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Negotiating Bretton Woods in Hindsight

Manmohan Agarwal

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RIS
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Core IV-B, Fourth Floor, India Habitat Centre
Lodhi Road, New Delhi – 110 003 (India)
Tel: +91-11-2468 2177/2180; Fax: +91-11-2468 2173/74
Email: dgoffice@ris.org.in

Negotiating Bretton Woods in Hindsight

Manmohan Agarwal*

Abstract: The Planning began during the Second World War in both the US and the UK to establish a system of international economic governance that would avoid the problems that had bedeviled the world economy in the inter-war period, particularly the great depression of the 1930s. The IMF was set up to provide balance of payments financing to prevent countries from adopting trade restrictive measures to manage the balance of payments. The essential features of the Fund, its size and amount of lending to a country tied to its quotas, reflected the US draft than the UK draft. While both White and Keynes prioritized domestic full employment the operation of the Fund has meant that governments have sacrificed full employment to the necessity of maintaining a sustainable balance of payments. Also again while both White and Keynes wanted to control short-term capital flows, the Fund has moved towards a more liberal capital flows regime.

Keywords: Negotiation, Bretton Woods

JEL Codes: F32, F33, F51, F55.

Section 1 Introduction

At the beginning of the Second World War, Germany offered bilateral trade deals to South East European countries if they joined the war as allies of the Germans. The British Foreign Office sought Keynes' help to counter this proposal. This was the trigger that set Keynes thinking about the post-war economic system and its governance (Keynes 1978a). This ultimately resulted in the establishment of the International Monetary Fund (IMF) and the World Bank (WB).[1] The Bretton Woods System (BWS) put in place at the end of the Second World War was the result of intense debate during the latter part of the war on how to prevent a repeat of the collapse of international finance and trade that had occurred in the 1930s.

* Adjunct Senior Fellow, RIS. Earlier Professor, Centre for Trade and Development, JNU. Email: manmohan44@gmail.com.

In the US, though planning for the post-war world economy was undertaken by many agencies, the main effort was at the Treasury led by White. His objectives were both development and monetary stability. In both these endeavours he built upon the earlier work at the department on Latin America, in which he had been involved. Together with the governments of Latin America a blueprint for the creation of an Inter-American organisation to help the development of Latin America was created (Helleiner, 2014). Treasury also provided expert advice to a number of Latin American countries on the establishment of a central bank and its operations.

During the 1930s many countries were faced by large current account (CA) deficits; they had run out of reserves and could not borrow to finance the CA deficits or to service their past borrowings. The inability to finance deficits forced countries to cut imports. They imposed quantitative restrictions on imports to immediately cut imports and depreciated their currencies to increase exports. Such policies hurt the exports of partner countries which then were forced to adopt similar policies to restrict imports which in turn hurt the original country. [2] The interactions among these policies of the different countries resulted in a much greater decrease in export activities, both in agriculture and manufacturing, than what would have occurred because of the reduction in demand resulting from the initial downturn. Many countries entered into managed trading arrangements to ensure that their imports from a country matched their exports to the country. Surplus countries did not face any pressures to increase imports while deficit countries were forced to cut imports. Though deficit countries initiated the bad cycle, ultimately both deficit and surplus countries were hurt by the policies. Also since adjustment by a deficit country often involved reducing demand for imports by reducing incomes, the method of adjustment imparted a deflationary bias to the world economy.

Countries sought to reverse this downward spiral in trade and its effects in the 1930s itself. The US adopted the Reciprocal Trade Agreements Act in 1934. This Act authorised the president to reduce tariffs up to 50 per cent if the partner country would also reduce tariffs. In 1935 the UK, the US and France reached agreement on a set of exchange rates. This would reduce uncertainty and encourage a recovery of investment. However, there was no substantial increase in trade. Countries wanted their exports to recover before they liberalised imports as there was no financing available for a deficit. The 1937 recession in the US added to the uncertainty.

The Objectives of the Negotiators

The principal negotiators initially for the system of international governance that culminated at Bretton Woods (BW) were the UK and the US. Other countries were brought into the picture at a later stage (Helleiner, 2014). The impetus for reform came from the need to eliminate the beggar-thy- neighbour policies that had been adopted in the 1930s. The negotiators sought to prevent a collapse of the international trading and financial system as had occurred in the 1930s. However, the British and US negotiators had a different view as to what the state of the post-war world economy would be and the position of their own countries within that system.

