

The Role of the Fund

Jacques J. Polak*

I. Introduction

The International Monetary Fund, created by the United Nations Monetary and Financial Conference held from July 1 to July 22, 1944, is a highly specialized institution. Its purposes, as set out in Article I of the Articles of Agreement, delineate with considerable precision the task that its prospective member countries wanted it to undertake. These purposes, six in number, deserve to be quoted here in full:

- (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

These purposes have lost none of their poignancy over the last 40 years. But the role of the Fund in the pursuit of these purposes has changed in response to changes in the world economy and the world financial system, changing opportunities for action and, especially on the financial side, the extent to which balance of payments financing to countries in need of it was available from sources other than the Fund.

*Executive Director, International Monetary Fund

The Fund has probably been most consistent in the pursuit of the elimination of payments restrictions, even in its early years when support for this activity was mostly restricted to North America. On other subjects its concern and its influence fluctuated a great deal over the years. Thus, there were periods when the Fund was actively concerned with the price of gold and the role of gold in the system—from 1947 to 1951 and, much more dramatically, from the early 1970s when the market price began to deviate sharply from the official price until 1980 when the Fund's gold sales ended. Since then, gold has disappeared from the Fund's agenda. On exchange rates the role of the Fund has shown both trend and cyclical variations. For all but the largest countries the Fund has developed a steadily rising interest, expertise, and influence on exchange rate policies, with an increasing willingness to see the instrument used as a major component of adjustment policy. For its largest members, the Fund did not play a major role in exchange rate changes until about the late sixties, at first because it was too young an institution to be trusted with an important role in a matter of extreme sensitivity, and then because the major countries attempted to impose a taboo on the entire subject of possible changes in their exchange rates. As this proved impossible, the Fund played an important role in the 1967 devaluation of sterling and in the drawn-out process of adjustment of rates among all major currencies that stretched from August 15, 1971 to the Smithsonian agreement of December 18 of that year. But since the advent of floating in the early 1970s, the Fund's role with respect to major currencies has shown a persistent decline. With the subtle substitution, by the second amendment of the Articles, (agreed in Jamaica in January 1976 and in force since April 1978) of the expression "a stable system of exchange rates" for "a system of stable exchange rates," and in spite of the simultaneous introduction of "firm surveillance over members' exchange rate policies," the Fund has gradually broadened the scope but, at the same time, lowered the depth of its surveillance to a point where its role in connection with the rates for the major currencies has become marginal. This was not a matter of choice; it reflected the reluctance of governments to accept responsibility for the exchange rates of their currencies in conditions where capital transactions played a much larger role in exchange markets than had been envisaged at Bretton Woods or had been the case for the subsequent 25 years.

The financial role of the Fund has similarly shown a succession of ups and downs. The "ups" were mostly attributable to severe disturbances in the world's payments situation, such as the Suez crisis (1958), a succession of sterling crises, the first oil shock, and, above all, the second oil shock cum the disinflation crisis of the last few years. The "downs" occurred typically when the supply of international finance from other sources became particularly plentiful: in the Marshall Plan period; in 1970–72, when the payments deficit of the United States produced surpluses in almost every other country, and in the second half of the 1970s, at the peak of the euphoric years of commercial bank recycling. In anticipation of a point to which more attention will be paid below, one can note that only in the first of these three periods of low financial activity for the Fund was the financing from other sources accompanied by adequate concern for adjustment.

Considering the attention that other papers for this conference will pay to the questions of reform of the system and exchange rate arrangements, I intend to concentrate my remarks on the role of the Fund as it relates to the twin problems of financing and adjustment.

In dealing with the role of the Fund in this area, I find it necessary to strike a careful balance between the positive, the normative, and the possible. In one sense, the role of the Fund is obviously what it does now. The tasks that it now performs are indicative of the role that its membership has assigned to the institution at this moment. These tasks have evolved quite dramatically over the years, with the institution—responding with alacrity to the changes and challenges of its surroundings—giving form and substance to what were only dimly perceived outlines 40 years ago. Any discussion of the role of the Fund could not be adequate without a fair amount of description of where the Fund now stands—even for an audience as well versed in the matter as the participants in this conference.

At the same time, the role of the Fund is not a static one. The present represents an uneasy balance between various forces operative among its members. No one is entirely satisfied with where the institution stands now, and it will doubtless undergo further changes in the years to come. There is every reason, therefore, to speculate on whether the fund should continue to do everything that it is now doing, and whether it should be performing additional tasks within the general framework of its purposes.

But these exercises in normative thinking will have to be qualified by a reasonable respect for the possible. This somewhat cliché phrase is intended to suggest that, even though the Fund, while staying within the boundaries set by its purposes, may be able to expand its scope of activities beyond what it is doing at any moment of time and it has of course done so decisively on a number of occasions in the past. However, there are still certain quantitative limits that it cannot transgress for any foreseeable period of time, whatever may be the theoretical desirability of going well beyond these limits. One important reason for this constraint on the Fund lies in the manner in which it is financed: from the reserves of member countries. In a discussion of the role of the Fund attention needs, therefore, to be paid to the financial structure within which it operates and, I believe, must operate.

A particular point to be noted here—and to be elaborated further below—is that the Fund's access to finance acts as a single constraint on its two financial functions—the granting of conditional credit and the across-the-board provision of reserves through the allocation of SDRs. This is one good reason why this second financial function of the Fund—introduced with considerable fanfare in the first amendment (1969) but by now preferably overlooked in much of the industrial world—deserves a place within the scope of this paper.

II. The Extention of Conditional Credit

1. *Adjustment and financing*

Adjustment and financing are the two poles that control the field of tension within which the IMF operates. Most disequilibria in the balance of payments, especially if they are large, are not likely to disappear or to reverse themselves without measures of adjustment. If in such cases the Fund granted financing without insisting on adjustment, such financing would not contribute to the correction of balance of payments adjustment, to which the fifth purpose, cited above, refers. But adjustment without financing is also in most cases an inappropriate policy response: that is, whenever the causes of the disequilibrium are so severe that the approach would inflict serious and needless harm to the national or international prosperity and thus also conflict with the fifth purpose.

The appropriate relative dosage of adjustment and financing is therefore the crucial problem of the Fund. And not only of the Fund: the same problem presents itself to countries whether they seek financing from the fund or not. Every country has to decide to what extent it should absorb external or internal shocks by fluctuations in its reserves or reserve liabilities (financing) or should counteract these shocks by policy measures (adjustment). Countries have, moreover, the option to use certain policy instruments (such as fixed exchange rates, freely floating rates, "leaning against the wind," a target for the money supply, a target for domestic credit expansion, etc.) as automatic pilots in such a way that they will induce either adjustment or financing in response to shocks of a particular nature. But even a country that tends to rely on such automatic pilots will abandon them if the seas become too rough—see, for example, the abandonment by Switzerland in 1978 of its norm for monetary growth to avoid excessive appreciation of its currency and by the United States of the M-1 norm, in mid-1982, to protect both the domestic economy and the international monetary system.

2. *The experience of the sixties*

In the 1960s the emphasis on attempts to reform the system among the leading countries and (marginally less so) in the Fund was on problems of financing rather than adjustment. International reform focusing on the supply of an adequate level of international reserves culminated in the amendment to the Articles of the Fund creating the SDR and in the first decision to allocate SDRs (both in 1969). At the same time, adjustment was seen under the double constraint of avoiding both "situations of higher or prolonged unemployment of resources or economic stagnation"¹ and, except in extremis, changes in exchange rates.²

One can fault the lack of attention paid to the weaknesses of the system as far as adjustment was concerned, but not the attention given to the reserve

¹International Monetary Fund, 1964 *Annual Report*, p. 26.

