UNIT 15 INTERNATIONAL MONETARY FUND

Structure

15.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the objectives and working of the International Monetary Fund
- Identify the issues involved in the systems of fixed and floating rates of exchange
- Describe the failure of the IMF in ensuring exchange rate stability
- State the problem of international liquidity
- Explain various proposals for raising international liquidity

15.1 INTRODUCTION

In Unit 14 you have leamt that the need for short-term international finance arises due to the problem of disequilibrium in balance of payments. The International Monetary Fund (IMF), which was established in 1944 at Bretton Woods, is considered as the leading international institution which helps its members in overcoming their short-term balance of payments problem. The IMF in the earlier phase of its existence had favoured exchange rate stability because it believed that stability in exchange rate helps both trade and capital movements at the international level, However, if exchange rate stability is overstressed, it often results in unwarranted balance of payments deficits. This actually happened in case of a number of countries making their currencies over-valued. Among these the US dollar was the most important. But the USA was not willing to devalue its currency and bring the exchange rate to its realistic level. Under the circumstances the system of stable exchange rates collapsed in the early 1970s. It got replaced by the system of managed exchange rate floating implying that the rate of exchange would keep on changing in response to changes in foreign exchange markets. This system will normally prevent emergence of a large deficit in the balance of payments of a country unless some structural factors in operation are keeping persistent pressures on its balance of payments position. Apart from systematising the determination of exchange rates, the IMF also works as an important source of international liquidity.

In this unit we shall discuss the objectives and the 'working of the IMF particularly stressing its role in ensuring a rational exchange rate system and adequate amount of international liquidity.

15.2 OBJECTIVES OF THE IMF

The IMF was set up in 1946 as a specialised agency of the United Nations and almost all the non-communist nations of the world are its members (though some communist countries also joined it later).

According to the Articles of Agreement signed by the member countries, the main objectives of the IMF are as follows:

1) to promote international monetary co-operation,
2) to facilitate the expansion of international trade with a view to realise high levels of employment and real income,
3) to promote exchange rate stability and discourage competitive devaluation of currencies,
4) to develop a multilateral international payments system,
5) to eliminate exchange controls over current transactions,
6) to assist member nations to correct balance of payments maladjustments, and
7) to reduce the duration and the severity of balance of payments disequilibrium.

Obviously these objectives are interrelated and aim at helping the member countries to realise economic prosperity by managing their balance of payments freely and efficiently in ways conducive to international harmony. Since competitive exchange depreciation and exchange controls undermine international harmony and are also considered to be affecting international trade adversely, they do not find favour with the IMF. Until the early 1970s the IMF stressed the need for exchange rate stability because it was believed to be a precondition for eliminating a major uncertainty factor in international trade. Of course, if some country persistently had deficits in its balance of payments, it could formally devalue its currency. But in response to its action of devaluation, other countries could not be allowed to indulge in competitive exchange depreciation. In 1973, in spite of endeavour's by IMF the system of Stable exchange rate broke down because the major industrial countries abandoned their exchange rates and floated their currencies. This implied that the exchange rates were to be determined by the prevailing conditions in the foreign exchange markets.

The founders of IMF recognised that if international trade is to be optimised it is necessary to have a multilateral international payments system. Under this payments system direction of foreign trade of a country is not directed by its holdings of particular currencies. This means that if a country holds pound sterlings, it is not necessary that it should import goods and services from the UK only. Under a multilateral payments system, foreign exchange reserves held in any currency can be used for importing goods and services from any country. This is possible because of the free convertibility of the currency. Obviously, it was not easy to develop this system due to the inherent weaknesses of the currencies of the less developed countries. However, the founders of the IMF saw no harm in at least making an attempt in the direction of developing a multilateral payments system.

The IMF has given particular attention to the objective of assisting member nations in overcoming their short-term balance of payments problems. From this point of view the IMF provides a right to its member-countries to 'draw' on its resources to finance a temporary deficit in their current account balance of payments. This arrangement enables member-countries to tide over their balance of payments problems without introducing exchange controls in one form or the other.

15.3 WORKING OF THE IMF

In the working of the IMF three aspects deserve particular attention. These are as follows:

1) Determination of quotas
2) Determination of par values or exchange rates
3) Borrowings from the IMF

15.3.1 Determination of Quotas

The quotas of all the members aggregated to SDR 90 billion in 1989. The Interim Committee of the IMF after reviewing the position in September 1989 had recommended that quotas of the members should be increased on priority basis keeping in view the changes in the world economy and the members' relative position in the world economy. While revising quotas of individual member countries it is necessary to maintain a balance between different groups of countries.