A major feature of the British balance of payments (BOP) before the First World War (FWW) was that earnings from the stock of foreign investment financed both the merchandise trade deficit and new foreign investments. But a significant portion of these foreign investments had been sold during the FWW. As a consequence the reduced earnings from foreign investment after the FWW could not finance the trade deficit as well as new foreign investments. New foreign investments which were usually long-term were financed by short-term borrowings - the UK was acting as an investment bank. But this meant that short-term interest rates had to be kept high in order to attract and retain short-term foreign capital. The high rates of interest reduced the level of economic activity and led to high rates of unemployment in the inter war period.[3] This situation would be aggravated after the Second World War (SWW) as most of the remaining foreign investments had been sold during the war. This was a condition for US assistance during the war.[4] So the UK negotiators expected that the UK would have a large trade deficit while export capacity which had been destroyed during the war, was rebuilt and large imports would be required for rebuilding this capacity.

Given this situation they believed that the UK had no alternative but to continue with managed trade. Furthermore, a major issue was how the financing gap could be met without having to tolerate high levels of unemployment as had happened in the inter war years. Domestic full employment was not to be sacrificed for managing the external balance. They, consequently, needed assured access to plentiful cheap credit to finance the anticipated trade deficit. Liberal credit for the world economy would also help in maintaining a buoyant world economy which would be necessary for increasing UK's exports.

The objectives of the US are less clear.[5] The three main departments involved in the negotiations were State, which was mainly interested in trade; Treasury, which was mainly interested in exchange rates and monetary stability; and the Board of Economic Warfare, which was mainly interested in pushing large international projects with substantial spillovers (Gardner, 1956). Each of the three departments had different objectives. But they were clear about the benefits from a multilateral system and pushed for it from the beginning. The British came to accept the need for a multilateral system.[6] The State Department was mainly concerned with elimination of preferential access. It was feared that the imperial preferences, which covered the British Empire and Dominions, and the attempts by the Germans to spread bilateral agreements with East Europe and Latin America would severely limit the scope for US exports.[7] Their elimination was a major objective of the negotiators from State. But it is not clear from the record whether they thought exports were essential for longer term prosperity.[8]

The British economists were divided in their views about the benefits of multilateralism. Lionel Robbins and James Meade, who successively headed the Economic Section of the War Cabinet Secretariat, continued to believe in the classical tradition of free trade (Gardner, 1956). At the Treasury academic economists were more divided. Henderson remained opposed to multilateralism. Robertson was convinced of the importance of reaching agreement with the US. Keynes who had supported managed trade early in the negotiations came to support multilateralism.[9]

After lengthy negotiations agreement was reached as codified in the Atlantic Charter. The charter combined the objective of the British who were concerned with the high US tariffs and wanted them reduced and elimination of discrimination as desired by the US. The former was important as high US tariffs militated against exports. So earning dollars to service the amounts borrowed from the US, and on which the US insisted had been difficult in the inter war period. But the US negotiators were unhappy that they had not gotten a stronger commitment from the British for elimination of imperial preferences. They got a somewhat stronger commitment in the negotiations governing Lend-Lease.[10]

We are concerned with the negotiations for the establishment of the IMF and these were mainly conducted by the Treasury led by Dexter White. It was recognised that in the short run the US would be the only source for loans for reconstruction in the European countries.

Issues in the Negotiations for the IMF

Both Keynes and White wished to preserve domestic economic autonomy so that a country's pursuit of employment policies would not be curtailed by developments in the balance of payments (Helleiner, 1994). The experience of the 1930s had resulted in a reversal of the priority given to a viable balance of payments position at the expense of domestic employment that had prevailed under the gold standard. But they also believed that beggar-my-neighbour policies that characterised the 1930s were not appropriate. They believed that an official source of funding BOP deficits must be available when private funding stopped as the risks became too great.

The major issues in the negotiations were: what would be the size of the IMF, how would the Fund carry out its lending operation, how would countries bring about adjustments when their BOP were not in equilibrium as short-term loans from the IMF would be a palliative and give time for adjustment but would not resolve the underlying causes for the BOP disequilibrium, and what arrangements needed to be made for the transition from a war economy to a normal economy.

Size of the Fund

The UK wanted a large size IMF as they would require considerable financing after the war. They also wanted this amount available without any restrictions or conditions. Their proposal for what they called the International Clearing Union (ICU) required that each country had an account at the ICU. Surpluses would be automatically credited to the account of the surplus country. At the same time this amount, as at a bank, would be available to a deficit country to draw on to finance its deficit .Since surpluses must match deficits, money would always be available to a deficit country to finance its deficits. So the country would not ever be placed in a position where it would have to restrict trade because it could not finance its deficits. Nor would it be forced to undertake contractionary policies to reduce demand and so imports.