²*Ministerial Statement of the Group of Ten*, Annex prepared by Deputies (August 1964) p. 5.

problem. Toward the end of the 1960s—in contrast to the preceding 15 years—there were some indications that reserves were becoming less adequate; the evidence did not lie in general deflationary symptoms of the world economy but in increasing tendencies to restrict the movements of goods and capital and in an increasing recourse to international financial assistance.³ Of course, the decision to allocate SDRs, taken in September 1969—after a few quarters when foreign official dollar balances had shown an actual decline—reflected something short of perfect foresight: such balances then increased by 50 percent in 1970 and again by over 100 percent in 1971.⁴ With this flood of dollars the payments problems of practically all other countries were washed away; one consequence was that the bulk of outstanding Fund credit was paid off. (Another consequence was that in 1972, towards the end of the first basic period, no decision was taken to allocate any further SDRs.)

3. *The Oil Facility and the lessons drawn from it.*

The issue of adjustment vs. financing could have arisen in full force again after the sharp increase of OPEC's oil prices just before Christmas 1973. In fact, it did not. The common fear, as expressed in the Rome meeting of the Committee of Twenty that took place a few weeks later, was that oil importing countries (developed as well as developing) might decide to deal with their sudden problems by means of deflation, competitive depreciation, or trade and payments restrictions. Thus, the Committee warned against measures "that could only aggravate the problems of other countries"⁵ and came close to approving the special oil facility in the Fund that the Managing Director had proposed (and that came into effect five months later). The oil facility was designed to meet unexpected high import costs, in much the same way as the compensatory financing facility (CFF)—on which it was patterned—assisted countries in dealing with temporary export shortfalls. The conditionality of the oil facility was only slightly greater than that of the CFF, in large part no doubt because of the existing fears of excessive adjustment. It is true that the principle was clearly enunciated that countries that financed their oil deficits by drawing on the facility should at the same time correct their non-oil deficits. This principle was not easy to apply, however, and the Fund did little to enforce it; indeed a far more stringent conditionality of drawings on the facility would have been necessary to make this principle stick. The oil facility reflected the common view of the great majority of the membership at the time: primary emphasis

³"Allocation of special drawing rights for the first basic period," Proposal by the Managing Director of the IMF, Washington 1969, p. 6/7.

⁴The figures at year-end were as follows:

1968	\$	17 billion
1969		16 "
1970		24 "
1971		51 "
1972		62 "

⁵Communiqué of the Committee of Twenty, January 28, 1974 (in IMF, *International Monetary Reform, Documents of the Committee of Twenty*, Washington, 1974, p. 217).

on the maintenance of demand, a secondary role for adjustment, and hence major reliance on financing. In spite of the oil facility, only a small proportion of total financing, about one-tenth, came from the Fund⁶; a very large part proceeded via an expansion of the international business of the banking system.

The experience of the Fund as a participant in the recycling business led to two, diametrically opposed, inferences. Some inferred from it that recycling constituted indeed an important, and potentially major, role for the Fund which should be enhanced by giving the Fund access to much larger resources. Others saw recycling as incompatible with the Fund's role in the adjustment process: in recycling, the emphasis is on smooth operation, and in many instances that cannot be reconciled with insistence on sufficient adjustment measures. For a number of reasons, the second view prevailed in the Fund. The oil facility was not renewed after its initial, two-year run and recycling is no longer accepted as an important (or perhaps as any) component of the Fund's financial role.

The financial constraint to which the Fund is subject played some role in the prevalence of this position. Aggregate annual balance of payments deficits of deficit countries can be very large, even after surpluses of oil exporters have disappeared; if the Fund were to assume the task of intermediating a large proportion of the amounts involved, it would require a number of times its present supply of resources. Moreover, recycling of surpluses—whether from oil exporters or industrial countries—toward developing countries has so far been mainly a one-way process—hardly reconcilable with the concept of the Fund as a revolving source of finance.

But the reasons for a decisive move towards greater conditionality go well beyond the financial impossibility for the Fund to be a ready and continuous source of current account financing of the developing world. In a number of respects the experience gained by member countries and the Fund in the first part of the 1970s pointed in a different direction; and this experience continues to accumulate and to confirm and strengthen the view on the proper role of the Fund.

One important lesson of the first oil shock was that delay in adjustment was a costly policy choice for the medium term. Those among the industrial countries that acted on this assumption in 1974 and 1975 (mainly the United States, Germany and Japan) and accepted a temporary reduction in activity to contain a persistent wage-price spiral were able to turn their balances of payments around and to provide a much sounder basis for their economies than others (such as the United Kingdom, France and Italy) that attempted to offset the deflationary impact of higher oil prices. The lesson was well learnt by 1978/79—not only in the industrial countries—and many countries reacted to the second oil shock with a much stronger dose of adjustment than they had to the first.

⁶The total current account surplus of the oil exporters in the three years 1974–1976 amounted to \$ 143 billion; credit extended by the Fund during the same period, mostly through the oil facility, was about \$ 14 billion.

As further evidence of the change in atmosphere one can observe that in 1979/80 there was never any serious consideration of a new oil facility in the Fund. Indeed, in the Fund as among members, the emphasis on adjustment became stronger precisely at a time when the world economy was less buoyant—a clear reversal of the Keynesian approach of the 1974 decision on the oil facility. It became increasingly clear that in cases where serious adjustment is required, its total pain (e.g., in the form of lost output) is not reduced but maximized by a gradual application. It follows from this that it does not make sense for the Fund to calibrate its conditionality as applied to individual countries in response to fluctuations in the level of world activity. I disregard for a moment the practical impossibility of devising adjustment programs for up to three years as a function of anyone's guess of the status of the world economy that far ahead, as well as the credibility problem for an institution that would be prescribing adjustment with one eye over its shoulder at the latest world indexes. The objection is more fundamental: when a particular country is in need of adjustment action—to correct internal and external price distortions, to introduce fiscal and monetary control, *and* to create credibility at home and abroad that it will be able to pull off the required package of measures—considerations of the possible impact of this package on world aggregate demand cannot be allowed to enter into the decision-making process. If world demand needs bolstering, the place to do it would be in those industrial countries that have their financial policies under reasonable control, and certainly not in the countries which the Fund is assisting to seek the road to such control. The notion that IMF conditionality should vary over time, depending on world economic conditions, in order to make some contribution to a global anticyclical policy⁷ should therefore be rejected not merely as impractical, but wrong in principle.

It can be noted in passing that without any attempt on the part of the Fund to adjust its policies, it will have somewhat of a countercyclical impact by the cyclical movement in the demand for its resources. The compensatory financing facility will be drawn on more heavily when world trade slumps than when it booms.⁸ The normal resources made available under the quotas will also be used more when the general economic climate is difficult than in a period of worldwide prosperity.

⁷John Williamson, *The Lending Policies of the International Monetary Fund*, (Washington, D.C.: Institute for International Economics, 1982) page 44.

⁸While CFF drawings in years of weak exports were important to the countries that benefited from them, their magnitude was not such that it could have had much impact on the world economy. Such drawings sharply increased, by about SDR 2 billion, from 1975 to 1976, and again from 1979 to 1982. The former figure was nearly 2 percent of the exports of the non-oil LDCs but only ¼ of a percent of world exports; for the second period, these percentages were about .7 and .1 respectively. Note, however that the figures do show sharp cyclical fluctuations (in billions of SDRs):

<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
.2	2.3	.2	.6	.6	1.0	1.2	2.6	2.8

4. *The Fund and the commercial banks*

At the same time that there was a growing recognition of the need for more adjustment and of the role that the Fund should play in bringing this about, the Fund was losing ground in performing this function. As the commercial banks discovered an almost unlimited market for credit in the LDCs and the smaller OECD countries, conditional credit from the Fund became an unattractive alternative for these countries, even though it was much cheaper than bank credit. Except in the near-desperate cases, the banks dislodged the Fund. From 1973 to 1979, low conditionality credit (oil facility and CFF) to the LDCs was three times as large as regular tranche credits.⁹