Quotas of the member countries reflect their contribution to the resources of the IMF and provide a basis for determining members' access to these resources and their voting power. Members' shares in allocation of Special Drawing Rights (SDRs) also depend on their quotas. Quotas of the member countries have been determined keeping in view their national incomes, gold and foreign exchange reserves and the volume of international trade. This has naturally resulted in large differences in the quotas of different countries. The largest quota is of the USA which accounts for 20 per cent of the total quota of the IMF. The UK, France, West Germany and Japan are the other leading members of the IMF. They together account for a little more than the US quota. Quotas of the other countries are small and thus in respect of decision making they do not matter much. In fact, the large size of the US quota has given it overriding powers to influence both the policies and practices of IMF.

It needs to be understood that quota of a country has three dimensions:

i) It specifies the amount of contribution of the member-country to the IMF. Of this contribution 25 per cent is to be paid in gold an the remaining 75 per cent in national currency

ii) Country's quota determines the drawing right of a country, i.e., the amount which the country can borrow from the IMF

iii) The quota also determines the voting right of the member countries.

15.3.2 Determination of Par Values or Exchange Rates

Until the system that was conceived at Bretton Woods in 1944 did not break down in the early 1970s, the members of the IMF were under a statutory obligation to declare par values of their currencies in terms of gold control of the US dollar (latter on in terms of SDR). Since this obligation was binding, most countries fulfilled it and declared the par values of their currencies. However, there were some defaulters, but even those countries attempted to maintain de facto parities and thus adhered to the IMF's system of the stable exchange rates often characterised as the system of pegged exchange rates.

Member-countries had transactions with the IMF at the official per values. Only these exchange rates were to be used even for private transactions. For spot transactions deviation from the par value in the range of 1 per cent was allowed. In December 1971 the Smithsonian Agreement widened this range to 2.25 per cent above or below the par value. This obviously suggests that the founders of the IMF in their wisdom thought that the stable exchange rates regime was conducive to both international trade and international flow of capital.

In the earlier phase that lasted for more than two and a half decades the member countries had the right to change the par values of their currencies in the range of 10 per cent by simply intimating the IMF. However, for changes in the exchange rates exceeding 10 per cent, approval of the IMF was necessary. These changes were allowed whenever they were required for correcting fundamental disequilibrium in the balance of payments. Hence the IMF never stressed upon exchange rate rigidity, though it always sought to promote exchange rate stability.

Although at the end of the 1960s the dollar was losing prestige, due to persistent deficits in the USA's balance of payments yet there was no crisis of confidence in it.

However, when on August 15, 1971 the US government announced that it would no longer redeem dollars from other central banks for gold or other reserve assets, the demand for the currencies of various European countries increased and people wanted to get rid of their dollar holdings. In this situation the earlier stable exchange rate system of the IMF became unworkable. A number of countries refused to support their parities, allowing their currencies to float upward. For about four years attempts were made to revive the earlier system but without success. Finally in January 1976 the issue was resolved by legalising the managed float. The IMF has not adopted formal rules for managed floating and therefore rates of exchange keep on fluctuating in response to changes in foreign exchange markets. This implies that if some country persists with deficits in its balance of payments, its currency will inevitably depreciate. Therefore, it is necessary that the balance of payments of the country must be kept in order.

15.3.3 Borrowings from the IMF

As explained earlier in this unit, the IMF aims at helping its members to overcome their balance of payments problems of temporary nature. From this point of view it sells those currencies to the member countries which they need for meeting their short-term debt obligations. These exchange transactions between the IMF and its members are not ordinary transactions involving buying and selling of currencies. In essence they are borrowings of the other countries' currencies by the member-countries from the IMF though the borrowers are required to give their own currencies in exchange of the foreign currencies from the IMF. The borrowers are required to pay interest which increases with the amount and the duration of borrowings. The repayment of loan involves repurchase of one's own currency by making payment in gold or in the currency in which the loan was originally taken.

A member-country, however, cannot get Ioans from the IMF in unlimited quantity. In this regard there are two restrictions: First, the IMF will not normally hold a country's currency in an amount exceeding 200 per cent of its quota. This means that in a normal case the total borrowings of a country from the IMF will not exceed 125 per cent of its quota. This condition can however be waived by the IMF in special cases. Second, the borrowings from the IMF by a country should not raise the Fund's holdings of the latter's currency by more than 25 per cent of its quota during a one year-period ending on the date of borrowing.

The right to borrow or draw foreign currencies from the IMF enables member-countries to tackle their short-run balance of payments problems without recourse to bilateral balancing of transactions. In a multilateral payments system which the IMF is waning to strengthen, the member-countries would not seek loans in currencies of only those countries wit11 which they have bilateral deficits. In fact, in such a system loans in any foreign currency will be good enough to meet debt obligations. In practice, the IMF has yet to evolve a multilateral payments system. Hence most of the time IMF is approached by the member-countlies to seek loans in particular currencies due to their wider acceptability.