US negotiators knew that they would be a major creditor and so would be required to give loans to the deficit countries. They wished to control the amounts of loans that the US would be obliged to give and the conditions on which they would give the loans, so no automatic loans.[11] They also wanted a larger scope for private US capital. Morgenthau, the Treasury Secretary, and White had aimed to shift the centre of the financial system from London to New York (Gardner, 1956, p 265). This objective reinforced the case for limiting the amount of official financing that was to be available as then there would be more scope for private financing. So they proposed that each country would subscribe to the Fund and what it could withdraw from the Fund would be based on its subscription. The amount that any country could borrow would be limited by the size of its subscription. The US proposed that the size of the Fund be US $ 5 billion.

In brief, the issue was whether the IMF was to merely provide loans to countries experiencing balance of payments problems or whether it was to act more as a central bank trying to manage the level of world economic activity. In the latter case it would issue its own currency and determine the amount of international money required for a high level of world economic activity.[12]

Once the size of the Fund was limited Keynes sought to make drawings on the Fund unconditional (Gardner, 1956). Developing countries were dependent on exports of primary commodities and their export earnings tended to fluctuate considerably. So they sought that developing countries be allowed to have larger quotas or borrow a larger multiple of their quotas (Helleiner, 2014).[13]

Ultimately the decision on quotas was a political one and was decided by the US negotiators.

Adjustment mechanisms

Both White and Keynes believed that stable exchange rates were needed to provide a stable trading environment.[14] A major question was the role of capital movements, whether such movements were a force for stability or a force for instability. The orthodox position held by most bankers was that capital movements should be free. Throughout the inter-war period they had pushed for balanced budgets, independent central banks, free capital movements and the gold standard. They believed that speculative capital movements occurred only when governments followed incorrect policies so that capital movements would force governments to adopt proper policies. Also, of course, bankers would profit from capital movements. The Keynes/White combination accepted that movements of productive capital were good but not movements of speculative capital.[15] They believed that speculative capital movements had contributed to the instability of exchange rates in the 1930s. In contrast to their views on a number of issues, Keynes and White both agreed on the need to restrict capital flows.

This debate has continued into the present as to what causes exchange rate crises. In first generation models such as those of Krugman (1979) crises occur because of fundamentally unsound government policies, namely fiscal deficits.[16] These fiscal deficits make the money supply greater than the demand. The excess supply is reduced by running a BOP deficit which reduces the foreign exchange reserves of the central. As long as the government runs a budget deficit foreign exchange reserves decline until finally the fixed exchange rate is no longer sustainable and there is a crisis.

However, the experience of the 1930s had revealed the limitations of the orthodox view and had also showed the conflicts that arose when national governments gave higher priority to domestic employment. Similarly, recent experience has not supported the orthodox view. The European crisis of 1992 occurred in a number of countries that were not adopting unsound policies (Obstfeld, 1996). Similarly is the case of the Asian crisis of 1997 as many countries had surpluses in the government budget and also in the current account of the BOP or if the current account was in deficit the deficit was small (Radelet et. al. 1998). So the final IMF agreement was based on the premise that capital movements should be controlled.[17] The issue of the impossible trilemma, namely the incompatibility of fixed exchange rates, free capital movements and autonomy of monetary policy, was to be solved by restricting capital movements.[18]

Whereas the US and UK positions were similar regarding capital movements, on a number of other issues they held opposing views. Their opposing positions were shaped in part by what they believed would be the major challenges in the post war period.[19]

It was recognised that even without speculative capital movements it could happen that countries had large surpluses or deficits, and the question was how these could be corrected. The US plan called for very substantial intervention in the monetary and fiscal policies of countries. Countries would be required not to adopt any monetary or banking measures that could lead to serious inflation or deflation without the consent of the members of the Fund (Gardner, 1956). The Fund would be authorised to recommend policy changes for countries with large surpluses or deficits. If the recommendations were not adopted then they could be enforced by sanctions.

The Keynes Plan did not recommend such far reaching interference in the policies of member countries since the British were against any interference by another body that would prevent the achievement of full employment. But it also contained strong measures to ensure adjustment. If a countries' credit or debit at the Fund reached a large amount, say half of their quota, then the value of the currency would be compulsorily changed. That of the deficit country would be devalued and that of the surplus country revalued. However, countries could not alter their exchange rates without the permission of the Fund so as to avoid the competitive devaluation that had been a feature of the 1930s and had contributed to exchange rate instability. Also, if a country accumulated large reserves these could be appropriated and used to finance global public goods.

