US also became a major purchaser of foreign currencies as its balance of payments (BOP) deteriorated. It purchased currencies worth 125 million in 1964, 475 million in 1965, and 550 million in 1966.

During this period there was increasing recourse by countries to standby arrangements, a form of insurance against future BOP difficulties. The number of countries availing of standby arrangements increased from 2 in 1953 to 11 by 1958 to 32 in 1968. The amounts involved also increased.

14 European countries made their currencies convertible in December 1958, thereby achieving a major goal of the IMF.

The Fund did respond to a specific problem that many developing countries faced. Most developing countries at this period depended on commodity exports and earnings from such exports fluctuated considerably so that periodically these countries would have large current account deficits not because they had created excess demand through inappropriate monetary and fiscal policies but because of international conditions over which they had no control. To help such countries the Fund started the Compensatory Finance facility (CFF) in 1963 to provide financing to countries that ran into balance of payments problems because of shortfalls in export earnings from their commodity exports and the conditions attached to such borrowings were much less stringent than those attached to regular Fund borrowings. In 1973 the CFF was extended to cover large increases in imports particularly of wheat imports.

In brief, there were two innovations during this period in the Fund's operations: the use of standby agreements and the initiation of the CFF.

III. The basis for conditionality

As noted above, IMF operations began after the dispute about the conditions to be attached to IMF loans was resolved. We first discuss the arguments for rejecting conditionality at the Atlanta meetings held in 1944 prior to the final negotiations at Bretton Woods. The US, however, stymied the working of the Fund, no loans were made in 1950, until the membership agreed to conditionality. In 1952 the standby arrangements were initiated. Under these drawings from the loan were phased in tranches, subject to fulfilling the necessary conditions. We discuss what was the nature of the dispute about conditionality.

The dispute at Atlanta negotiations in 1944, before the final negotiations at Bretton Woods, was fundamentally about whether it was the Fund or the member country that would decide whether the payments for which a country sought to purchase currency from the Fund were consistent with the purposes and policies of the Fund (Dell, 1981). The US wanted the Fund to decide in order to ensure that the member did not misuse the resources, whereas the members wanted unrestricted access to Fund resources. The UK, in particular, argued that a deficit country should not be required to introduce "a deflationary policy, enforced by dear money and similar measures, having the effect of causing unemployment; for this would amount to restoring, subject to insufficient safeguards, the evils of the old automatic gold standard" (Keynes, 1980, Vol. 25, p. 143). It was argued that if countries had to get Fund approval every time they needed small amounts of foreign exchange, they would not forego the exchange practices used earlier for the protection of their economies.

While the members thought that the idea of conditionality had been rejected at Atlanta, the US did not believe so and Keynes believed that the agreement did not call for the Fund to automatically accept a member's request for access to resources. The Treasury brief for the U.K. delegation for the second Annual Meeting of the Board of Governors of the IMF in

1947 suggested that the "battle for 'automaticity' may be largely regarded as won" pointing out US failure to discuss the French economic situation before allowing additional French drawings (Dell, 1981).

In light of later developments on conditionality it is interesting what the US thought should be the role of the IMF. Dell (1981) quotes a remark by White:"I don't think the Fund should butt into every country's business and say 'We don't like this or that.'" It was pointed out to Dell by Bernstein, a top economist at the IMF and deputy to White, that the intention of Article IV, Section 5(f) the Agreement as a whole was to preclude Fund interference with domestic policies having social objectives. In general the Fund would intervene only in extreme cases of violation of rules, and would bear the burden of proof (Horsefield, Vol. 1, 1969, p. 69.)

By 1950, the Fund had come to a complete standstill with no drawings at all in that year. An US proposal that drawings be repaid within five years was adopted despite initial opposition, on legal as well as policy grounds, by most members of the Executive Board [Horsefield, (ed.), 1969, Vol. 2, pp. 399-400]. Fund members gave way to American views on the question of conditionality because the US cooperation was necessary rather than any conviction that such conditionality was indispensable for a successfully functioning IMF (Dell, 1981).