A somewhat overdrawn and less than prophetic picture of this situation was painted by Rimmer de Vries in the April 1982 issue of *World Financial Markets* (published by the Morgan Guaranty Trust Company) under the title "The limited role of the IMF" (pp. 7-11). Citing figures to show that in 1980 and 1981 the banks lent \$ 85 billion net to the non-oil LDCs and the Fund only \$ 5.6 billion, de Vries concludes that "the IMF is playing, and probably will continue to play, a qualitatively very important but nevertheless quantitatively limited role in the international financial arena" (page 9). Further analysis relates this experience to the fact that the Fund has a specialized clientele of essentially low per capita income and communist member countries, while it "has with few exceptions, failed to attract countries that are major borrowers from the commercial banks and that have large external financial requirements. Industrial countries, such as Belgium, Denmark, Ireland, and Spain do not have programs with the Fund, and neither do developing countries such as Argentina, Brazil, Chile, Greece, Israel, Portugal, and Mexico. All this illustrates that the IMF and the commercial banks increasingly have operated, and are likely to continue to operate, in different markets. As in the recent past, the bulk of the Fund's resources can be expected to be channeled to countries that by and large are excluded from ready access to private capital markets. . . . The commercial banks, therefore, must come to the realization that they are on their own when it comes to international lending because the Fund is no longer a catalyst for prompt external adjustment in the major deficit countries. . . . Thus, the Fund must not be viewed as a protective umbrella under which the international banking community can find shelter in times of trouble."

In part, this displacement of the Fund was attributable to the inadequate size of the resources that it stood ready to provide to its members, at a time when their payments problems were unusually severe and the banks could supply credit virtually without limit. Inflation, and quota increases that did not take adequate account of inflation had, by the middle seventies, reduced at least by half the quotas as a percent of imports both for the membership as a whole and for its main customers, the non-oil LDCs (Table 1).

⁹In the next four years (1980 to 1983) the proportions were approximately reversed.

Table 1
Ratio of Quotas to Imports
(percent)

<u>Year^{a)}</u>	<u>World^{b)}</u>	<u>Non-oil developing^{c)} countries</u>
1963	10.6	9.4
1964	9.6	8.9
1965	8.9	8.9
1966*	10.4	10.3
1967	10.1	10.3
1968	9.2	10.1
1969	8.1	9.4
1970*	9.4	10.7
1971	8.6	9.8
1972	8.0	10.2
1973	6.4	8.2
1974	4.4	5.2
1975	4.3	5.0
1976	3.6	4.6
1977	3.2	4.1
1978*	3.9	4.9
1979	3.2	4.0
1980*	4.0	5.3
1981	3.7	4.5
1982	3.8	4.8
1983*	5.6	7.0

^{a)}Quota figures at end of year. Asterisks indicate years when general quota increases went into effect.

^{b)}Total of Fund quotas divided by world imports.

^{c)}Sum of quotas of non-oil developing Fund members in each year divided by imports of all non-oil developing countries.

Source: IFS, various issues

As a result, the amount of financial assistance that a country could expect from the fund under its prevailing policies became too small, in relation to the size of its payments problem, to make recourse to the Fund an acceptable political choice. Around 1980, the Fund took major steps to remedy this and other drawbacks in its disadvantaged position vis-à-vis the commercial banks. It adopted access limits for conditional credit of 150 percent of quota *per year*, with an overall limit of 600 percent of quota—a six-fold increase over the overall limit of 100 percent of quota that prevailed until a few years earlier; it shifted emphasis from one-year to three-year arrangements; and it lengthened the maximum period of repayment under the “Extended Fund Facility” (EFF) from eight to ten years.¹⁰

The consequences of the Fund’s decision on enlarged access went well beyond compensating for the relative decline of quotas to world trade. That

¹⁰See Group of Thirty, “Balance of Payments Problems of Developing Countries,” (New York, 1981).

decline had reduced quotas to somewhat below one-half of their previous relation to trade; the combination of these quotas with the new access rates¹¹ produced a theoretical availability, in relation to trade, that was about double that before 1972. Accordingly, enlarged access has always been considered a temporary policy related to the exceptional payments difficulties of recent years, and in conjunction with the entry put into effect in the 8th Quota Review a beginning was made to reduce enlarged access.

These modifications of policy played an important part in inducing countries that faced adjustment problems to conclude arrangements with the Fund—including a number of larger countries, such as India, Korea, Morocco, Pakistan, the Philippines, Turkey, Romania and Yugoslavia. The banking crisis of mid-1982 did the rest. Some part of the enlarged activity of the Fund can be attributed to a short period during which conditionality was somewhat weakened. This is, of course, an area in which comparative judgments are difficult to make, but there can in any event be no doubt that since 1981 the Fund's conditionality has been more demanding than it was in any earlier period. The hardening of conditionality is not seen in the Fund as a matter of arbitrary choice, but as the necessary response to the worsening situation of many countries' payments position and outlook.¹²

There occurred, at the same time, a substantial hardening, over the last year or so, of the conditions applicable to CFF drawings. Previously, such drawings required, at least for the first 50 percent of quota, no more than a serious undertaking on the part of the country to discuss with the Fund the measures that might be required to bring its payments to a more satisfactory position. At present, however, CFF access even for the first 50 percent of the quota requires the member to take prior action that gives reasonable assurance that corrective policies will be adopted. For the remaining access of 33 percent of the quota (reduced from another 50 percent of quota when quotas were recently increased), the conditions are now practically the same as those for drawings in the higher credit tranches. As a result of these changes the CFF has largely become a supplement to general conditional access for those countries that meet not only the general test of the fund's conditionality but also the criteria for an export shortfall.

5. *The Fund as a lender of last resort?*

In connection with the proper scope of the Fund's lending activity, considerable attention has been given to the question whether the Fund is, or should be, a lender of last resort.¹³ The question relates to an important issue of Fund policy; unfortunately, by being couched in terms that originated in

¹¹Of which so far the figure of 450 percent (of the 1983 quotas) for three years has normally been operative, rather than the overall limit of 600 percent of quota.

¹²Explicitly on this: "A conversation with Mr. de Larosière," *Finance and Development*, (IMF/IBRD) June 1982. pp. 4-7.

¹³William B. Dale (Deputy Managing Director of the Fund), "Financing and Adjustment of Payments Imbalances" in John Williamson, ed., *IMF Conditionality*, Washington 1983, p. 11: "Is the Fund to be regarded as a lender of last resort, or is it to be a routine provider of financing to meet balance of payments deficits?"

the theory of central banking, it evokes associations that do not apply to the Fund and that make it difficult to produce a clear answer. There are, in fact, two entirely different answers.

(1) During the 1970s, when commercial banks were readily lending to many countries, countries had a tendency not to approach the Fund except when their financial position was in extreme distress (indeed, the continued absence from the Fund of OECD countries in recent years suggests that many countries with access to bank credit still prefer such credit at a higher cost to drawing on the Fund). The Fund has explicitly deplored this tendency when it stated, in the first of its "guidelines on conditionality" (adopted in March 1979) that members should be approaching the Fund for assistance "at an early stage of their balance of payments difficulties." It is necessary to report, however, that since the adoption of this guideline the opposite view has also surfaced in the Fund. One of the main reasons why the United States initially opposed the large stand-by arrangement for India (in 1981) was that India had hardly used its ability to borrow from commercial banks.

(2) When a central bank, in performance of its function as lender of last resort in the domestic monetary system, lends to a commercial bank in difficulties, it must lend extremely promptly, in very large amounts if these are needed, and typically at a penalty interest rate. There is no parallel function for the Fund in response to payments difficulties of a country. The Fund does not lend extremely promptly, but on the basis of a negotiated adjustment policy which takes weeks, more often months, to arrange; it does not lend a very large sum at once, but in installments, on the basis of performance; and it does not have to charge a special interest rate to deter frivolous use of its resources. In some cases, the instant lending role is performed by others, e.g., by the central banks of other countries under existing swap lines, or in some recent cases by the BIS; in other cases that role is simply not performed and the country struggles along without outside money, perhaps by incurring arrears. While experience over a long period suggests that national banking systems are in need of a true lender of last resort (which, of course, need not—and indeed should not—step in on every occasion where a commercial bank might fail), the international experience of the last few years suggests no clear need for a general lender of last resort; from a systemic point of view, a mechanism for the Fund's instant rescue of a country that had landed in serious payments difficulties, on the principle of "pay first, talk later," would almost certainly be worse than the present approach—messy as it sometimes is—which seeks to ensure an adequate adjustment effort in exchange for international financial assistance.