Both the White and Keynes plans required deficit and surplus countries to adjust. For instance, the Keynes proposal called for automatic financing of deficits through the balances built up by surplus countries, so that the clearing union would act like a commercial bank providing loans from deposits built up by surplus countries, compulsory confiscation of reserves exceeding a certain level and/or compulsory exchange rate adjustments when balances at the Clearing Union exceeded or fell below certain levels. The US proposal banned the use of the resources of the Fund to prolong a basically unbalanced international position. The Fund would require countries to pursue policies that would lead to an orderly return to equilibrium.

The preferences of the US carried the day. The US, which expected to be the main creditor country after the Second World War, preferred that the IMF be merely a lender and the amounts available for lending to be limited so the demand on US resources would be limited (Strange, 1976). The IMF was established with a fixed amount of money based on subscriptions from countries, these subscriptions, initially amounting to \$7.4 billion, reflecting the country's importance in the international economy. The voting rights as well as the rights to borrow from the IMF were both governed by the size of the subscriptions. The subscriptions limited the amount of resources available to the IMF to meet the BOP needs of its members and also limited the amounts that a country could borrow to meet their BOP financing needs.

The negotiating position of the US was further strengthened as immediately at the end of the War the lend-lease agreement came to an end. A new agreement had to be negotiated for additional loans to the UK. The US was in a strong negotiating position as the UK very urgently needed a loan.[20] One of the conditions for the Anglo-American loan for US$3.75 billion signed in July 1946 to pay for imports was that international sterling balances became convertible one year after the loan was ratified, namely on 15 July 1947 (Rosenson, 1947).[21]

Exchange controls as regards citizens of countries with sterling balances would come to an end and the pound would be convertible.

Furthermore, the system of exchange rates agreed upon expressed the value of the US dollar in terms of gold and the US had the obligation to convert dollars into gold whereas the exchange rates of other currencies were expressed in terms of dollars. Also exchange rates were more subject to international agreement in order to prevent competitive devaluations (de Vries, 1986). Countries with a fundamental deficit, a term not defined, could devalue with IMF concurrence so that competitive devaluations would be avoided.[22] However, there was no pressure on the surplus countries to revalue.[23] Furthermore, while countries were in general not supposed to impose quantitative restrictions on trade such restrictions could be imposed if the IMF certified that the country faced a severe balance of payments problem. But the Fund has become increasingly reluctant to grant such a certification as the belief has grown that exchange rate adjustment rather than QRs are the appropriate mechanism to manage the BOP.[24]

A system was established which provided for BOP financing of deficits in the short run, possibilities for adjustment in the longer run and restricted recourse to trade restricting measures to manage the BOP.

The Role of Developing Countries

Developing countries exported mainly primary commodities before the SWW and were likely to continue to do so. This dependence on primary exports resulted in special problems. Though it was not recognised at that time exporters of primary products suffered a terms of trade (TOT) loss vis-à-vis exporters of manufactures. Prebisch (1949) provided empirical support for this hypothesis of declining terms of trade only at the end of the 1940s and drew the conclusion that this provided a justification for industrialisation.[25] While the TOT argument was not known at that time policy makers in developing countries wanted their countries to industrialise. They expected the Bretton Woods institutions to help in their industrialisation. Mr. C.D. Deshmukh, the then governor of the Reserve Bank of India, commented on the initial draft of the White Keynes plans that these institutions would be acceptable to developing countries only if they helped to raise living standards in these countries (Helleiner 2014 ,p 251). When Australia and India pushed for the inclusion of development as one of the objectives of the IMF the developed countries took the position that development was the mandate of the Bank; the Fund was to provide short term BOP support. The Indian delegation wanted to add the phrase 'to assist in the fuller utilization of the resource of underdeveloped countries' to the purposes of the Fund (Helleiner 2014, p 252). While this phrase was not accepted, the article did include the phrase, ' the development of the productive resources of all member countries' [26].