From 1952 onward, the standby arrangement was developed as the main instrument for conditionality applicable to drawings beyond the first credit tranche (Dell, 1981). In 1956, phasing was introduced; in other words, drawings were authorised in installments over a period of time, each installment being approved in the light of satisfactory performance by the drawing country. Binding performance conditions evolved gradually, beginning in 1958 to a drawing by Paraguay. When this matter was reviewed in the Executive Board, the Executive Director for the United Kingdom asked that it be recorded that the performance conditions required of Paraguay on this occasion should not be regarded as a precedent for general application [Horsefield, (ed.), 1969, Vol. 2, p. 485]. But phasing and reviews became the norm.[5]

Such conditions were considered necessary to ensure that the current account deficit was eliminated and the loan repaid.[6] The conditions were based on a particular view of the nature of BOP problems. The income expenditure approach pioneered at the Fund (Alexander, 1952) argued national accounting identities showed that investment minus savings, namely the excess demand equaled imports minus exports, the current account balance.[7] Since deficits arose because of excess demand in the economy contractionary monetary and fiscal policies could eliminate this excess demand and restore equilibrium in the current account. However, such policies would also reduce demand for non-traded goods and create unemployment there. A second instrument was needed to achieve both full employment and current account balance.[8] Therefore, contractionary policies were to be accompanied by a devaluation which would shift demand towards traded goods and so resources released by the non-traded goods sector would be absorbed in the traded goods sector. So the conditions were usually contractionary monetary and fiscal policies and a devaluation. The devaluation was an expenditure shifting policy shifting expenditures from non-traded goods to traded goods and the fiscal and monetary policies were expenditure reducing policies that would free resources from the non traded goods sector and these resources would be shifted to traded goods production. [9] Furthermore, such an analysis implied that the conditions accompanying IMF loans should be similar for developed and developing countries.

However, Asian countries received easier treatment because of their strategic importance in the Cold War (Babb and Carruthers, 2007). Industrialised countries, too, tended to receive easier treatment (De Vries 1976, pp. 338–43, Babb and Carruthers, 2017). Yet the information placed before the Executive Board by the IMF staff during the discussion on the 1957 standby to the UK showed that the number of performance criteria in standby arrangements for members in Latin America and Asia had on average been much greater than for members in Europe.The unhappiness of developing countries with conditionalities reached a head when in 1957 the UK received a large standby agreement with few conditions,

it contained no provisions for phasing, no performance clauses, and relatively few monetary or credit ceilings.[10] Developing countries represented on the Executive Board raised questions about the equality of treatment of member countries. This led to a review of conditionality by the Board. The most significant recommendation by the Board was that performance clauses would be limited to stipulating criteria necessary to evaluate the implementation of a member's stabilisation program. (de Vries, 1976, p. 347.). However, conditionalities were given explicit legal basis in 1969 when the agreement was amended.

The idea that BOP deficits reflected excess demand provided a basis for the Fund's anti-inflationary stance. But there was long history to its strong anti-inflationary ethos even before it became an element of conditionality. As early as 1947, the IMF's managing director called inflation a serious handicap to recovery and restoration of economic equilibrium (Babb and Carruthers 2007). This anti-inflationary stance was partly because of the predominance of financiers in the Funds. More than half of IMF top management appointed from 1946 through 1959 were individuals with professional backgrounds in the public financial sector (Babb and Carruthers, 2007). Public sector financiers have always been well-known advocates of prioritising price stability and the servicing of debts above other goals, such as economic growth and full employment (Williamson 1994, p. 20). Furthermore, the Fund's approach to monetary policy as reflected in its programming model was the old so-called 'Treasury view' that public borrowing would crowd out private investment. It nowhere considered the possibility of crowding in, a feature regularly stressed by economists in developing countries. [11]Also it always sought to reduce the excess demand by reducing demand, never by increasing supply. Many economists in Latin America criticised the Fund for this deflationary approach (Sunkel 1958; Felix 1961; Seers 1962; Hirschman 1963).