Beyond the question of "lender of last resort" there are other fundamental differences between the role of a central bank within a country and the, actual or potential, role of the Fund in the international monetary system. At least two of these deserve mention here:

(a) the Fund has no territory where the currency it creates is *the currency*; hence the value of the Fund's currency, the SDR, must be a derived value (initially from gold, thereafter from a basket of currencies); and

(b) the Fund is not backed up by an international government that can impose and enforce an unlimited "acceptance obligation," i.e., an unlimited

legal tender status, for the Fund's currency.

The question whether the Fund is, or is developing toward, a World Central Bank is therefore essentially spurious. The Fund may, over time, perform many more useful functions for its members than it already does, and some of its present or future functions have close counterparts in what central banks do within individual countries. According to one's taste, one may proclaim at some stage that the Fund is, or is almost becoming, a World Central Bank. But it should always be remembered that such a statement cannot be more than a figure of speech.¹⁴

6. *The expanded role of the Fund*

In spite of the fact that the Fund has raised very considerably the resources it is prepared to make available to a member—both in absolute terms and even more as a percentage of quota—the payments disequilibria in recent years have been so large that even these amounts have often been greatly insufficient to cover the debtor's minimum balance of payments deficit, i.e., the deficit that remained after the maximum feasible adjustment effort. When the Fund faced such situations it has taken the position that it would not commit its resources to an inconsistent program and that the remaining gap would have to be filled before the Fund would approve its contribution to the program. Procedurally, this approach has led the Fund into an explicit two-stage decision-making process: (i) agreement between the country and the Managing Director on a program and (ii) approval of this program by the Executive Board.

More important, and substantively, the Fund Management stepped into an international void and accepted a new international role for the institution: the role of the leader of coordinated balance of payments assistance. The Fund was first faced with situations that needed such intervention a few years ago, in certain countries where the additional resources to fill the gap would have to come from aid donors. Jamaica and the Sudan were two early cases in which the Fund gained experience with the fulfillment of this novel role. Its scope became much larger when the banking crisis affected large borrowers from the banks one after another; but the need to complement Fund resources by aid flows also spread, in particular in connection with Fund programs for African countries.

¹⁴When William McChesney Martin addressed the question "Toward a World Central Bank?" in the September 1970 Per Jacobsson lecture, he implied an affirmative answer. This was, indeed, the ideal short moment in history when such a view could plausibly be taken. The SDR had just come into being. "We may regard," he wrote, "the SDR mechanism in the Fund as a regulator, imprecise though it may be, of the growth of world reserves. This is truly a world central banking function—as distinct from the quite different task performed by the United States when it was (sic) the principal source of additions to world reserves." (p. 24) In addition, the Fund could act as a "restraining conscience" internationally, just as national central banks constrain their respective governments from indulging in overexpansion (p. 24). Perhaps the Fund could absorb other reserve assets against claims on itself, similar to the SDR (p. 25). The central bank function of lender of last resort "may be said already to be performed by the IMF" because of the sizable expansion of its transactions (p. 25). And, just as central banks regulate financial institutions and financial behavior, the IMF administers the par value system and promotes sound exchange practices (p. 25).

The Fund thus found itself, within a few years, in a major role of financial organizer for many of the countries that used its resources. Its activities in the field of "persuasion" affected commercial banks, that were asked to roll over debt falling due, to keep open lines of trade credit, to maintain or restore the level of overnight deposits, and to provide very large amounts of new money; ministries of finance, that were prevailed upon to reschedule debts and to provide new credit; exports guarantee agencies; aid donors in the industrial countries and the surplus oil exporters; the World Bank; and the Bank for International Settlements to provide bridging credit pending the design of a full-fledged Fund program.

In the process, further gradations were introduced in the Fund's decision-making process in order to take care of the difficult situation where every creditor wanted to be assured that every other creditor was coming along at the right time. As the occasion required, the two-step process just mentioned was lengthened by the addition of a further stage at either end. Providers of bridging credit—at the beginning of the chain—were induced to participate by a statement of the Managing Director to the effect that the Fund's negotiations with the country concerned were making good progress; and at the other end of the chain, the approval of a program by the Executive Board sometimes makes the entitlement of the country to make even its first drawing on the Fund contingent on subsequent decisions by other lenders, such as the Paris Club (for intergovernmental credits) or a consortium of commercial banks.

The Fund could influence other creditors by its willingness to stake its prestige and its resources on a particular program, provided only that the others did their duty in filling the remaining gap, if they did not, the Fund would not act either, the payments situation of the country concerned would remain unsolved, and its creditworthiness would plummet even further. In the process, it inevitably also fell to the Fund to determine the relevant magnitudes: the maximum payments adjustment it considered feasible, the extent and phasing of the Fund's credit, and the targets that it determined as the indispensable contribution of other groups of providers of funds. In principle, these magnitudes were all subject to a process of iterative decision-making among the debtor country, the Fund, and the other creditors; in practice, however, the Fund made the initial plans and the final outcome—a few weeks or a few months later—was usually not far different.

There can be no question of the invaluable contribution to the system that was made by the willingness on the part of the Fund—and, to be more precise and more accurate, of its Managing Director, Jacques de Larosière—to accept this responsibility. At the same time it is clear to all concerned that the Fund cannot in the longer run play as strong and decisive a role in the determination of the flow of financial resources to developing countries as circumstances have now forced it to perform. It cannot be the normal function of the Fund to determine how much credit each country should get, to use its best efforts to ensure that it gets that much and not more, or to persuade various classes of creditors to bring together the financial packages of the Fund's design.

Let me say specifically that I do not share Dr. Witteveen's ambition that

the Fund (by being put in charge of variable solvency ratios for sovereign loans and variable reserve requirements for Eurodeposits) should become the regulator of "the growth of international credit and liquidity. . . guided by the need for balanced growth of the world economic and financial system, leaving individual central banks free to follow their own national monetary policies."¹⁵ Such a system would be incompatible with an international capital market in which borrowers and lenders from many countries compete. In so far as monetary instruments are to be marshaled to achieve a "balanced growth of the world economic and financial system" these instruments would have to be directed toward the control of money creation in the main financial centers. If that is done, international credit as such does not need to be—and should not be—subject to quantitative controls, although internationally agreed prudential controls would certainly be desirable; if (as seems likely for the foreseeable future) a coordinated control of national monetary targets cannot be achieved, there is no point in an attempt at quantitative control by the Fund over "international credit."

While there may be little likelihood of the Fund being entrusted with global control over the flow of credit from abroad to its member countries, it is increasingly designing its own assistance to member countries against the background of medium-term projections of the balance of payments and the resulting debt service profile. Such projections are particularly useful to obtain a consistent view of the evolution of a country's debt service as a function of current account deficits over a series of years. They tend to encourage moderation in borrowing, including borrowing from the Fund with its rather short maturities.