The Working of the IMF the Early Years

The working of the Fund in its basic principles was very different from that envisaged by White and Keynes. This was partly because of unexpected developments. President Roosevelt died and Truman became the president. He was a person with a very different personality and ideas. One of the consequences of this and another accident was the ascendancy of bankers at the Bank and the Fund. The Bretton Woods conference had voted to abolish the Bank of International Settlements (BIS) as the Norwegians argued that the BIS helped Germans to transfer assets from occupied countries (BIS).[27] Furthermore, White and Keynes wanted its abolition as they feared that otherwise the central bankers' preference for balanced budgets and so-called sound finance that was antithetical to the maintenance of full employment would be reinstated. They held that adherence to these central banking preferences principles had been a major reason for the prolonged and deep suffering in the war years.[28] Momentum for the scrapping of BIS faded after the death of Roosevelt as most of the top officials wanting to abolish the BIS left office. Unfortunately, because of suspicions that White was a Soviet spy he was not made the director of the Fund.[29] The Belgian Camille Gutt, a person Morgenthau believed had ties to old finance and was supported by New York interests, became the managing director of the Fund (Helleiner, 2014). Similarly Collado who was a new dealer and the US executive director at the World Bank had wanted Bank to lend to Chile after the first few loans had gone for European countries reconstruction. Meyer, an investment banker and president of the World Bank, delayed the decision. Soon after he resigned, Jon McCloy another investment banker, accepted the position, but only on the condition that Collado was replaced . Collado was replaced as executive director by Robert Garner, another Wall Street financier.[30] Chase Bank's Eugene Black became the deputy director of the World Bank.[31]

One of the consequences of the dominance by bankers has been that the governance of the IMF has been heavily in favour of the developed countries. In fact, it is in favour of creditor countries as the bankers who have dominated believed that greater voice for debtors would lead to unsound lending practices. The developed countries have more than 50 percent of the voting rights. But their decision making power is even greater as major decisions currently require 85 per cent of votes. The US alone with about 17 per cent of voting rights wields a veto power, one that it has had for the entire period of operation of the Fund. A small group of European countries could also wield the veto. So could the developing countries. But they would need a much larger coalition. The head of the Fund has always been a European and the second in command, who was initially the Deputy Managing Director and since 1994 the First Deputy Managing Director as the number of deputy directors was increased to 3, a US citizen.

In the immediate post war years the IMF and the World Bank played a limited role. The needs of the countries were much beyond the resources available at these institutions. The European trade deficit was US$5.8 billion in 1946 and $7.5 billion in 1947 (Gardner, 1956, p 294). These deficits showed the success of the reconstruction effort (Milward, 1984). But the deficits were much larger than what had been anticipated as not only was there a large deficit in merchandise trade, but the surplus in invisibles that had covered the merchandise trade deficit had now turned into a deficit. The large deficits and political instability in many European countries resulted in capital flight.[32]

In compliance with a mandate of the US Congress, the US executive director had obtained an interpretation that the Fund's resources could be used only for short term stabilisation and not reconstruction. Since no country could provide such a guarantee the Fund made no loans. The executive directors held that the Fund could only operate in normal circumstances and not in the abnormal conditions actually prevailing (Gardner, 1956).

Since private US finance was unwilling to finance the balance of payments deficits and Fund resources were not available the US Government had to step 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.

One of the conditions of the Anglo-American loan was that international sterling balances became convertible one year after the loan was ratified, on 15 July 1947 (Rosenson, 1947).[33] Within a month, nations with sterling balances had drawn almost a billion dollars from Britain's 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, 1956). The currencies of the European countries became convertible only in 1958, and even then merely on the current account.

In brief, the Fund played almost no role in meeting the BOP needs of the European countries in the immediate post war period. However, it was already evident that the mode of operation of the Fund would be very different from that envisaged by Keynes and White. It was to be much more traditional and dominated by bankers' concepts of a correct monetary system.

Retrospective Look at the Major Negotiating Issues

How do the concerns of those negotiating the post-war system look in retrospect.

Size of the IMF

At the time of the inception of the IMF total quotas were 7.47 billion (IMF Annual report 1947) while world trade in 1947 was 48.62 billion (UN Annual Report 1947). Quotas were 15.2 per cent of world trade. Every 5 years a decision is taken whether to increase quotas and by how much. In 2016 quotas were 667 billion (IMF Annual report, 2017) whereas trade was 15.46 trillion (WTO, Annual Report, 2017). Quotas had fallen sharply and were only 1.5 per cent of trade. Trade has expanded very substantially. Trade has been considerably liberalised compared to the time of the SWW, a step that the original designers of the post war system of economic governance would have approved, but may not have expected. The system of imperial preferences became much weaker even before the independence of countries in Asia, Africa and the West Indies resulted in very different trade policies in those countries.[34] Tariffs levied by developed countries on manufactures have declined from an average of about 40 per cent at the end of the war to under 5 per cent. Applied tariffs on manufactures in many developing countries are about 10 per cent even though the bound tariffs are about 35 percent. Most quotas on imports have been eliminated.