Check Your Progress A

1) What is the International Monetary Fund?

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2) List the various dimensions related to the country's quota allotted by the IME

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3) What are the main aspects of working of the IMF?

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4) Which of the following statements are True and which are False:

i) The IMF in the earlier phase of its existence had stressed exchange rate stability.

ii) After the break down of the earlier IMF system the new system that has emerged is known as the fluctuating exchange rate system.

iii) The decision to set up the IMF was taken at the conference held at the Bretton Woods.

iv) Exchange controls are necessary for the international harmony.

v) Quotas of all the members of the IMF are not the same, and therefore the voting rights of the members are also different.

vi) Members of the IMF borrow funds from it for financing their development projects.

vii) Members of the IMF can borrow from it in unlimited quantity to meet their debt obligations arising from the deficits in their balance of payments.

viii) In a multilateral system of payments the members of the IMF would not seek loans from it in currencies of only those countries with which they may have bilateral deficits.

15.4 EXCHANGE RATE STABILITY VERSUS MANAGED FLOAT

For a long time economists were convinced that the system of fixed exchange rates was preferable to a system of fluctuating exchange rates. As stated earlier in this unit, this was also the view of the founders of the IMF. They had therefore provided for a system of stable exchange rates. However, under changed circumstances, adjustment could be formally made in the exchange rates. This system was known as adjustable peg regime. This system broke down in the 1970s giving way to a new system known as, the system of managed float.

15.4.1 Adjustable-peg System

The adjustable-peg system of exchange rates which was adopted by the IMF at the Bretton Woods Conference (often called the Bretton Woods system) continued for about two and a half decades. It was believed to be having the following merits:

1) **Eliminates uncertainties of foreign trade:** International trade is beneficial to all the participating countries and, therefore, everything possible must be done to encourage it. However, international trade involves two problems which are not there in domestic trade. First, for making payments the importer needs to obtain the necessary foreign exchange as the domestic currency will not be of any use to him. A fluctuating exchange rate upsets his plans and calculations of obtaining foreign exchange for imports. Secondly, if the rate of exchange keeps on fluctuating in an erratic manner, it can also upset the importer's calculations with regard to his profits. Hence the rate of exchange should be relatively stable. The IMF system of adjustable-peg was expected to tackle this problem.

2) **Facilitates inter-country flow of private capital:** Although in modem world international flow of capital is not decided entirely on economic considerations, the inter-country movement of private capital surely takes into account the relevant economic factors. Among these an important factor is the absence of uncertainties associated with fluctuations in the exchange rate. Fluctuations in exchange rate create conditions in which large capital losses cannot be ruled out. This naturally deters inter-country movement of foreign private capital. The adjustable-peg system of exchange rate, which prevailed till the seventies created conditions conducive to inter-country flow of foreign private capital by eliminating uncertainties caused by possible fluctuations in exchange rates.

3) **Prevents speculation in foreign exchange:** Theoretically it is possible to argue that speculation in foreign exchange has a tendency to smooth out fluctuations in

the exchange rate caused by trade and has thus a stabilising effect. In practice, however, the experience of speculation in foreign exchange is not very encouraging, as it has invariably contributed to unwarranted fluctuations in the rates of exchange. Freely flexible exchange rates provide much scope for speculation in foreign exchange, while adjustable-peg regime of the IMF provided little scope for such speculation as the exchange rates were by and large fixed.

4) Checks **import of inflation**: When a currency depreciates, it increases the prices of imported goods and services, resulting in a rise in the prices of domestic goods and services. Due to persistent deficits in their balance of payments, the currencies of most of the developing countries have a tendency to depreciate over time in a flexible exchange rates system, these countries fail to avert import of inflationary pressures. However, under adjustable-peg regime the stable exchange rates help by insulating an economy from the possible import of inflation resulting from continuous fall in the external value of the country's currency.