The anti-inflation stance was, however, reinforced by the Fund's experience in the 1950s. Latin America which accounted for 65 per cent of all standby arrangements from 1952 to 1960 (IMF, various

years) provided the basis for IMF's theory and practices (Thorp and Whitehead 1979; De Vries 1987). Inflation was a principal characteristic distinguishing countries in Latin American devaluing from those not devaluing. Furthermore, inflation averaging more than 20 per cent between 1952 and 1970 was almost always in countries with ambitious state-led social and economic development projects and relatively high levels of urbanization. Wage demands by unionised workers and higher public social spending by the urban populations resulted in accelerating inflation and worsening BOP position (Sheahan 1987, pp. 99–129, Babb and Carruthers, 2007). While many economists and policy makers, inspired by Keynesian ideas, were ready to tolerate moderate inflation if full employment was achieved, inflation tended to create BOP problems and devaluations resulted in higher inflation.[12] It is, however, important to remember that price stability was not included as a purpose in the Articles of Agreement until 1969, (Polak, 1991).

There is an important issue of what incentive a country has to correct a BOP imbalance. If unlimited credit is available to finance deficits then there may be no incentive for the country to live within its means. Even Keynes had quite stringent requirements to make countries undertake corrective actions. If a member's debit balance, namely its accumulated deficits exceeded half its quota, the Governing Board could require the member to devalue, to control outflow of capital, and to surrender gold or an appropriate amount of foreign exchange to reduce its debit balance. Where a member's debit balance exceeded three-quarters of its quota, the Governing Board could ask it to take measures to improve its position," and if a member's debit balance had exceeded three-quarters of its quota on the average for at least a year, the member could be "asked by the Governing Board to take measures to improve its position," and if appropriate improvement had not occurred within two years, the member could be declared in default and could not draw any additional amount. There are, however, two important points to note. Keynes required symmetric action by surplus countries whereas current IMF practice requires no action from surplus countries. Furthermore, the corrective

action was left to the country's policy makers and was not to be mandated by Fund staff. Only the result, correction of the imbalance was mandated.

The newer attempts by developing countries to establish mechanisms to provide BOP financing, the Chiang Mai Initiative by East Asian countries and the Contingent Reserve Arrangement have not provided any fresh ideas on this issue. Most of the funding under these schemes would be available only if the country has a Fund arrangement. Maybe this is the reason that neither has been used by its members.

The lack of assured financing from the IMF has had the expected effect of countries' providing self-insurance by building up their reserves beyond amounts according to various criteria.

IV. The Fund and reserves

The Fund articles allowed for periodic assessment whether Fund quotas were sufficient to finance possible BOP deficits. It had been decided in 1956 that no quota revision was necessary despite a 93 per cent increase in world exports between 1947 and 1956. The share of quotas to trade had declined from about 15 per cent in 1947 to about 10 per cent in 1956. However, it was decided in 1959 to increase quotas by 50 per cent. With this increase quotas were about $14.8 billion, 11 per cent of world exports, still less than the ratio in 1947. Quotas were next increased in 1965 to 21 billion. World exports in 1965 were 189.62 billion, so that quotas were kept stable at about 11 per cent of world exports. But it was a moot question whether these increases were sufficient.

The experience during the 1950s and 1960s revealed major shortcomings in the manner in which the agreement crafted at Bretton Woods dealt with the question of international reserves.[13]. One was the size and nature of reserves held by countries and the other was the adequacy of the resources of the IMF to meet the needs of major country, particularly a reserve currency country. The first issue which came to be known as the "Triffin paradox" was about the size and nature of reserves. Triffin (1960) argued that there was an instability at the core of the arrangements. International reserves needed to grow as trade grew

in order to provide adequate reserves as a precautionary measure. But since gold production was growing very slowly and adjustment of quotas every five years only after a review of their adequacy was not considered sufficient, reserves would be provided by the reserve currencies and, in practice, this meant dollars.