Import substitution behind high tariffs and QRs has fallen into disrepute.[35]

In addition, flows of capital both short-term and long term have been liberalised.

Liberalisation of short term capital flows creates problems of macro management. When there are inflows the exchange rate appreciates leading to a shift in production from tradeables to non-tradeables. This usually leads to a worsening of the current account deficit that could lower credibility in the stability of the exchange rate and lead to outflow of capital. Such outflows could create not only a BOP problem but a currency crisis with serious domestic repercussions.[36] Domestic entities with foreign loans find that they have to suddenly repay them and repay them with much more domestic currency as the exchange rate depreciates. This leads to some of them going bankrupt. The entire macro economy gets thrown out of gear. The sums needed to tackle the currency crises are much larger than those that had been required earlier for current account deficits or even to finance debt repayments. So, most recent IMF programmes have had to tackle these newer forms of BOP crises, namely crises. The sums that countries require to tackle these new crises have been much larger than their quotas and often larger than the resources available to the IMF. So the IMF has had to devise new methods of raising finance.[37]

Method of Adjustment

Through much of the period until the 1970s the Fund adopted a savings income approach to tackle current account deficits. This approach (Alexander, 1952,) held that a CAD was a reflection of excess demand in the economy. Devaluation would lead to an increase in demand for domestic goods and so might merely lead to inflation. To create increased supply of tradeables to meet the extra demand generated by a devaluation demand, factors of production have to be shifted from production of non tradeables to the production of tradeables. This required that demand for non tradeables be reduced. This was done by contractionary monetary and fiscal policies. So the Fund required countries to devalue, an expenditure switching policy[38] with expenditure reducing policies. This seemed to have worked well in the sense that developing countries grew much more rapidly in this period than subsequently.

Later conditionality became much more extensive. Countries were not able to increase exports very much and therefore repeatedly had a CAD. The IMF came to believe that this lack of export performance was due to government policies that interfered with the working of the market. The conditions imposed by the Fund became much more extensive in the attempt to make the countries more market friendly. In particular they forced countries to reduce import tariffs and so try to shift production from import substitutes to exports.[39] This policy did not work as resources did not shift automatically (Bruton, 1998) as the Fund did not help countries to work out export promotion policies to go along with reduced import tariffs.[40],[41]

The conditions imposed by the IMF have undergone a further change as the nature of BOP crises has changed from those caused by CAD and those caused by capital account problems.

In the recent cases of exchange rate crises conditions have been geared towards inducing confidence in financial markets.[42] So they impose contractionary monetary and fiscal policies; balancing the budget and reducing monetary expansion. While they may look similar to earlier conditions the motivations on what causes the crisis and how it should be tackled is very different. An immediate improvement in capital flows is sought. Sometimes these policies can be bad for the real economy. Very high rates may be forced to encourage capital inflow or discourage outflow. But these high rates have a very adverse effect on investment and growth and this effect may discourage capital inflow more than higher interest rates encourage inflow. For instance, the Asian countries were severely affected and the recovery has taken a decade and in some cases it is still not over (Agarwal and Vandana, 2020).

At the same time the IMF imposes no conditions on the surplus countries over which it has no leverage. The scarce currency clause was never used. So again we have asymmetric adjustment and the Fund imposes very traditional conditions on deficit countries that have the backing of the financial world. We are back to conditions against which Keynes, White and the new dealers had struggled.[43]

Furthermore, some of the conditions had little to do with macro stability but seemed to be designed to bring about changes in the economic structure. The crisis in Korea, as was the case with the crises in most of the other Asian countries in 1997, was caused by excessive borrowing by the private sector. But the conditions imposed were very traditional ones where the cause of the deficit is excessive government expenditure. In addition, public enterprises were to be privatised, the rationale for this condition is not clear. In fact, there is a general problem of moral hazard. Since conditions are imposed on the government whereas the private sector is responsible for the behaviour that led to the crisis the private sector has no incentive to avoid the crisis causing behaviour. Particularly as the Fund is at the same time asking for a greater role for market forces.

The Effect of the conditionalities

The conditionalities imposed by the Fund have had a profound effect on the behavior of developing countries and through that on the international monetary system. Developing countries have responded to their unhappiness with Fund conditionality by increasing their reserves so that they do not have to approach the Fund for balance of payments support and developing alternate sources of financing. The major developing countries, including those who are members of the G20, have increased the level of reserves between 1997 and 2007 whether measured as a percentage of GDP or of imports or of M2 or of short term liabilities.[44] This increase is a substantial departure from trend and reflects the response to the Fund's actions in the Asian crisis.