It has of course to be borne in mind that the medium-term development of a country's balance on current account cannot be derived from projections of the various components of the balance of payments, such as export estimates based on knowledge of commodity markets, import estimates as a function of the country's growth rate, etc. Such a method of estimation tends to miss the crucial role that financial policy—the budget deficit, domestic credit expansion—plays in the determination of the current account deficit. Thus, while it is possible and useful to make consistent *projections* of a country's balance of payments over the medium term, it is not possible to make balance of payments *forecasts* that could claim a reasonable degree of accuracy.¹⁶

The Fund is not responsible for the flow of development capital to its developing members. But in engaging in what is intended to be a long-term effort to project, jointly with a member country, its payments balances as a function, i.a., of its borrowing profile, the Fund will also have to tailor its own lending policy in such a way as to ensure that it is sufficiently responsive

¹⁵H. Johannes Witteveen, *Developing a New International Monetary System: A Long-Term View* (1983 Per Jacobsson Lecture, Washington, D.C. 1983), pages 11 and 12.

¹⁶This is not exactly a new finding. See J.J. Polak, "Balance of Payments Problems of Countries Reconstructing with the Help of Foreign Loans," *Quarterly Journal of Economics*, Vol. LVII (February 1943) pages 208–240; reprinted in American Economic Association, *Readings in the Theory of International Trade*, 1949, pages 459–493, especially the conclusions on page 485.

to the vagaries of the balance of payments. This cannot mean that the Fund offers unconditional finance as and when deficits occur. But it does require flexibility of the Fund in the amounts that it is willing to make available, on a conditional basis, to countries that plan and—when necessary—adjust their financial policies in close cooperation with the Fund.

III. The Allocation of SDRs

Concern about the adequacy of world reserves antedates by decades¹⁷ the establishment of the IMF and at least one provision to deal specifically with this problem was incorporated in the original Articles of Agreement: Article IV, Section 7 providing for the possibility of a “uniform change in par values,” an equiproportional change in the value of gold in terms of all currencies.¹⁸ The concern continued in the 1950s and 60s. In two Fund staff reports, published in 1953 and 1958, it was argued that the supply of reserves was and would continue to be adequate,¹⁹ but in 1963 extensive studies were launched by the Group of Ten and the Fund which culminated in the establishment of the SDR mechanism through which the Fund could “meet the long-term global need, as and when it arises, to supplement existing reserve assets....” (Article XVIII, Section 1)

After the first amendment had given the Fund the capacity to add²⁰ reserves to the system as needed, the discussion of the Group of Twenty in the early seventies envisaged generalizing that function to that of regulating the supply of reserves—perhaps by giving the Fund a near-monopoly on the supply of reserves after replacing gold and reserve currencies by SDRs via substitution accounts. These ideas did not, however, find sufficient support and all that is left of them is a pallid injunction to members in Article VIII, Section 7 to “...collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system.”

At the same time that the G-20 patiently explored a universal system of “asset settlement” by means of a centrally controlled stock of SDRs, the actual world moved to a system of near-universal “liability settlement” (a technique of escaping balance of payments discipline that had previously been the special prerogative of the United States) in which the uncontrolled supply of dollars issued by the United States was supplemented by equally

¹⁷In 1922, the International Monetary Conference of Genoa believed it had found a solution to the problem—which of course was not a new problem then—by means of the gold exchange standard.

¹⁸The provision became redundant as a consequence of the first amendment of the Articles but was not abolished until the second amendment, when gold was dethroned generally as far as the Fund was concerned.

¹⁹“The Adequacy of Monetary Reserves” (October 1953) and “International Reserves and Liquidity” (September 1958), both reprinted in J. Keith Horsefield, *The International Monetary Fund, 1945–1965*, (Washington, D.C., 1969) Vol. III: Documents.

²⁰It has always been recognized that the symmetrical provision to *cancel* previous allocations was unlikely ever to gather the required 85 percent support.

uncontrolled supplies of other reserve currencies and of dollar liabilities of other countries.

In these circumstances, is there still a role for the Fund to allocate SDRs? The question has not been clearly answered by the Fund membership after the first allocation in the three years 1970 to 1972. Since then there have been nine years without an allocation on January 1: 1973–78 and 1982–84, and only three years with an allocation (1979–81); but important elements in the decision to allocate for the three-year period were the recently taken commitment to make the SDR the principal reserve asset of the system (Article VIII, Section 7) and the idea that a “modest” allocation would help to keep the SDR alive for an as yet undefined future role in the system. Any decision in the near future to resume allocations for a number of years would be most unlikely to reflect a clear agreement on the place of deliberate reserve creation by the Fund, but rather follow from considerations similar to those that prevailed in the 1978 decision.

Thus, while there is a movement toward consensus on the role of the Fund in the supply of conditional balance of payments credits, its role with respect to the deliberate supply of reserves remains imprecisely defined. Space does not permit me to enter into this question at length, but a few principal considerations deserve to be mentioned.

1. While, in the 1970s, the international banking system was a reasonably efficient provider of reserves—for countries wishing to accept the risk of relying on borrowed reserves—this has no longer been the case since about mid-1982. A large number of countries—including many whose policies are endorsed by IMF stand-by arrangements—have not found it possible to maintain or regain an adequate level of reserves. Others are slowly reconstituting reserves through the painful process of earning current account surpluses, beyond what they need for debt service. In these circumstances, the Fund can make a contribution if it activates to a reasonable degree the credit mechanism created under the 1969 amendment and allocates SDRs. Part of the credit extended in this way (to all members, in proportion to their quotas) will lead to a reduced demand for credit for reserve building from banks in the main countries; thus SDR creation will in principle have to be matched by some reduction in credit creation in the reserve centers. SDR creation favors the reserve needs of weaker countries; but the fact that the stronger members of the Fund, and in particular the reserve centers, can get by comfortably without this credit mechanism of the Fund is not a good reason not to allow it to perform the useful international function that it can perform. Indeed, the stronger members of the Fund are also unlikely to need its conditional credit mechanism, but they are sufficiently aware of the international value of that mechanism to provide it periodically with enlarged resources. In a period in which the commercial banks are reluctant to expand their overseas credits, there is every reason to use both of the credit mechanisms for which the Fund's Articles provide.

2. The use of two Fund mechanisms raises the question of their compatibility. In this connection the starting premise is that prompt adjustment is necessary wherever payments positions are not in sustainable equilibrium. Conditional credit is a natural in these circumstances. Is there also a role for

the provision of unconditional credit through the allocation of SDRs? It would seem to me that the answer to this question is in the affirmative.

First, a large proportion of the countries for which adjustment is required has acknowledged this fact by concluding conditional credit arrangements with the Fund. Once there is an agreement on adjustment, ensured by the provision of resources on a conditional basis, there is no reason to insist that the supply of any and all resources must be tied with the strings of conditionality.

Second, the argument referred to above of keeping the SDR alive continues to have merit. However, these arguments should be qualified by the proviso that the amounts made available by allocation of SDRs should not be so large as to undermine the careful calibration of resources under Fund programs. These programs envisage a certain maximum flow of Fund money to a country, depending on such factors as the quality of its adjustment program, the extent of its indebtedness to the Fund, and the medium-term perspective for its balance of payments. The Fund applies a scale of access based on these factors, ranging (at present) from 25–50 percent of quota per year for some members to 102–125 percent per year at the top of the list. Annual allocations, which of course have to be the same percentage of quota for each member, must be compatible with this system of gradation. It follows that however large the established need for reserves may be—and convincing statistics on the size of this need are notoriously hard to establish—the level of allocation will have to be a low enough percentage of quota so as not to undermine the Fund's conditionality.

3. Like any bank, the Fund must constrain its credit creation to the demand that exists for the claims that it creates. It is traditional to consider this demand in two separate compartments, associated with the two Departments that form the structure of the Fund (the General Resources Department and the SDR Department). In the first Department, the willingness to hold claims on the Fund is periodically established through the quinquennial quota reviews, and occasionally by negotiated arrangements to lend to the Fund. The demand for SDRs manifests itself in the process of decision-making on allocations, where every member knows that its participation in an allocation entails its obligation to accept, in specified circumstances, and against payment in a "usable currency," a further amount of SDRs equal to twice its allocation.

