International Finance and the Bretton Woods Institutions

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Background: Bretton Woods

- With the world at war, participants from each of the Allied countries convened on July 1, 1944 in Bretton Woods, New Hampshire to create a new international monetary system.

- The breakdown of the inter-war gold standard, and the mutually destructive economic policies that followed, convinced leaders that a new set of cooperative monetary and trade arrangements was a prerequisite for world peace and prosperity.
Background: Bretton Woods

- The outcome of the conference, known as the Bretton Woods Agreement, included the creation of an adjustable peg exchange rate system (termed the par value system) and the establishment of two international organizations (the IMF and the IBRD) that were created in the hopes of maintaining economic cooperation among the participating countries.

- The ITO (International Trade Organization) was also part of the original Bretton Woods plan. Its’ charter was never ratified, though GATT (and more recently the WTO) subsumed some of its original goals.
Some Pre-History

- Under the gold standard from 1870–1914 and after 1918 for some countries, each central bank fixed the value of its currency relative to a quantity of gold (in ounces or grams) by trading domestic assets in exchange for gold.

  For example, if the price of gold was fixed at $35 per ounce by the Federal Reserve while the price of gold was fixed at £14.58 per ounce by the Bank of England, then the $/£ exchange rate must have been fixed at $2.40 per pound.
How a Fixed Exchange Rate Works

- To fix the exchange rate, a central bank influences the quantities supplied and demanded of currency by trading domestic and foreign assets, so that the exchange rate (the price of foreign currency or gold in terms of domestic currency) stays constant.

- In other words, the central bank must adjust the domestic money supply until the domestic interest rate equals the foreign interest rate.

- Because the central bank must buy and sell foreign assets to keep the exchange rate fixed, monetary policy is *ineffective* in influencing output and employment.
Devaluation and Revaluation

- **Devaluation** refers to a change in a fixed exchange rate caused by the central bank.
  - a unit of domestic currency is made less valuable, so that more units must be exchanged for 1 unit of foreign currency (or gold).

- **Revaluation** is also a change in a fixed exchange rate caused by the central bank.
  - a unit of domestic currency is made more valuable, so that fewer units need to be exchanged for 1 unit of foreign currency (or gold).
How Does a Central Bank Devalue?

For devaluation to occur, the central bank buys foreign assets or gold (using domestic currency), so that the domestic money supply increases, and interest rates fall, causing a fall in the return on domestic currency assets.

- Domestic goods are cheaper, so aggregate demand and output increase.
- Official international reserve assets (foreign assets and/or gold holdings) increase.
Why Did Countries “Competitively Devalue” in the Inter-War Period?

- A devaluation is designed to cheapen a nation's currency and thereby increase its exports at other countries' expense (and reduce imports).

- Such devaluations are often described as “beggar thy neighbor” policies.

- If all countries try to devalue at the same time (as they did during the inter-war period), they will all be expanding their money supplies, resulting in higher world-wide inflation (and few devaluation benefits).
How Was the New (Par-value) System Supposed to Work?

- The idea was to set up a “cooperative” fixed exchange rate system which avoided the incentive to “beggar thy neighbor”. Countries were to seek financial assistance from the IMF, rather than devalue, if they found that their imports exceeded their exports.

- Each central bank fixed the value of its currency relative to the US dollar by buying or selling domestic assets in exchange for dollar assets.

- The dollar, in turn, was fixed to gold (at $35 an ounce).

- The system was asymmetric, in that only the US could decide its own monetary policy.
The “Special” US Role in the Par-Value System

- Suppose the US increased its money supply.
  - This would lower US interest rates, putting downward pressure on the value of the US dollar.
  - In order for the other central banks to maintain their fixed exchange rates, they would need to buy dollar denominated (foreign) assets, increasing their money supplies.
  - In effect, the monetary policies of other countries had to follow that of the US, which was not always optimal for their levels of output and employment.
The Role of the IMF

The IMF's two original responsibilities were to:

- administer the par value system
- provide members financial assistance to enable them to maintain their par values in the face of short-term balance of payments shortfalls.
The IMF and the Par-Value System

- IMF members that were not occupied by the enemy during WWII were obligated to establish par values, expressed either in terms of gold or the U.S. dollar, within 30 days of the official commencement of the Bretton Woods System.

- All current account exchange transactions were to be made within 1% bands of the established par values.