Table 2: Evolution of World Reserves and Export

Year	Gold	Position in Fund	Total Reserves	World X (B$)	Currency /R	R/X
1952	33.9	1.9	51.5	80	30.5	64.4
1953	34.3	1.9	53.2	82	32.0	64.9
1954	34.9	1.8	54.9	85.5	33.2	64.2
1955	35.4	1.9	55.8	92.8	33.2	60.1
1956	36.1	2.3	57.9	102.8	33.7	56.3
1967	37.3	2.3	58.4	110.8	32.2	52.7
1958	38	2.6	59.4	106.8	31.6	55.6
1959	37.9	3.3	59	114.7	30.2	51.4
1960	38	3.6	61.8	123	32.7	50.2
1961	38.9	4.2	63.8	128.4	32.4	49.7
1962	39.3	3.8	64.4	134.1	33.1	48.0
1963	40.2	3.9	67.8	147	35.0	46.1
1964	40.8	4.2	70	165.2	35.7	42.4
1965	41.8	5.4	71.6	179.2	34.1	40.0
1966	40.9	6.3	71.8	196.2	34.3	36.6
1967	39.5	5.7	71.9	207.1	37.1	34.7
1968	38.9	6.5	73.8	230.3	38.5	32.0
1969	39.1	6.7	75.4	262.9	39.3	28.7
1970	37.2	7.7	91.9	302.3	51.1	30.4
1971	36.1	6.3	121.3	338.6	65.0	35.8

Source: Reserves IMF Annual report 1972. Exports 1960 to 1971 World Bank Data; 1952-1959 UN Trade Statistics.

The rest of the world could accumulate dollars only if the US ran current account deficits. So over time its liabilities would rise while its

gold reserves would be constant. At some stage when gold reserves as a percentage of dollar liabilities had fallen sufficiently other countries would lose confidence in the ability of the US to convert dollars to gold, as required by the articles of the IMF, and this would precipitate a lack of confidence and a run on the dollar. On the other hand, if the US did not run deficits other countries' reserves would be insufficient and this would stifle the growth of world trade. So the world seemed to have a choice between a loss of confidence in the dollar and a collapse of dollar convertibility and inadequate international money and a stifling of world trade.

Over the years 1952-1971 the share of reserves to exports decreased from over 64 per cent to under 36 per cent. The vulnerability of countries to fluctuations in trade increased.

Furthermore, the value of gold in official reserves was almost constant. The increase in total reserves was mainly because of growth in reserves currencies, mainly dollars, whose share increased from 30 per cent to 65 per cent. Two steps were taken to avoid a crisis such as that Triffin had warned against. One, gold was gradually taken out of the international monetary system. The gold pool was established in Oct 1961 under which central banks supplied gold to the private market at a fixed price of US$35 per ounce in order to dampen speculative demand for gold.[14] France withdrew from the gold pool in June 1967. Such interventions in the gold pool were stopped in March 1968 so central banks had no responsibility to meet private demand for gold. It also meant that the private price of gold was divorced from the official price of $35 an ounce. Central banks stopping catering to private gold demand economise on its use and restricted it to that of a reserve asset. Later, on the afternoon of Friday, August 13, 1971 President Nixon, announced that after August 15 the US would suspend, with certain exceptions, the convertibility of the dollar into gold or other reserve assets so foreign governments could no longer exchange their dollars for gold so there could not be a run on the dollar. The US was no longer obliged to convert dollars into gold and the system moved to a full-fledged dollar standard.