The reserve accumulation seems to be justified as it helped cushion the effect of the 2008 crisis and many countries were able to maintain their investment rates and so their growth by drawing on their reserves in the face of a worsening current account position.

But while the reserve accumulation might be justified at the individual country level it may not be so desirable from the point of view of world welfare. The accumulation of reserves has meant that developing countries have been lending to the richer countries, particularly to the US to maintain its consumption, rather than the richer countries lending to the poorer countries to raise their investment levels. Such a perverse flow of savings reduces world welfare. Furthermore, one of the consequences with the establishment of the Fund was that because of the availability of a pool of reserves each member country need hold a smaller amount of reserves. But because of the manner of operation of the Fund this economy on the use of reserves has not occurred. Since in the current system reserves consist largely of dollars it entails the US running BOP deficits, whereas the richest country should be supplying capital to the rest of the world, as the UK did before the FWW.

We, thus, see two harmful consequences of the Fund's policies. Countries have to sacrifice internal goals in order to meet external goals, a situation that the Fund was established to avoid. Such an adjustment is likely to impart a deflationary biased to the world economy. This seems to have happened as growth of the world economy has been considerably slower after 1973 than earlier. Also, developing countries have been forced to accumulate reserves as a form of self insurance leading to savings flowing from low income countries to high income countries than the other way around.

A major conclusion that can be drawn from the recent experience is that a symmetric Fund as desired by the British would have been better. The IMF was set up with the notion that the US would always be the surplus country. If the operation of the Fund had been more symmetric then the US would not have run into the problem it has faced first with Japan and Germany and now with China and Germany running large persistent surpluses. The US has had to use restrictive trade practices to threaten Japan and China to take steps to reduce their surpluses. Again trade policy is being used to achieve balance of payment or macro effects.

Endnotes

1 Meanwhile in the US, Dexter White had been tasked with developing a system of international economic governance.

2 Such policies were called beggar-thy-neighbour policies.

3 In only two years during this period did the unemployment rate fall below 10 per cent.

4 Morgenthau and White did not want that US assistance be used to build up foreign exchange reserves for the post-war period. They required a weekly accounting of the foreign exchange budget as narrated in Keynes (1978a).

5 For the US perspective see van Dormael (1976) and Bordo (1993).

6 The Keynes (1978a) papers show that the proposal for a multilateral reformed trading system arose to prevent the Balkan countries joining a German led grouping. The evolution of thinking to support a multilateral system is shown by the discussions on the various drafts and subsequent changes in the drafts.

7 In the case of the elimination of Imperial Preferences the objective might have been political also.

8 There were fears that after the war economies such as the US would face a lack of demand and a return of depression conditions. In such a situation a higher level of exports would enable the US economy to have a higher level of economic activity and employment. A similar belief that European recovery was essential to US prosperity prevailed in the immediate years after the First World War also but proved to be unfounded.

9 Keynes had supported managed trade during the recession in order to raise employment. He was concerned that the US would continue to follow a policy of high tariffs and also a recessionary policy. Once convinced that this was not the case he reverted back to supporting multilateralism. This evolution can be followed in his war time writings (Keynes, 1978 a 1978 b). Also see Gardner (1956).

10 The two governments stressed different parts of the agreements, the UK tariff reduction by the US ad that there was no definite commitment to eliminate preferences only that these would be considered. The US negotiators stress that the UK had committed to eliminating preferences (Gardner, 1956).

[11] Many Senators and newspapers were unhappy that lend-lease seemed to give credits to the UK without requiring any recompense. The US Administration always insisted that there would be compensation, only that it was still being negotiated. The clause in the Atlantic Charter and the lend-lease agreement against preferences were considered a part of the compensation (Gardner, 1956).

[12] Keynes1978a) wanted the Clearing Union which is what he called his proposed organisation to act as an international central bank and to operate on banking credit rules.

[13] In the negotiations for the International Trade Organisation they sought mechanisms to stabilise prices.

[14] Exchange rate movements could change the competitiveness of a country's goods and so create a demand for protection. Negotiations in the 1930s had shown that countries were reluctant to accept tariff cuts as long as exchange rates were unstable. Also exchange rate movements could nullify the effects of a cut in tariffs.