- The rules did not permit members to change par values (other than a one-time change of 10 percent), except to correct a fundamental balance of payments disequilibrium and only after consultation with the IMF.

- Moreover, if a member changed the par value of its currency over the objections of the IMF, then the member would be ineligible to use IMF resources.
IMF Quotas and Voting Power

- Each member of the IMF has a quota equal to its subscription to the Fund.
- The original quotas totalled $8.8 billion with a U.S. contribution of $2.75 billion.
- A member's quota determines its financial contribution, its voting power in the IMF (based on one vote for each $100,000 of quota), and its access to the financial resources of the IMF.
Borrowing (Drawing) from the IMF

- Member drawings fall into four categories.
- Drawings up to the first 25% of a country's quota are in the gold tranche.
- The next three categories are called credit tranches.
- Transactions in the first credit tranche bring the IMF's holdings of a member's currency above 100% but not above 125% of its quota.
- Drawings in the second, third and fourth credit tranches require substantial justification and typically involve *conditionality*, terms and conditions to guarantee that the country is able to repurchase its currency in a timely fashion.
Stand-by Arrangements

- Stand-by arrangements were first introduced in 1952.
- A stand-by arrangement involves the IMF granting financial assistance to members in advance of difficulties.
- "Indeed, a stand-by arrangement presents the contradiction that the drawing country does not have to establish need at the time the arrangement is entered into and the Fund in effect waives any power to judge need at the time the drawing is made" (Dam, 1982, 122).
- While stand-by arrangements do not involve justification by the member country, they typically involve commitments to performance criteria.
The Role of the IBRD

The International Bank for Reconstruction and Development was designed chiefly to supply the capital needed for post-war reconstruction and long-term development projects.

Although the IMF and IBRD institutions are explicitly separate in terms of charter, funding and staff, membership in the IMF is a prerequisite for membership in the IBRD.
The IBRD

Along with providing long-term loans and technical assistance, the IBRD was to promote private foreign investment by guaranteeing and participating in loans by private investors.

Member country's subscriptions in the IBRD take the form of shares of capital stock. 20% of subscribed capital is paid-in, and of this, 2% is in the form of gold or U.S. dollars and 18% is paid to the Bank in each member's domestic currency (and cannot be used for loans without the consent of the member whose currency is to be lent). The remaining 80% of the Bank's subscribed capital is subject to call by the Bank only when required to meet its own obligations on its borrowings or guarantees.
The IMF and the IBRD

- The division of labor between the IMF and the IBRD has always been somewhat blurred.
- The Fund was to provide short-term balance of payments assistance while the Bank was to provide longer-term project assistance.
- In an often quoted passage, Keynes stated, "I should like to see the Board of the Fund composed of cautious bankers, and the Board of the Bank of imaginative expansionists"
Assessment: The IBRD

- The IBRD's original mission was to provide capital for European reconstruction.
- The IBRD's resources were from the beginning limited, but the intention was that the Bank would encourage private investment by providing loan guarantees.
- The President of the IBRD in 1947, John McCloy, "thought of the Bank as a temporary institution which would go out of business if it were successful, for it would no longer be needed as an intermediary between productive borrowers and private lenders" (Oliver, 1975, 259).
Assessment: The IBRD

- It was soon realized that the task of reconstruction was beyond the Bank's scope and the Marshall Plan, implemented in 1948, largely took over the job.
- The Bank then shifted its resources and focus to financing development projects in underdeveloped regions.
- Rather than serving as a guarantor of private investment, as the Bretton Woods participants had envisioned, the Bank took on an intermediary role, borrowing funds from private investors and lending them to developing countries.
The IBRD: A Shaky Start...

- The Bank's began with a passive approach toward development lending.
  - In 1950 the President of the Bank, Eugene Black, explained that the reason the Bank had not made many loans to developing countries "has not been lack of money but the lack of well-prepared and well-planned projects ready for immediate execution".

- The Bank organized its first economic survey mission to Columbia in 1949. Although these missions initially received mixed receptions, the IBRD increasingly took the view that it needed to assist countries in formulating long-term development programs.
The (Current) World Bank Group

Over the years 1956-1988 four additional agencies were combined with the IBRD to make up the World Bank Group:

- The (original) International Bank for Reconstruction and Development (IBRD)
- The International Finance Corporation (IFC)
- The International Development Association (IDA)
- The Multilateral Investment Guarantee Agency (MIGA)
- The International Centre for Settlement of Investment Disputes (ICSID)
Technically the World Bank is part of the United Nations system, but its governance structure is different:

- Each institution in the World Bank Group is owned by its member governments, which subscribe to its basic share capital, with votes proportional to shareholding.
- Membership gives certain voting rights that are the same for all countries but there are also additional votes which depend on financial contributions to the organization.