Second, the Triffin paradox was sought to be resolved by the establishment of the Special Drawing Rights (SDRs).[15] White had resisted Keynes' view of having such an international currency. However, shortly before his death, however, White drafted a proposal to amend the Articles of Agreement to enable the IMF to create its own reserve assets (Boughton, 1998). This was an international currency that could be used to make payments between central banks and its supply could be increased, if the members of the IMF so desired, and reserve holdings of central banks would no longer have to depend solely on the US running current account deficits. Since countries could hold SDRs as reserves and these could be used to pay other countries the need to hold dollars would be reduced or even eliminated. But the US prevented the creation of enough SDRs to eliminate the use of the dollar as a reserve. So though the SDR potentially could avoid the Triffin paradox it was never used in that way.

The question of international reserves was closely tied to the question of BOP adjustment. Countries other than the US could not run deficits for long as they would run out of reserves and soon also out of their borrowing capacity from the IMF.[16] However, the US could run deficits indefinitely as dollars would be held by other countries since it was the international currency. This privilege was called the exorbitant privilege by the French President de Gaulle. Of course, the Triffin analysis called into question the existence of such a privilege but the cost of refuting such a privilege might be a collapse of the international monetary system. Another asymmetry of the system that was often stressed was the asymmetry between countries running a deficit and those running as surplus. The former were under pressure to adjust as they would soon run out of reserves including their rights to borrow from the IMF, the latter were under no such pressure. The only pressure on them would arise from the increase in the money supply as they ran up surpluses and then the further threat of inflation. But this would happen only after they had exhausted the possibilities of sterilisation.

A second issue had arisen in the mid-sixties when the UK was given a large loan by the IMF and the US was also running large deficits. It was

feared that the IMF may run out of convertible currencies if a sufficiently large demand was made on its resources. This problem was resolved by the 10 largest economies agreeing to provide additional amounts to the IMF if such a situation arose.[17] This was the General Agreement to Borrow (GAB), under which the resources available to the IMF were expanded beyond the quota subscriptions. This allowed additional flexibility to the IMF as increasing quota subscriptions was time consuming as most countries had to get budgetary approval for making their contribution. The GAB and the increase in IMF quotas negotiated successfully in 1964-65 by the managing director, Per Jacobson, was a way to finance large capital movements and so obviated the need to use controls on capital movements.[18]

The IMF sought to prevent recourse to protectionist measures by encouraging increased use of Fund resources by becoming more liberal in giving access to these resources, creating new facilities such as the Compensatory Financing Facility (CFF) to help commodity exporters who often faced BOP difficulties because of declines in the price of their primary exports, and expanding its resources through the establishment of the General Agreement to Borrow and increasing quotas following the Fifth review of quotas (de Vries, 1986).

Meanwhile the international financial system was changing in ways whose full impact still lay in the future. Private capital flows became freer with the development of the Eurodollar market. This was the market in London for dollars. It meant that countries could borrow dollars without the concurrence of the US government. The development of the euro dollar market was encouraged by UK authorities, especially the Bank of England. It was a way to restore international financial business to the London financial market especially since the US restricted capital flows in 1963.[19] The Bank of England not only took no steps to regulate the market but in 1962 allowed issuing of foreign securities denominated in foreign currencies which resulted in the development of the Eurobond market. The Eurodollar market allowed US banks to circumvent various domestic requirements such as capital controls, interest rate ceilings,

etc. The development of the euro dollar market was also in the interest of the US government as it allowed foreigners to hold dollars and there would be less pressure on them to convert these to gold which might have been the consequence of the domestic restrictions on foreign lending by US banks.[20] But yet capital controls had not been eschewed by these governments. The US and UK governments used capital controls to prevent capital outflows that would worsen their balance of payments position. The European governments used them to limit inflows which would lead to expansion of their domestic money supply with inflationary consequences. For them capital controls seemed to be a second best substitute for imperfections in the international system, which placed no restrictions on the US, the exorbitant privilege. But the use of capital controls implied that they gave greater importance to domestic economic objectives.