[15] The US accepted the need for restrictions on capital movements. For a detailed discussion of the debate see (Helleiner, 1994). Also see Ruggie (1982) and Horsefield Vol. 3 (1969).

[16] In the Krugman model (1979) the government is running an unsustainable budget deficit that leads to an excess supply of money which is eliminated by a trade deficit which reduces the foreign exchange component of the money base. In other models (Obstfeld, 1996) crises occur when there are two equilibria both of which can be sustained by appropriate expectations .Crises occur when expectations change and the economy shifts from one equilibrium to another.

[17] For instance, Keynes (1978a) said of the IMF agreement that "Not merely as a feature of the transition, but as a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements."

[18] But the bankers were successful in diluting some of the proposals. The final version allowed countries to cooperate in enforcing capital controls instead of requiring them to. Keynes/White believed that controls would be more effective if they were monitored at both ends. Also governments were no longer required to submit a list of all assets held in their country by foreigners. For a discussion of the impossible trilemma see Aizenmann(2010) and Obstfeld et. al. (2010).

[19] For a discussion of the opposing interests see Strange (1976).

[20] It is often asserted that Keynes who died shortly after his return to England died because of the strain of the negotiations.

[21] 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).

22 There was considerable ambiguity of this provision. Countries argued that consulting the IMF before a devaluation could lead the market getting wind of a possible devaluation and this would create a panic in the foreign exchange market so a country would merely inform the IMF of a devaluation. As it turned out most countries were reluctant to devalue and often the Fund had to force a devaluation as a condition for a loan.

23 The currency of a country running persistent large surpluses could be declared scarce and other countries could discriminate against the exports of such a country. Keynes (1978a) accorded great importance to the scarce currency clause. But White in testimony to the Senate maintained that declaring a currency scarce did not imply the responsibility of the US. Nor is the burden of adjustment solely on the US (Gardner, 1956, p137).

24 The WTO has also become less tolerant of QRs. Consequently only a handful of small countries still levy QRs.

25 For a detailed analysis of the terms of trade controversy see Spraos (1983).

26 Some of the Latin American countries supported the Indian position Many Latin American countries had been involved in the 1930s in negotiations with the US to establish a Latin American development institution. White had be engaged in these negotiations (Helleiner ,2014).

27 A brief history of the BIS, 1930-2017,2017, BIS.org. accessed at https://www.bis.org/about/arch_guide.pdf on 7th June 2019.

28 They believed that these had been partly responsible for the rise of fascism and the war.

29 Whether he was or was not a spy is controversial (Broughton, 2000).

30 Collado had been a new dealer. There had been in general a replacement of original new dealers by more conservative members after the 1942 elections which saw conservatives make gains in Congress.

31 Eugene Black later from 1949 to 1963 was president of the World Bank.

32 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.

33 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).

34 These countries levied high tariffs and adopted QRs in an attempt to industrialise.

35 Trade policies have moved very far from the provisions for trade policies to achieve full employment and also economic development negotiated in the charter of the ITO.

[36] That premature capital account liberalisation could create problems as had been pointed out by analysts was ignored by the IMF. For an analysis of problems with such liberalisation see Diaz-Alejandro (1985). Z-ALEJANDRO

[37] Even in the 1960s it was realised that additional resources may be needed, in particular, if the UK or the US needed to borrow from the Fund. The General Agreement to Borrow was negotiated between 10 countries and later Switzerland to lend money to the Fund if necessary,

[38] It switches demand from foreign goods to domestic goods.

[39] In two goods trade models that assume full employment such a shift occurs automatically when relative prices change.

[40] Such a combination of policies were responsible for the success of Korea (Amsden, 1989) and Taiwan (Wade, 1990).

[41] For a general discussion of the rationale for encouraging market oriented policies and the reasons for their failure see Toye (1987), (, Mosley, Hartigan and Toye, 1991.

[42] As we have seen above the UK and the US differed as whether funds would be available feely or conditions could be imposed. There was a debate in the 1950s whether conditions were advisable and whether they were legal. See Babb and Carruthers (2008), Buria (2003), and Gould (2006).

[43] There is another asymmetry. The US can run deficits seemingly without constraint as the dollar is the international currency. But this was not an issue at Bretton Woods as the US was expected to continue running surpluses.

[44] For a discussion of these trends and their causes see Agarwal (2013).

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Core IV-B, Fourth Floor, India Habitat Centre
Lodhi Road, New Delhi-110 003 India., Tel. 91-11-24682177-80
Fax: 91-11-24682173-74, Email: dgoffice@ris.org.in
Website: http://www.ris.org.in

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