15.4.2 Failure of the IMF

The adjustable-peg regime broke down in the 1970s, underlining the failure of the IMF. One important factor which contributed to the system's collapse was inflation in the USA caused by the wrong policies of the government to finance the Vietnam War. This inflation resulted in deficit in balance of payments of the USA. On the other hand, at this juncture, there were certain countries of Europe which were having surplus in their balance of payments. These countries were unhappy with these developments. They were keen to prevent import of possible inflation from the USA. In 1971 the prevailing conditions encouraged speculation in foreign exchange. Since dollar at this point of time was overvalued and the US government was unwilling to devalue it, speculators became more and more anxious to change dollars into German marks. In the first week of May 1971 there was large trading in marks and dollars and in three days $2 billion were exchanged for marks. Since further trading could have serious repercussions on the German economy, it was suspended and the Frankfurt foreign exchange market was closed. When the foreign exchange market reopened the following week, Germany allowed the mark to float contrary to the statutory provisions of the IMF. At this juncture Australian shilling and Swiss Franc were revalued. However, the deficit in the US balance of payments continued. to increase. There was massive outflow of both short-and long-term capital from the USA. The speculation against dollar persisted and the confidence in it was greatly shaken. In spite of these developments the USA's approach was not to devalue the over-valued dollar. This made the matter worse. The central banks of major countries in this situation failed to stave off speculation against dollar. The integration of the world economy in general and of the financial markets in particular had exposed the system to speculation and certain other types of disturbances. Multinational firms moved large funds around in pursuit of short-term gains. Unable to sustain all these pressures the IMF system as conceived at Bretton Woods finally collapsed. According to the experts, August 15, 1971 the day when the USA formally abandoned the convertibility of dollar into gold actually marks the demise of the Bretton Woods system.

Let us now attempt to understand whether there was any basic defect in the Bretton Woods system or it was some unexpected chance development that caused its break down. Most experts now believe that undue stress on exchange rate stability and reluctance on the part of the leading developed countries to devalue their currencies for correcting balance of payments disequilibrium were the two most important reasons for the collapse of the Bretton Woods system. The system was based on the presumption that the parities of major currencies would be maintained and in any case the exchange rate of dollar would persist unaltered. This implied that in no situation the dollar would be devalued and that no other major currencies would be revalued. This is evident from the fact that except for the 1949 adjustments the industrial countries accounted for fewer than ten exchange rates adjustments between 1945 and 1971. The US government adopted the attitude of total casualness to the persisting deficits in its balance of payments and the consequent outflow of dollar. This situation would have caused no anxiety had the US remained the natural leader ..ofthe Western World. But this was not to be. The world inflation transmitted from

the USA in the late 1960s shook the confidence of IMF members in the Bretton Woods system. Consequently, there was a drift from the adjustable peg regime. The Bretton Woods system no doubt failed but the working of the IMF taught the leading developed countries that there are certain benefits of international monetary co-operation.

15.4.3 The System of Managed Float

Some leading economists, like J.E. Meade, H.G. Johnson and M. Friedman have advocated adoption of a system of flexible exchange rates. In their opinion, in a system of flexible exchange rates there is a continuous process of adjustment. Compared to this, in a system of fixed exchange rate, adjustments in exchange rate are under-taken only under situations of crisis. Obviously, this rnakes the system of flexible exchange rates preferable to the system of fixed exchange rate. The system of flexible exchange rate removes pressure on the government to intervene in international trade for restoring equilibrium in balance of payments. It also gives freedom to governments to use instruments of domestic policy exclusively for the pursuits of domestic objectives. Further, when flexible exchange rates are used as instruments of adjustment, the need for assets that could be used for meeting international payments obligations is very much reduced.

However. the experiences of flexible exchange rates system (or free floating) are not very encouraging. Immediately after the collapse of the Bretton Woods system the world witnessed highly destabilising swings in the exchange rates of major currencies. These swings in exchange rates rarely reflected the basic economic situations of the countries concerned. They, in fact, were often caused by the speculative activities in the foreign exchange market. Hence, a completely flexible exchange rates system was ruled out. Rather, a system of managed floating is found far more conducive to international trade and capital rnovemcnts in the existing international monetary situation. In this system various forms of co-operation and management are required. After the break down of adjustable-peg regime when the new system of managed float was emerging one could easily see the European countries cooperating among themselves under the 'snake scheme'. The snake scheme provided for the joint float of the currencies of the European Economic Community (EEC) countries, i.e., West Germany, France, Belgium, Netherlands, Luxemburg and Denmark. Though not members of the EEC, Sweden and Norway joined the common EEC float. You have learnt earlier in this unit that under the Smithsonian agreement a currency could fluctuate 2.25 per cent around its central rate. 'Therefore, in 1972 the EEC countries decided to tie their currencies together and limit fluctuations in their exchange rates within this narrow limit. This arrangement was known as "the snake in the tunnel" After March 1973 the EEC currencies though remained tied together, there was no restriction on the amount of change in par values relative to other currencies. The new arrangement was called "the snake in the lake". It should be noted that right from the beginning in 1973 the UK, Italy and Ireland were not party to the joint float. France disassociated itself from the 'snake arrangement' in 1974, Sweden left it in 1977 and Norway in 1978. However, the way the common EEC float was operated it can be safely concluded that the managed float does not permit completely free fluctuations of exchange rates, and therefore does not involve the risk of complete disorder in the system of exchange rates.