The obligations of members to acquire the two types of paper issued by the Fund are separate; but since both are acquired, in many member countries, by the same agency—outside the Anglo-Saxon countries usually the Central Bank²¹—the demand for the two assets cannot be considered as in-

²¹The situation in the United States is more complicated. The SDR position of the United States is held by the Exchange Stabilization Fund of the Treasury. The ESF has the right to issue "SDR certificates" to the Federal Reserve Banks, both against allocated SDRs and to finance the acquisition of designated SDRs, and it has in fact done so for the bulk of the U.S. holdings. At the end of January 1984, the ESF had issued SDR certificates for SDR 4.5 billion of the total U.S. SDR holdings of SDR 4.9 billion. Thus SDR holdings in the United States are essentially financed by the Federal Reserve. The reserve tranche and the General Arrangements to Borrow (GAB) positions are held by the General Fund of the Treasury, and financed directly by the Treasury.

dependent. Indeed, there is increasing evidence that the financial activities of the two halves of the Fund are becoming subject to a joint constraint.

IV. The Joint Constraint on the Fund's Two Departments

Contrary to what could have been expected from the original Articles of Agreement, the development of the Fund has brought about the situation in which the activities of the Fund (of both the General and the SDR Departments) are financed by the issuance of reserve assets held mostly by central banks as part of their portfolio of foreign assets—a portfolio that must above all be liquid and that should, in addition, earn an adequate rate of return.

In the Anglo-American discussions that preceded Bretton Woods, the U.S. negotiators prevailed over their British counterparts on the question of the financial structure of the Fund: the Fund, it was decided, would operate on the basis of “a mixed bag” of contributed currencies (plus contributions in gold), not on the basis of overdrafts that would create assets for its members expressed in “bancor.”²² But this decision *not* to make the Fund a “bank,” which would create international “money” by extending credit, was overtaken by the natural development of the institution itself almost as soon as the Fund began to use currencies other than the U.S. dollar in its transactions on a large scale.²³ When the Fund provides nonreserve currencies to a borrower, the normal practice is for the borrower to present these currencies at once to the issuer for conversion into dollars. Thus the country whose currency is used, while receiving an enlarged position in the Fund, loses a corresponding amount of interest-earning U.S. dollars. Since about 1958, the Fund has, accordingly, been subject to pressure to adopt practices that would offset as far as possible the effects on the countries concerned, both as to the level of their reserves and as to their interest income. Hence the policies, and then the amendment, concerning the gold tranche (later “reserve tranche”) by means of which creditors of the Fund could now consider their claims as liquid reserve assets; the introduction (again by amendment) of a rate of interest (“remuneration”) on such positions, and the persistent effort to increase the rate of remuneration, from the initial 1.5 percent, to 85 percent of an equivalent market rate (the SDR interest rate) until recently. In early 1984, the Fund decided to raise the rate of remuneration further under a formula that makes it likely that this rate will rise to the full SDR interest rate over the next few years.

When the SDR was created by the First Amendment, its characteristics were to a large extent patterned on those of the Fund's gold tranche positions, but a successful effort was made at the same time to give the SDR readier usability and greater liquidity than were enjoyed by the gold tranche position. Thereafter, in leap frog fashion, the qualities of the SDR became the standard to which the quality of the gold tranche position should, as far as possible, be raised. This has to a large extent been achieved. But although the interest rate gap between the two assets is now small and likely to vanish,

²²J. Keith Horsefield, *The International Monetary Fund, 1945-1965*, Vol. I, pp. 28-30.

²³See J.J. Polak, “Thoughts on an International Monetary Fund Based Fully on the SDR,” IMF Pamphlet No. 28 (Washington, D.C., 1979), pp. 4-6.

the same catching up cannot be achieved in terms of two other characteristics that affect the comparative "quality" of the two assets: usability and liquidity.

On the first point, the reserve tranche can only be used in case of need, and by "drawing on the Fund"—a process that has unpleasant overtones; unlike in the case of SDRs, there are no provisions for bilaterally agreed transfers not subject to the requirement of need. Probably more important is the fact that at some times the liquidity ratio²⁴ of the Fund has been low, that is, when, as before the recent quota increase, outstanding drawings were large as compared to total quotas; in that situation, there could be some question whether the Fund's resources were sufficient for any contingent encashment of reserve tranche positions and loan claims. This contrasts with the better liquidity provisions that were built into the SDR system, by means of an acceptance obligation that equals twice a member's allocation.

Whatever the comparative "quality" of the various components of "Fund-related assets"²⁵ held by central banks, it is the growth in their total as a share of reserves that has become a matter of concern in some creditor countries. This share is by now important and it could become still much larger if the Fund's holdings of a country's currency, its General Arrangements to Borrow (GAB) commitment, and its acceptance obligation for SDRs were all to be used in full. Table 2 shows, for each of the G-10 countries, the present situation in the first three columns and the maximum commitment following from the increased quota and the enlarged GAB—which of course represents an extreme situation—in the next four. For the EC countries, a further relevant variable is shown in column (8), viz. that part of their "nongold" reserves as reported by the Fund that consists of ECUs swapped against gold (at prices close to the market) with the European Monetary Cooperation Fund; the inclusion of these assets among "nongold" reserves is at least open to some question. The figures show that except for the United States, whose position as the main reserve center is of course special, the current share of Fund-related assets in reserves, in the order of 10 to 20 percent, is still modest. But this figure rises to 40 percent or more (91 percent in the case of Belgium) if the gold ECUs are added in, and to very much higher figures if allowance is made for the maximum potential substitution of Fund-related assets for foreign exchange holdings.

²⁴The ratio between usable uncommitted currencies plus SDR holdings to reserve positions in the Fund.

²⁵"Reserve positions in the Fund" (which equal reserve tranche positions plus loan claims) plus SDR holdings.

Table 2
Share of Actual and Potential Fund-Related Assets in Reserves
Group of Ten Countries
Year-end 1983
Figures are percent of nongold Reserves

Countries	Fund-Related Assets							ECUs derived from Gold Swaps
	Actual			Potential				
	Reserve Position	SDR Holdings	(1) + (2)	Quota	GAB Commit- ment	3xSDR Alloca- tion	(4)+ (5)+ (6)	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
United States	50	22	72	83	19	68	170	—
Canada	21	0	21	88	27	73	188	—
Japan	9	8	17	18	9	11	38	—
Sweden	5	3	8	28	10	18	56	—
<u>EEC-Countries</u>								
Belgium	11	9	20	47	13	33	93	71
France	7	2	9	24	9	17	50	46
Germany	9	4	13	13	6	9	28	22
Italy	5	3	8	15	6	11	32	33
Netherlands	9	5	14	24	9	16	49	42
United Kingdom	19	5	24	57	16	53	126	17

Source: IFS

In these circumstances it is not surprising that some of the creditor Central Banks have become somewhat concerned about the degree of concentration of Fund assets in their reserves.

The German Bundesbank has recently made a public allusion to the risks that it sees in this situation²⁶:

The share of our IMF-related monetary reserves (reserve position and amount of SDRs allocated and acquired) in our overall reserve assets amounted at the end of August 1983 to just over 19 percent.* The assumption is that these assets can be mobilized in case of need. However, situations are conceivable in which the exercising of definite rights would have to be weighed against the possible consequences of such a step for Fund liquidity and therefore for its ability to function in a given scenario in the world economy. The very possibility of such a conflict makes it necessary to ensure that our monetary reserves contain

²⁶“The Financing of the IMF and Multilateral Development Banks” in Deutsche Bundesbank, *Monthly Report*; September 1983, p. 49. The article contains a table showing Germany's current and maximum potential holdings of Fund-related assets as percentages of reserves (the latter apparently defined ex ECUs) swapped for gold.

*The difference between this figure and the 13 percent shown for Germany in Table 2 is partly due to a difference in dates but mostly to the definition of reserves used in the calculations (see preceding footnote).

an appropriate share of reserves which are immediately available and absolutely liquid.