V. The Collapse of the Bretton Woods System

The success of the measures can be seen in that the collapse of the system in 1971 was not because of any of the problems that had been dealt with. For instance, there was no large scale conversion of dollars into gold by central banks (De Grauwe, 1996). In 1970 the current account imbalances of any of the G7 countries were small, none lager than USS$3billion (Boughton, 1997). But then current account imbalance became larger and more unstable even before the 1973-74 oil price increases.

There was agreement that the dollar was overvalued particularly relative to the German mark and the Japanese yen as the current account shifted from large surpluses to deficits, with the problem of the current account deficits being aggravated by capital outflows from the US. The German mark was allowed to float in May 1971. The battle in 1971 was over whether the US dollar should be devalued or the other currencies revalued. Over the course of the week before August 15, 1971, foreign central banks intervened massively to support the dollar, buying about $3.7 billion to prevent their currencies from appreciating (Irwin, 2012). By the end of August, the Japanese government announced that it would allow the yen to appreciate.

The steps taken by the US in August 1971 precipitated a crisis and forced the others to the negotiating table.[21] Despite extensive intervention by the Japanese central bank to support the dollar, 1971, Japan's central bank had to buying $1.3 billion within two days August 16-17, and another $2.7 billion (30 per cent) a week later and $4 billion the following week the yen appreciated. The problem ultimately was met by making the dollar not convertible into gold and a combination of a US dollar devaluation and revaluation of other currencies. The price of an ounce of gold was increased from $35 to $ 38, and the trade-weighted depreciation of the dollar against OECD currencies was slightly less than 8 per cent, or 12 per cent excluding Canada (Irwin, 2012). The Smithsonian agreement only bought a little time before the ultimate demise of the Bretton Woods system with the advent of floating exchange rates in March 1973.

But no agreement could be reached either on the question of capital controls or on measures to regulate the euro dollar market. Under these circumstances, the new parities turned out to be only a stop gap measure. The new fixed exchange rates turned out to be unsustainable. Negotiations to come to a new agreement failed and most developed countries adopted a floating rate.

VI. Conclusions

The operation of the Fund during the period till 1973 can be considered a success as the world economy grew rapidly. [22] Developing country regions participated in this growth. They did not have a period of such rapid growth till the first decade of the current century before the 2008 financial crisis (Agarwal, 2017). However, the operations of the Fund during this period give pointers about the problems that beset an international monetary system (IMS). First and foremost is the question of adjustment, policies that governments should follow when the BOP is in imbalance. There were certain aspects on which both White and Keynes agreed. Both thought full employment to be of paramount importance and a goal that should not be sacrificed to maintain BOP equilibrium. Both thought that capital controls were necessary to prevent speculative destabilisation of exchange rates. They also did not want the IMF to be

interfering in the economic management of countries. Neither could have envisaged the extent of interference by Fund staff that exists today. However, White's experience with lending to Latin America from the Economic Stabilisation Fund also convinced him that the IMF should not extend credits automatically but only if the country was prepared to make the policy changes necessary to correct the underlying causes of its balance of payments problem. Keynes objected to this idea and argued in favour of automatic lending (Boughton, 2006). Keynes believed that countries must adjust and was willing to have strong sanctions when countries imbalances became very large. But he wanted such sanctions to apply to both surplus and deficit countries and that the actual policies to get back to equilibrium would be the prerogative of national governments. Obviously, White did not want any constraints on surplus countries, something that came to haunt the US when in the 1960s Germany and Japan had surpluses and now when China and Germany have large surpluses.