The floating exchange rates system can be managed in various manners. However, two proposals in this regard desenre particular attention. Since the managed float approach is based on the idea of the 'normal' price implying that the exchange rate should fluctuate around some equilibrium value, (in case of drift of the actual exchange rate from this equilibrium value) the central bank of the concerned country will intervene in the foreign exchange market. One proposal for intervention suggests that when the central bank intervenes it should not contribute to swings in the exchange rate. In fact its attempt should be to moderate the swings. Therefore, no central bank should sell its currency when the exchange rate depreciates, nor should it buy its currency when its price rises. According to a second proposal, a system of reference exchange rates should be evolved. These reference rates should be periodically revised and should not deviate much from the equilibrium values of the currencies. The rule for managing the exchange rates is that no central bank should sell its currency at *a* price below the reference rate and it should not buy its currency at a pride above the reference rate.

The system of managed float apparently looks similar to an adjustable-peg system. In reality the two systems are different. Under the managed float system there is virtually no bias towards rigidity as it permits constant adjustment of rate of exchange. In contrast, the adjustable-peg system invariably delays adjustments and, therefore, eventually needs relatively large changes in the exchange rates.

Check Your Progress B

1) Describe the Bretton Woods system of adjustable-peg.

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2) Distinguish between managed float and free float.

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3) Which of the following statements are True and which are False:

i) The adjustable-peg system of exchange rates facilitates inter-country flow of private capital.

ii) In a system of freely fluctuating exchange rates uncertainties of foreign trade are completely eliminated.

iii) So long the adjustable-peg system worked well, it did not leave much scope for speculation in foreign exchange.

iv) The adjustable-pcg system was not expected to provide a safety valve against import of inflation.

v) The IMF system of stable exchange rates broke down because the dollar appreciated in value.

vi) Undue stress on exchange rate stability and reluctance on the part of leading developed countries lo devalue their currencies even when they had deficits in balance of payments caused the collapse of the Bretton Woods system.

vii) A completely flexible exchange rates system or free floating is preferable to managed float because of its merit of constant adjustment.

viii) The "snake scheme" provided for the joint float of the dollar and the pound sterling.

ix) The central bank's intervention in the foreign market under the managed float should contribute to swings in the exchange rate.

15.5 THE IMF AND INTERNATIONAL LIQUIDITY

The term 'international liquidity' usually refers to gold and foreign exchange reserves position at the international level. In September 1967, the Board of Governors of the IMF at their Annual meeting at Rio De Janeiro decided to create a new reserve asset in the form of Special Drawing Rights (SDRs) for meeting steadily increasing demand for international liquidity. Since then the demand for international liquidity emanating from deficits in the balance of payments is met from three sources: (i) the official gold and foreign exchange reserves of the various countries, (2) gold and foreign exchange reserves with the IMF and **(3)** the SDRs. In this section; you will first study the problem of international liquidity followed by a brief discussion of some important proposals for increasing international liquidity. Since creation of the SDRs by the IMF has been the most radical measure since World War II to augment the international liquidity, it will be explained separately in this section in the end. the end.

15.5.1 The Problem of International Liquidity.

After World War II the importance of pound sterling declined and the US dollar emerged as the most widely acceptable currency at the international level. Since dollar was convertible into gold, most countries wanted to hold their foreign exchange reserves in dollars. The supply of dollars depended on the amount of deficits in the US balance of payments. In addition to dollar reserves of the various countries the IMF's reserves also constituted international liquidity. This system of creation of international liquidity was haphazard and thus the rate at which the international liquidity grew during the 1950s was erratic. This disturbed various economists. Robert Triffin one of the most distinguished economists of the late 1950s, felt that the international liquidity was growing too slowly considering the rate of growth of world trade. The trade had grown at the rate of 7.5 per cent per annum, while gold reserves had grown at 1.4 per cent per year and overall international liquidity had increased at the rate of only 2.7 per cent per annum. Further, the distribution of foreign exchange and gold reserves among the various countries was uneven. However, the most serious aspect of the problem was that there was no built-in mechanism whereby an orderly increase in the international liquidity could be possible.

Under the IMF system attempts to increase the supply of gold at the desired rate were scuttled by the USA. When the IMF was established the price of gold was fixed at $35 per ounce. It could not be revised upward for 28 years due to the US opposition. As a result neither the producers of gold had the incentive to increase the supply of gold, nor the countries holding large stocks of gold were prepared to release them for monetary use. The dollar reserves, however, increased in a big way because the USA had large deficits in its balance of payments. During the 1950s, dollars were considered as good as gold due to their convertibility into gold. In the late 1950s when the fact of persistent huge deficits in the US balance of payments attracted attention of some west European countries there was great pressure on the USA to ,convertdollars into gold. This caused flow of gold from the USA to Europe. As a result the US share in the official stock of gold declined rapidly and the dollar's convertibility into gold became suspect. The confidence in the dollar was on the decline and further deficits in the US balance of payments did more damage to prestige of the dollar. In this situation further growth of international liquidity became difficult.