Germany—whose potential exposure according to the table is smaller than that of the G-10 countries—is not the only country to harbor such sentiments. These sentiments act to some extent as a constraint on the role of the Fund in terms of its financing activities—including SDR allocations.

These concerns of certain central banks regarding the composition of their reserves are no less real because they cannot be proven to be justified; indeed, the Fund and, worse, the international monetary system, would be in a perilous situation if anything approaching proof of these concerns ever materialized. At the same time, it is clear that while an individual industrial country may have to face a situation where it needs to mobilize a large proportion of its foreign assets, this can hardly occur for the industrial countries as a group. It should, therefore, be possible and indeed relatively simple for these countries to reach mutual understandings on the transfer of SDRs among them to meet the requirements of any situation. A relevant fact in this connection is that since the beginning of the SDR system the unused acceptance obligation of the United States alone would broadly have sufficed to absorb *all* SDR holdings of *all* other industrial countries.

An arrangement of the nature indicated would not enhance the liquidity of reserve tranche positions.²⁷ However, there are other reasons to suggest the merit of recasting the credit operations of the Fund in such a way that they would lead to creditor positions in the form of SDRs, rather than, as at present, reserve tranche positions. This would happen if the Fund were to substitute SDRs for contributed currencies in its credit operations. This would require a new power for the Fund to create SDRs on the occasion of every drawing and to cancel SDRs on the occasion of every repurchase. I have worked out suggestions to this effect in my 1979 pamphlet on a "Fund based Fully on the SDR." This would be a desirable change in itself, among other reasons to simplify the working of the Fund and make it more understandable. But in order to alleviate also the reservations of creditor central banks against their concern about the composition of foreign assets in their portfolios it would need to be accompanied either by the arrangement described above or by that mentioned in the next paragraph.

A much more radical change that would also lighten the weight of Fund paper in central bank portfolios would be to allow SDRs to be held outside the official circuit so that they could be used for market intervention. In a formal sense this could only be done by an amendment of the Articles of Agreement; but very much the same result could be achieved if some official holder (say the BIS) would, as a trustee²⁸, issue SDR certificates against of-

²⁷Loan claims are transferable by agreement and in a few cases transfers among creditors have been arranged bilaterally.

²⁸Similar ideas have been discussed by Warren Coats and Peter Kenen. See Warren L. Coats, Jr., "The SDR as a Means of Payment" IMF, *Staff Papers*, Vol. 29 (September 1982) pp. 422-36 and Peter B. Kenen, "Use of the SDR to Supplement or Substitute for Other Means of Finance," in George F. von Furstenberg, ed., *International Money and Credit: The Policy Roles*, IMF, Washington, 1983, pp. 327-73. Both authors speak of a "clearing house" as an intermediary rather than a "trustee." Kenen refers to the possibility of SDR certificates in footnote 14 on page 345.

official SDRs. Official holders could then deposit SDRs with the trustee (or clearing house) to acquire the certificates which they could then sell in the private market. This would take away some of the present drawbacks of the SDR as a reserve asset. In addition, the size of the possible demand for these certificates in the private market, e.g., on the part of commercial banks, would reduce the amount that needed to be kept in official portfolios.²⁹ It should be stressed, however, that these ideas, while undoubtedly interesting, have not been thoroughly analyzed in their many aspects, which include such questions as the effect of private holdings on the formation of the price and the interest rate on the SDR and—more fundamentally—the consequences for the role of the SDR if it were to cease being exclusively an asset for the official circuit; these aspects may well be considered more important than any impact that nonofficial holdings of SDRs would have on the constraint on the Fund's financial role.

²⁹These possibilities were discussed in a panel session at the end of the Fund-organized conference referred to in the previous footnote. See *Ibid.*, page. 433.

Discussion

C. Fred Bergsten*

The great achievement of the International Monetary Fund in the 1980s has been its dramatic, and so far successful, assertion of global leadership in dealing with the international debt crisis. As Jacques Polak points out, "the Fund management stepped into an international void" and performed a critical systemic task. Indeed, it did so even when its member countries did not fully provide the needed financial resources as in the delay in negotiating the Eighth Quota Increase in late 1982 and the uncertainties, primarily in the U.S. Congress, surrounding the implementation of the quota increase throughout 1983.

This great success by the Fund, however, must not be allowed to obscure the fact that, during the same period of time, it has fallen considerably short of fulfilling its responsibilities in managing other key aspects of the international economic and financial system. Indeed, the Fund's ultimate success in resolving the debt crisis may turn on whether it can attain similar effectiveness in promoting changes in the policies of the major industrial countries—which must provide a global framework of stable growth if the developing countries are to resume servicing their external debt on a market basis.¹ With or without a debt crisis, however, the Fund must play a much greater role vis-à-vis the industrial countries if there is to be an assurance of effective management of the world economy.

First, the Fund needs to adopt a much more creative and aggressive approach toward exercising its responsibilities for maintaining "multilateral surveillance" over the world economy. The recent emphasis on "convergence" is both inadequate and misplaced. Indeed, we now have a great deal of convergence—particularly in terms of inflation performance in the major countries (United States, Japan, Germany, United Kingdom and increasingly France). However, massive currency and thus current account imbalances remain. Hence the world recovery is sharply unbalanced, both among countries and among sectors within countries, and its sustainability is subject to much uncertainty. Protectionist pressures are intensified, especially in the United States, jeopardizing the entire world trading system.²

*Director, Institute for International Economics.

¹For details see William R. Cline, *International Debt and the Stability of the World Economy* (Washington, D.C.: Institute for International Economics, September 1983), particularly pp. 46-73.

²See C. Fred Bergsten, "The United States Trade Deficit and the Dollar," Statement before the Senate Committee on Banking, Housing and Urban Affairs, June 6, 1984. The most notable imbalances are of course the U.S. current account deficit, which is expected to reach \$100 billion in 1984 and perhaps \$125 billion in 1985, and Japan's current account surplus of \$30-40 billion in 1984 and 1985.

The Fund must therefore find new ways to promote more internationally compatible policies among the largest countries. At a minimum, this requires addressing their *policy mixes*. At the moment, for example, fiscal policy is headed in opposite directions in the United States and in the other largest countries.³ Fund management has spoken out increasingly against the huge U.S. budget deficits, but has said nothing about the excessive fiscal tightening elsewhere and the institution as a whole has made no visible effort to exercise meaningful surveillance over the whole evolution of events.

To be sure, doing so is no easy task. A first question is whether to attack the need for better policy coordination directly, or to do so indirectly via seeking more multilateral control over the relationships among the exchange rates of the major countries. This is of course a central question that has arisen throughout the brief history of the European Community as they have sought closer policy harmony among their member states.

At this point in time, I would advocate a serious effort by the Fund to get a better handle on national macroeconomic policies by promoting changes in the exchange rate regime—the most direct point at which national policies intersect, and hence the most logical fulcrum at which to address them. There need be no effort to return to fixed rates, nor could there be such a return. The current imperative is to find a synthesis between the excessive rigidity which came to dominate the fixed rate regime of Bretton Woods, and the incessant overshooting and excessive volatility which are seemingly endemic under the current regime of unmanaged floating.

The “target zone” approach appears a promising way to make a start in that direction.⁴ Beyond its substantive merits, such an approach would provide the international community—presumably working through the Fund—with a legitimate basis for addressing the policies of individual industrial countries, *particularly* the largest of them because of their greater systemic impact, in the (proper) global context.⁵ Rather than arguing that “target zones” would not have worked in recent years because of the high U.S. budget deficits and interest rates, as many do, one should ask whether the existence of such a system could have tilted the United States toward achieving its recovery with a more sustainable and internationally compatible policy mix.

I would make only one other point regarding the role of the Fund in managing the international adjustment process. Polak argues that it is wrong in principle for the Fund to attempt to vary its conditionality in such a way as to contribute to global anticyclical policy, and implies that Williamson has

³Stephen Marris, “Why Europe’s Recovery is Lagging Behind,” *Europe*, March/April 1984.