Governments can choose which of the 5 World Bank agencies they sign up to individually. The IBRD has 184 member governments, and the other institutions have between 140 and 176 members.
The IMF: Another Shaky Start...

- In 1948 both France and Mexico suspended their par values without IMF approval and allowed their currencies to float.
- 19 countries devalued in 1949.
- In the years to follow, the IMF became increasingly tolerant of member countries' refusals to “play by the rules” of the par value system.
  - In 1950, Canada informed the IMF of its decision to allow its currency to float because of a heavy capital inflow (mainly from the U.S. during the Korean war). After debating the issue at length, the IMF made no official pronouncement. Canada’s exchange rate floated for 12 years, yet the country was not denied access to IMF resources.
Assessment: The par value system

- The empirical evidence on the par value system indicates that the rules of the system were rarely enforced and the goal of the architects of the system, stable exchange rates, was only achieved by a small number of countries for a short time period.

- During the so-called heyday of the Bretton Woods era, 1959 through 1967, most developed countries did maintain stable and convertible exchange rates.

- However, few developing countries were able to maintain stable rates without the help of exchange and trade restrictions.

- The par value system came under a new set of strains in the late 1960s and finally collapsed in the early 1970s.
Assessment: IMF Financial Assistance

- The participants at Bretton Woods had originally envisioned use of the IMF's resources as a privilege granted to members that were otherwise in compliance with the IMF's rules and in need of short-term balance of payments assistance.

- But as was the case with the par value system, the IMF took on an increasingly broad definition of member eligibility for Fund resources.
Assessment: IMF Financial Assistance

- In the IMF's first two decades of operations, drawings by industrial countries accounted for over half of total Fund credit.
- The share of developing country drawings did not exceed that for industrial countries until the late 1970s.
- With conditionality as the Fund's major means of enforcing its rules, this change in the IMF's “loan clientele” has effectively led to a two-tier membership system. Those developing countries that rely on IMF credit are subject to the rules-of-the-game, while the developed countries are not.
What the IMF (Currently) Does:

- The IMF self describes its work as involving: (1) surveillance, (2) lending and (3) technical assistance.
- Surveillance involves the monitoring of economic and financial developments, and the provision of policy advice, aimed especially at crisis-prevention.
- The IMF lends to countries with balance of payments difficulties, to provide temporary financing and to support policies aimed at correcting the underlying problems; loans to low-income countries are also aimed especially at poverty reduction.
- The IMF provides countries with technical assistance and training in its areas of expertise.
Criticisms of the IMF and WB

- These institutions have been accused of being a US or Western tool for imposing economic policies that support Western interests.

- Critics argue that the free market reform policies — which the IMF and WB advocate in many cases — in practice are often harmful to economic development if implemented badly, too quickly ("shock therapy"), in the wrong sequence, or in very weak, uncompetitive economies.
Criticisms of the IMF and WB

- It is frequently suggested that the IMF and the WB intervene in order to rescue commercial banks (which provided irresponsible loans to governments in developing countries), and thus shifts the risk from the original risk-takers to the public of the rich countries, who ultimately must back the two institutions.
- The IMF’s recent experience in Argentina is a good case-in-point.
An Overall Assessment:

- If the IMF and the World Bank had not been established after the war, would it have been necessary to create them subsequently?
- It is difficult to find evidence that they were (or are) indispensable. The IMF was not able to maintain the par value system (which collapsed in 1971) and the World Bank was not able to satisfy the financing needs of post-war reconstruction and development.
- But to their credit, both organizations had the flexibility to evolve with economic circumstances and take on new roles in the maintenance of international cooperation.
History suggests that more recent architects would have less ambitious goals than the ones formulated at Bretton Woods.

The evolution of commitment mechanisms used by the post-war organizations indicates less reliance on rules and more reliance on the provision of centralized information to promote international cooperation.

Many countries allow the value of their currencies to be market-determined (rather than fixing its value). And those countries that fix (e.g. Europe) do so in a symmetric (rather than asymmetric) system.