The problem of international liquidity is also linked with the exchange rate pegging. As discussed in Section 15.4.3 of this unit, in a system of flexible exchange rates there would be much less demand for international liquidity and that would not be difficult to meet from the given foreign exchange reserves. Hence, the pressure on augmenting the supply of international liquidity has diminished much ever since the Bretton Woods system of adjustable peg has been replaced by the system of the managed float.

15.5.2 Proposals for Raising International Liquidity

Having noted that the international liquidity was not increasing at the required rate some economists and other experts made both radical and reformist proposals in order to tackle the problem of international liquidity. Among the radical proposals two were most important. One of these proposals was that the system of adjustable peg should be abandoned and in its place the flexible exchange rates system should be adopted. This would obviously reduce the demand for international liquidity and the existing foreign exchange reserves could easily meet this reduced demand for international liquidity. In the early 1970s the world finally switched over to a system which is in essence a variant of the flexible exchange rates system. The other radical proposal was for reviving the gold standard of pre-World War II period. This was considered unworkable and thus lacked much support. The reformist proposals sought to increase the international liquidity in the JMF system itself. Among these the following proposals received much attention, but for various reasons could not be adopted. Nonetheless they merit brief discussion.

1) **Raising the price of gold**: During the 1950s and 1960s some experts, including Roy Harrod and Jacques Rueff, Economic Adviser to President de Gaulle of France recommended that the price of gold which was pegged at $ 35 per

ounce should be raised. In their opinion, this price was unrealistic and was discouraging gold supply to increase, thus creating shortage of international liquidity. However, such a scheme was found to have its share of shortcomings. An upward revision in the price of gold could induce speculation in gold which was not considered a desirable development. The possibility of flights from national currencies to gold could also not be ruled out. If that was to happen, the national currencies could not be used as international reserves. Probably on account of these considerations the USA and some other leading industrial countries never favoured the idea of raising the price of gold though it could help in tackling the problem of international liquidity.

2) **The Triffin Plan :** Robert Triffin recommended that the centralisation of foreign exchange reserves was necessary for tackling the problem of international liquidity. In his opinion, a system based on one or two reserve currencies was very fragile, because any attempt to augment the supply of international liquidity by increasing their supply could impair confidence in them. It actually happened in case of the dollar. Triffin, therefore, proposed that the IMF should assume the character of the central banks and the members of the IMF should be asked to deposit their foreign exchange reserves with it. Triffin was aware of the fact that most countries would not like to surrender their foreign exchange reserves to the IMF as it would amount to compromising on their economic freedom. He thus suggested that to begin with the members of the IMF could provide around 20 per cent of their foreign exchange to augment the supply of international liquidity. The Triffin Plan being utopian was not considered to be practicable and thus did not receive wider support. Hence no attempt was made to adopt it.

3) **The Bernstein Plan :** E.M. Bernstein was associated with the IMF. He had put forward aproposal that could be carried out in the basic framework of the IMF. There were two main aspects of the Bernstein Plan. First, it recommended that the IMF quotas of each country should be integrated with its official reserves. This arrangement would have made the access of the members of the IMF to its foreign exchange reserves automatic. The second proposal was with respect to creating a Reserve Unit Account in the IMF. The members of the IMF by subscribing to Reserve Unit Account could create additional reserves. The Bernstein Plan, like other proposals tried to augment international liquidity failed to get adequate support and was thus not adopted. The chief weakness of the Bernstein Plan was that it offered little to tackle confidence problem which in fact was at the heart of the problem of shortage of international liquidity.

15.5.3 Role of Special Drawing Wights

In 1969 the Board of Governors of the IMF at their annual meeting decided to create a new reserve asset, Special Drawing Rights (SDRs) to meet the growing demand for international liquidity. In order to implement this decision the Articles of Agreement of the IMF was amended in 1967. The allocations of SDRs aggregating 9.3 billion were done in 1970, 1971 and 1972. Thereafter for seven years there were no allocation of SDRs. The 1979 fresh allocations of SDRs totalling 12 billion began. This allocation process was completed in three years. Physically, SDRs are simply book-keeping entries at the IMF in accounts of member-countries and the IMF itself. The SDRs are not usable like national currencies. They are to be first exchanged for national currencies with other central banks and the IMF before a country can use them for meeting its payments obligations.