⁴Details can be found in John Williamson, *The Exchange Rate System* (Washington, D.C.: Institute for International Economics, March 1984). A possible set of guiding principles can also be found in Ronald McKinnon, *A New International Standard for Monetary Stabilization* (Washington, D.C.: Institute for International Economics, March 1984).

⁵To be sure, first steps in this direction would probably require some informal efforts in smaller circles, such as the Group of Five. It would be a mistake, however, as proposed by Robert V. Roosa in his paper at this conference, to institutionalize the process *outside* the Fund. Doing so would mean a less effective system in my judgment, and would undermine the Fund in its needed effort to play a much *larger* role in surveillance.

argued that this was desirable in order to directly limit the extent of world recessions. What Williamson in fact wrote was that "the logic is that even well managed countries can easily find themselves facing a need to borrow during a world recession, whereas this is much less likely in a boom. The proposal to temper conditionality by the state of the world business cycle would have the *additional* advantage of making a modest contribution to a global anti-cyclical policy."⁶ The primary question is what is appropriate for the individual country; it is all to the good if that has a desirable effect on the global economy, but it is a secondary point.

Turning to the liquidity side, I believe that here too the Fund has abdicated a good deal of its responsibilities—even though, in this case, the relationship to its leadership in resolving the debt crisis is even more direct. One of the requirements for a return to creditworthiness by the debtor countries is that they rebuild their reserves. Indeed, most Fund programs require such an effort and the Fund staff has reportedly estimated that the LDCs, as a group, need annual reserve increases of \$10 billion from 1984 through 1988 simply to restore the ratio of reserves to imports which prevailed in 1977-78.⁷

However, the obvious and least-cost method to achieve such a reserve buildup has so far been ignored: a substantial one-shot allocation of Special Drawing Rights, followed by a resumption of more modest annual increases. In retrospect, it is clear that the global liquidity situation would have been served by SDR allocations during 1982-84—the first three years of the current "basic period." Fears of rekindling inflationary expectations precluded such actions. But now that inflation has declined dramatically, it would seem safe to make up for lost time with a "rear end loaded" allocation of \$30-35 billion in 1985. Doing so would meet a global liquidity need by helping to address the critical problem of LDC reserve shortages, and would also begin to restore the role of the Fund in meeting world liquidity needs.⁸

In this context, Polak puts forward the critical point, made previously by the Bundesbank, that the Fund may be constrained in issuing any kind of asset because of the unwillingness of major creditor countries to hold Fund-related assets in their reserves. But what is the real worry here? Is it the question of backing? Is it a question of liquidity, that people are afraid that in the event of a balance of payments deficit they won't be able to pass these assets on? That the acceptance obligations won't be honored?

The Fund is sufficiently close to a closed system to ensure that there ought not be a liquidity worry if countries fulfill their obligations. If it is a liquidity worry, implying a doubt that countries will in fact accept additional claims on the Fund, that creates another reason (as Polak points out) for allowing the private sector to hold SDRs directly through the mechanism of a clearinghouse or something analogous. But surely the members would not want to limit the scope of the institution to fulfill its mandate due to fears

⁶See John Williamson, *The Lending Policies of the International Monetary Fund* (Washington, D.C.: Institute for International Economics, August 1982), p. 44.

⁷The data are in International Monetary Fund, *World Economic Outlook*, Occasional Paper 27 (Washington, D.C., April 1984), Table 33, p. 203.

⁸For details see John Williamson, *A New SDR Allocation?* (Washington, D.C.: Institute for International Economics, March 1984).

concerning the usability of Fund-related assets; a direct response to any such fears would be by far the more desirable approach.

There is a third issue-area, which bridges adjustment and financing, where additional IMF action may be needed. As part of its leadership role in responding to the debt crisis, the Fund has lent heavily to a large number of developing countries. There is a major question, however, as to whether the Fund will be able to expect repayment from those countries on the timetable which has traditionally been normal for its "revolving fund" approach. Just as the commercial banks cannot on balance withdraw funds from the debtor countries without *precipitating* a major crisis, neither may the Fund be able to do so for some time to come. This would be particularly true if the next world economic slowdown occurs around 1986-87, just when repayments on major Fund loans are scheduled to become substantial.

The Fund may thus need to develop ongoing programs in these countries, going beyond the acute crisis stage of their difficulties. Moreover, it may need substantial additional funding itself to offset the absence of anticipated repayments. One obvious possibility is a simple rollover of the loans made to the Fund by the Saudi Arabian Monetary Agency (SAMA) and other monetary authorities in the early 1980s.

Another, however, would be for the Fund to start tapping the private capital markets. Doing so now, before any shortages of funding developed, would represent an orderly approach to assuring that the Fund would be fully prepared to cope with any future exigencies which emerged. Some of the policy questions surrounding such borrowing are complex, and may take time to resolve. So prudent forward planning suggests that the Fund begin the process soon.⁹

Finally, there are several other possibilities which the Fund could consider pursuing to further enhance its capability to carry out the objectives already cited. It might integrate its activities much more closely with the World Bank, to bring the latter's developmental and supply-side expertise more directly into its own programs and augment the financial resources (and thus policy leverage) available in a given country context; for example, there could be explicit linkage between the Fund extended facility programs and structural adjustment loans by the Bank.¹⁰ It might, at some time in the future, revive the discussions on a Substitution Account to head off the further, seemingly inexorable, development of a destabilizing multiple reserve currency system.¹¹ More immediately, it could consider whether—if adequate resources were available—to broaden the compensatory financing facility to cover the adverse current account effects on debtor countries of

⁹I certainly do not mean to rule out future quota increases despite the problems caused by the U.S. Congress in 1983—and which, to a lesser but still considerable extent, I faced personally when bearing major responsibility for winning Congressional approval of the Seventh Quota Increase in 1980 and the Witteveen Facility in 1977-78. However, prudence dictates looking to additional means of funding the Fund, as via the private markets.

¹⁰John Williamson, *The Lending Policies of the International Monetary Fund* (Washington, D.C.: Institute for International Economics, August 1982), pp. 21-25.

¹¹See C. Fred Bergsten and John Williamson, *The Multiple Reserve Currency System*, (Washington, D.C.: Institute for International Economics, forthcoming September 1984).

unanticipated, exogenous rises in the cost of their interest payments.

In all of these areas, the goal should be to steadily promote the role of the International Monetary Fund as manager, or at least coordinator, of the global economic and financial system. It is becoming increasingly difficult, if not impossible, for individual nations—no matter how large—to effectively manage their affairs on a unilateral basis. Real economic sovereignty is far less than nominal sovereignty, and the failure to realize and bridge this gap can only cause increasing problems for all concerned.¹² It is thus essential that the role of the Fund continue to grow, perhaps along some of the lines suggested here.

¹²See C. Fred Bergsten, "The International Dimension" in G. William Miller, ed., *Regrowing the American Economy* (New York: Prentice Hall, 1983).

General Discussion

Jacques Polak rejoined that the costs to the IMF of entering the world capital market for funds could well exceed the benefits. Once the IMF entered that market, the perceived quality of Fund paper (SDRs) held by central banks might diminish, so that the SDR's value could decline.

Also, the Fund's ability to intensify surveillance over global economic policies is constrained by existing mechanisms. The prevailing forums for discussion—economic summits, OECD meetings, IMF interim committee sessions, and the like—must operate under conflicting views on what good policy is. Surveillance has thus been quite broad, but not very deep.

Polak noted further that the severity of adjustment programs for countries such as Brazil and Mexico was necessary. The absence of creditworthiness and the degree of maladjustment in these countries justified stringent conditionality. The high real interest rates accompanying such programs were inevitable and should not have been a surprise. For several industrialized countries, even less severe adjustment programs have produced high real interest rates. Furthermore, the size of Fund resources had little to do with the severity of adjustment programs for these countries. By 1982, Fund resources had become, or were about to become, substantial.