There are broadly speaking two channels for adjustment. One, reducing domestic demand was rejected by both. The other is exchange rate adjustment, and both Keynes and White had similar views.[23] Both believed that a country should have a fixed exchange rate but the central should have the flexibility to change the rate. They supported what is called an adjustable peg. However, in the 1950s and 1960s developing countries were reluctant to change the exchange rate; the Fund had to pressurise deficit countries to devalue. But it did nothing to force surplus countries to adjust. Furthermore, its programming model seems to have adopted what was called the 'Treasury view' that public borrowing crowded out private borrowing. It never seems to have considered that public expenditure and investment may crowd in private investment. Nor did they consider increasing output to reduce the excess demand. The newer institutions established by developing countries, Chiang Mai Initiative and Contingent Reserve Arrangement have not resolved this issue of adjustment.

Endnotes

[1] Lack of cooperative capital controls and US resistance to comprehensive controls on economic transactions limited the effectiveness of controls by only the European countries and so capital controls were not used.

[2] It has been argued that this requirement for convertibility reflected a resurgence of the influence of bankers in the Truman administration formed after the death of Roosevelt (Helleiner, 1994).

[3] Transactions required a country to purchase the necessary foreign currency by paying in its own currency and subsequently repurchasing its own currency, a design based on US operations in Latin America in the late 1930s (Boughton, 2006)

[4] The deficit was actually of the rest of the world. But most of it was by European countries (IMF, 1947)

[5] For a review of the evolution of conditionality see Polak (1991).

[6] Furthermore, since the conditions were to be part of a contract they had to be easily verifiable. Monetary and fiscal data is readily available whereas national income and balance of payments data is available only with a substantial lag. So conditionality was based on fiscal and monetary policies.

[7] Also see Johnson (1962).

[8] In the Mundell-Fleming (Fleming, 1962, Mundell, 1963) approach monetary and fiscal policy were used to achieve the two objectives as they had a differential effect on capital flows. Monetary flows affected capital flows whereas fiscal policy did not. But this analysis was not appropriate in the 1950s and 1960s as capital flows were negligible particularly for developing countries.

[9] The actual model used the programming model is described in Mikkelsen(1998). See also Polak, (1957). For a critical analysis of the model see Easterly(2002).

[10] In the seven standby arrangements received by Great Britain between 1956 and 1964, only two (in 1961 and 1962) had fiscal conditions, and *none* had monetary conditions

[11] See Ambler, Bouakez and Cardiac (2017) for a discussion of this issue and empirical estimation showing crowding in.

[12] For a discussion of the pillars of the IMF's anti-inflation stance also see Babb (2007).

[13] See de Vries (1976) (1985), and Horsefield (1969).

[14] For a discussion of the gold pool see Boughton (1997).

[15] For a discussion of SDRs including their history see Williamson (2009).

[16] Private credit for BOP purposes was still largely unavailable.

[17] Later Switzerland also became a party to the GAB so though the group continued to be called the 10 it had actually 11 members.

[18] Per Jacobson had a traditional bankers' view of how to manage the economy based perhaps on his earlier work at the Bank for International Settlements (BIS). The BIS was a proponent of orthodox finance, balanced budgets, free capital movements, etc. The BIS had more flexible working procedures than the IMF and often was the first to provide emergency funding to finance capital movements. The IMF would later follow to provide longer term financing.

[19] Capital controls became more stringent over time and reflected the scepticism about the benefits from a liberal capital flows regime. Even the American Bankers Association admitted in 1968 that the case for free capital movements was weak, given that many such movements were speculative, unproductive, and tax avoiding, quoted in Helleiner, 1994. Also the interests of US bankers continued to be subordinated to other domestic interests (Odell, 1982).

[20] Secretary of the Treasury Dillon quoted in De Cecco, 1987. The euro dollar market enabled US authorities to continue with their domestic and foreign policies in the face of increasing balance of payments imbalances.

[21] Apart from the suspensions of conversion of dollars into gold, the US levied a ten per cent import duty surcharge. Also a wage and price freeze for 90 days was announced.

[22] It has been called the 'golden age of capitalism' (Marglin and Schor, 1990)

[23] See Boughton (2002) for a discussion of their views.

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