Since SDRs are created to supplement the existing international reserve assets out of nothing, great caution is needed in their creation. Any proposal to create SDRs must have the approval of the IMF members enjoying at least 85 per cent of the voting power. Therefore, a proposal to create SDRs can be scuttled by the USA alone which has 20 per cent voting power or by the EEC countries which together have votes exceeding 15 per cent of the total votes. SDRs have been allocated to the members of the IMF in proportion to their quotas. Therefore, the benefit of the creation of SDRs has gone largely to the developed countries whose quotas are much larger than the quotas of the less developed countries. The proposal of the' developing countries to allocate SDRs to the members of the IMF on the basis of economic backwardness was not accepted due to lack of adequate support.

When the SDRs were first created in the early 1970s their value was fixed in gold;

one SDR equalling 0.888671 gram of fine gold. Since this was also the value of the dollar one SDR became equal to one dollar. With the devaluation of the dollar in 1971 and 1973 the one-to-one relationship between the SDR and dollar was disturbed. Later *m*, with the decline in the importance of gold in the IMF system, the value of SDR was fixed on the basis of a currency basket. Presently, the basket is composed of the currencies of the world's five largest exporting countries. The weights of the currencies of these countries in the basket are: the US Dollar 42 per cent, Deutsche Mark 19 per cent, French Franc, Pound Sterling and Japanese Yen 13 per cent each.

SDRs can be lased by a country to finance its balance of payments deficits. As stated earlier in this unit, SDRs are not directly usable. Therefore, a needy country will have to obtain the required currency by exchanging SDRs for it. As a result, SDR holdings of the country providing the required currency will increase, while those of the country which transfers SDRs will diminish. **A country facing no balance of payments problem is not allowed to draw SDRs from the IMF with a view to exchange them for national currencies.** In other words, the members of the IMF are not expected to use SDRs for changing the composition of their reserves but only for meeting temporary disequilibrium in their balance of payments.

It might be useful to compare the importance of SDRs with that of gold and **foreign exchange** reserves. Presently, SDRs total around $25 billion, while the international Liquidity is estimated to total $500 billion. Therefore, SDRs account for hardly 5 per cent of the international liquidity. When the IMF declares that in future SDRs will become the principal reserve asset, it is actually a statement of intentions rather than a reflection of existing facts. Many experts are convinced that these intentions in future also will not be translated into reality. In their opinion, SDRs suffer from some basic **problems** which cannot be easily overcome. First, SDRs cannot be used as an intervention currency. Secondly, there is no mechanism whereby SDRs can be created in response to increased demand for international liquidity. Finally, the veto power which the USA presently enjoys on the basis of its voting strength can always scuttle any proposal to create fresh SDRs, if it conflicts with the national interests of this country.

Check Your Progress C

1) List the reserve assets which presently constitute the international liquidity.

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2) Fill in the blanks:

i) The unique reserve asset created by the IMF is ..... .

ii) In a system of adjustable peg, since exchange rate did not change too often demand for international liquidity ..... rapidly.

iii) Under the Triffin Plan there was stress on ..... of foreign exchange reserves.

iv) Roy Harred had recommended ..... revision in the price of gold with a view to augment the supply of gold.

v) Physically, SDRs are simply ..... entries at the IMF in accounts of member countries.

3) Which of the following statements are True and which are False:

i) The demand for international liquidity emanates from disequilibrium in the balance of payments of a country,.

ii) Since the World War II pound sterling has emerged as the most widely acceptable currency at the international level.

iii) Upward revision in the official price of gold could augment its supply and thereby could ease the problem of international liquidity.,

iv) Large surpluses in the US balance of payments during the 1950s and 1960s resulted in considerable increase in the supply of dollars which could be used as reserve assets.

v) SDRs are presently the biggest component of the international'liquidity.

vi) . SDRs arc directly usable for meeting payments obligations at the international level.

15.6 LET US SUM UP

The International Monetary Fund (IMF) has existed for rnore than four decades. It has promoted international rnonelaryco-operation, facilitated international trade and assisted member-countries to correct their balance of payments disequilibria. The IMF has, however, failed to eliminate exchange controls. It attempted to promote exchange rate stability, but the system of adjustable-peg which was expected to serve this purpose finally broke down in the early 1970s.

In the working of the IMF the relevant aspects are i) determination of the quotas of the member-countries, ii) determination of the par values or exchange rates, and iii) borrowings by the member-countries from the IMF. The quotas of all the member-countries taken together presently amount to SDR 90 billion. The quotas of individual countries reflect their comribution to the resources of the IMF and have been fixed keeping in view their national incomes, reserve assets and volumes of foreign trade. The quotas also determine the voting powers and drawing limits of the member-countries. The IMF assists the mernber-countries in overcoming their short-term balance of payments problems. For this the members are allowed to borrow form the IMF within statutory Emits.

Until the early 1970s, the par values or the exchange rates in the IMF system were determined in terms of the national currencies' parity with gold. In case of fundamental disequilibrium in the balance of payments of a country it could revise the value of its currency in terms of the other currencies and gold. However, competitive exchange depreciation was not allowed. The original IMF system known as the Rretton Woods system stressed the exchange rates stabilty.

From this point of view the system of adjustable peg was adopted. Under this arrangement the exchange rate could be altered only if it was so warranted by the fundamental disequilibrium in the balance of payments of the country concerned. This system eliminated uncertainties of foreign trade, facilitated inter-country flow of private capital, prevented speculation in foreign exchange and acted as a safety valve against import of inflation.

The adjustable-peg system, however, broke down in the 1970s underlining the failure of the IMF. The failure was caused by persistent deficits in the USA's balance of payments which undermined confidence in the dollar. As a result, devaluation of the dollar became necessary. The USA resisted pressure to devalue the dollar for some time and abandoned the convertibility of the dollar into gold, Under these circumstances some leading European countries decided to float their currencies and in the process the dollar was depreciated. Thus, adjustable-peg system gave place to a new system called the system of managed float. On theoretical grounds some economists favour flexible exchange rate to the system of managed float. But in practice the former has been found highly destabilising, while the latter involves co-operation among countries to systematically revise exchange rates continuously thus not permitting free fluctuations in exchange rate. It is for this reason that the system of managed float was adopted by these countries.

The balance of payments disequilibrium and lack of multilateralism create demand for international liquidity. The demand for international liquidity is presently met from three sources, viz., the official gold and foreign exchange reserves of the various countries, gold and foreign exchange reserves with the IMF, and the SDRs. After World War II the supply of international liquidity has not increased as fast as the demand for it. The persistent deficits in the USA's balance of payments though

augmented the supply of the international liquidity, it created the problem of crisis of confidence in the dollar. Hence, Robert Triffin, E.M. Bernstein and Roy Harrod put forward proposals to tackle the problem of international liquidity. These proposals however were not adopted. To meet growing demands for the international liquidity the IMF has created a new reserve asset called the Special Drawing Rights (SDRs). In essence SDRs are only book-keeping entries at the IMF in accounts of member countries and the IMF itself. They are not directly usable. They have to be converted into national currencies, before they can be used for meeting foreign debt obligations. SDRs have been created in small quantities and have been allocated to member countries in direct proportion to their quotas. Presently SDRs account for about 5 per cent of the international liquidity. The value of SDRs has been fixed on the basis of a currency basket which is composed of the currencies of the world's five largest exporting countries.

15.7 KEY WORDS

Adjustable-peg Regime: A system of stable exchange rates with the provision for adjustments in cases of fundamental disequilibrium in balance of payments.

Bretton Woods System: The system of stable exchange rates in the IMF framework as adopted at the conference held at Bretton Woods in 1944.

Devaluation: Reduction in the external value of the currency in terms of gold and/or some foreign currency.

Exchange Control: A system under which foreign exchange transactions are subject to government control.

Exchange Rate: Value of a currency in terms of some other currency.

Fixed Exchange Rate: Rate of exchange that does not change.

Flexible **Exchange Rate**: Rate of exchange which continuously keeps on adjusting with changing conditions.

Free Float: A system under which rate of exchange fluctuates freely.

International Liquidity: Reserve assets position at the international level.

Managed Float: A flexible system of exchange rates under which exchange rates adjustments are collectively made.

Multilateral Payments: A payments system at the international level under which any country's currency can be used for making payments to all other countries.

Par Values: Exchange rates..

Special Drawing Rights: A reserve asset created by the IMF.

15.8 ANSWERS TO CHECK YOUR PROGRESS

A) 4) i) True ii) False iii) True iv) False v) True vi) False vii) False viii) True

B) 3) i) True ii) False iii) True iv) False y) False vi) True vii) False viii) False ix) False

C) 2) i) SDRs ii) rose iii) centralisation iv) upward v) book keeping
3) i) True ii) False iii) True iv) True v) False vi) False

15.9 TERMINAL QUESTIONS

1) What are the various objectives of the International Monetary Fund? How far they have not been realised?

2) Describe the working of the IMF. How does it help member countries in dealing with their temporary balance of payments problems?

3) What is meant by the adjustable-peg regime'? Why did it fail?

4) Explain the circumstances in which the world has switched over to the system of managed float.

5) What is international liquidity? Discuss various proposals to augment the supply of international liquidity.

6) What are the Special Drawing Rights? Wow far has their creation solved the blem problem of international. liquidity?

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.