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Recent Proposals to Reform the International Monetary Fund

J. Herbert Furth

During the Suez crisis of 1956 and the exchange rate scare of 1957, the International Monetary Fund played a decisive role in preserving the freedom of international payments and the stability of exchange rates.

Nevertheless, criticism of alleged insufficiency of the Fund's resources and alleged inactivity of the Fund management has not ceased; perhaps the very success of the Fund in 1956-1957 has spurred some observers to excessive hopes for an even more effective role of the Fund in the restoration and maintenance of financial stability throughout the world.

Two recent reform proposals stand out among such criticism, because of the personalities of their authors and the weight of their arguments. They have been presented by Professor Robert Triffin in a book on "Europe and the Money Muddle," and by Sir Oliver Franks in a statement to the annual general meeting of Lloyd's Bank on February 14, 1958. This paper summarizes these proposals and attempts to analyze and criticize them.

Summary of the proposals

Professor Robert Triffin calls the record of the first ten years of International Monetary Fund operations "a grim and dismal one" (Page 116), and he criticizes "the over-all failure of the Fund to affect significantly the course of events in the postwar world" (page 137). In order to remedy these alleged defects, he proposes -- in addition to a number of less drastic and less important changes -- the following procedures.

All major countries should be induced or required "to maintain an appropriate proportion of their international monetary reserves in the form of a deposit account with the International Monetary Fund. Such accounts would be fully usable in international payments, and would carry an exchange risk guarantee with respect either to gold or to an internationally defined unit of account. They could be drawn upon at any time to make payments in any currency whatsoever, or even converted into gold, as long as the proportion of the country's international deposits to its total reserves is maintained above the minimum agreed to" (page 299).

These deposits would be invested in the financial centers of the free world, mainly (but by no means exclusively) in London and New York. Moreover, the depositing countries, including the United Kingdom and the United States, would be given "overdraft facilities with the Fund, which could be drawn upon to cover all or part of any future declines" in existing sterling and dollar balances (page 301). Professor Triffin recognizes "the negotiating difficulties which the implication of such proposals would raise"; as an interim solution he would be willing to accept "a European clearing house" (ibid).

Sir Oliver Franks seems to have taken up Professor Triffin's suggestion without substantial change. He proposes that "countries should be prepared to deposit exchange reserves with the Fund and treat the Fund's certificates of indebtedness as exchange reserves, in the same way that some European countries already treat as part of their exchange reserves their stake in the European Payments Union."

Mechanism of the proposals -- a numerical example

The following example may clarify the working of the proposals:

On June 30, 1957, the official gold and foreign exchange reserves of the free world (excluding the holdings of international institutions) totaled approximately $39 billion of gold, $8 billion of short-term dollar assets, $6 billion of sterling balances, and $1 billion of EPU balances, making a total of $54 billion.

Let us assume that Professor Triffin's "appropriate proportion" of reserves to be deposited with the International Monetary Fund would be equal to one-half of those total reserves. In this case, the countries of the free world would deposit with the Fund $19-1/2 billion of gold, $4 billion of short-term dollar assets, $3 billion of sterling balances, and one-half billion dollars of EPU balances, making a total of $27 billion. In particular, the United States would deposit with the Fund $11 billion of gold, and would be debited by the Fund with $4 billion of dollar liabilities, receiving a net credit balance with the Fund of $7 billion. The United Kingdom would deposit with the Fund $1 billion in gold and dollars and be debited with $3 billion of sterling liabilities (and a small amount of EPU debt), making a net debit balance of more than $2 billion.

The United States would thus have divested itself of $11 billion of gold, but been relieved of $4 billion of dollar liabilities and acquired $7 billion of Fund certificates. If the holders of the remaining $4 billion of official, and $5 billion of private, dollar balances decided to withdraw their holdings, the United States could at its discretion pay them off either by drawing on its remaining gold reserves of $11 billion, or instead by utilizing its holdings of Fund certificates; if the use of Fund certificates were to be restricted to monetary authorities, private dollar holders might (directly or through their national monetary authorities) present their certificates to the Fund for conversion into dollars, sterling, EPU currencies, or gold according to the Fund rules. The United States would presumably prefer to pay in Fund certificates since this alternative would keep intact its statutory gold reserve for Federal Reserve notes and deposits. Should the withdrawal of foreign balances go so far that the United States holdings of Fund certificates would be in danger of exhaustion, the United States could utilize the Fund's "overdraft facilities" and thus honor the withdrawal of all foreign-held dollar balances without having to touch its remaining gold reserve.

Similarly, since the United Kingdom would be granted "overdraft facilities," if necessary, sufficient to redeem all its remaining official and private sterling liabilities (totaling about $8 billion), it would once and for all be freed from the fear that a withdrawal of foreign-held sterling balances might not only deplete its assets in gold and convertible currencies but, beyong this, endanger its international solvency.

All countries, including those that do not have such extensive foreign demand liabilities, would presumably be granted "overdraft facilities" for the same purposes for which they could draw on the Fund under the present Articles of Agreement.

Advantage of the proposals

The immediate effect of a realization of these proposals would be to rid the United States and the United Kingdom of any threat to their reserve position posed by the existence of large foreign holdings of dollar and sterling balances, respectively.

Needless to say, this threat is far more serious for the United Kingdom than for the United States. The United Kingdom actually has negative net reserves since its sterling liabilities -- even deducting liabilities to its dependent overseas territories -- are greatly in excess of its foreign exchange assets. In the United States the danger is, at worst, a potential threat in the non-foreseeable future; nevertheless the fear of such a threat might at some time prevent the United States from pursuing policies that would improve the dollar position of foreign countries.

The arrangements presuppose a world-wide acceptability of the Fund "certificates" as a substitute not only for dollars and sterling but also for gold. The obligation to convert dollar or sterling balances or Fund certificates into gold would apparently be imposed only on the Fund, and only in proportion to the ratio of the Fund's holdings of gold to its total liabilities; in the numerical example given above, this ratio would be 72 per cent. If the United States or the United Kingdom were obliged to convert on demand the remaining dollar and sterling balances into gold, the main effect of the scheme would be frustrated.

Within these limits the proposal would in effect make foreign-held sterling fully convertible, since the United Kingdom would be in a position to redeem it at any time into Fund certificates and the Fund certificates in turn would be accepted by all monetary authorities in international payments transactions. Such a restoration of sterling convertibility would presumably facilitate further progress in the struggle against bilateralism and discrimination in international trade and finance.

Cost to the United States

These advantages would be achieved without any actual deterioration in the net international reserve position of the United States, but at the cost of a deterioration in the composition of United States reserves and of an increase in the potential drain on United States resources.

The immediate effect of the proposals on United States reserves would be equivalent to paying off in gold those foreign-held dollar balances that are transferred to the Fund by their holders. This transaction, together with the substitution of a Fund balance for those United States gold holdings that are transferred to the Fund by the United States, would involve some deterioration in the quality of United States reserves since the Fund balance, as explained above, would be only fractionally convertible into gold, and the convertible fraction would be bound to decline whenever member countries make use of the proposed "overdraft facilities."

Such a deterioration would be insignificant, however, if the Fund certificates really proved to be "as good as gold" in international payments transactions. More important would be the potential drain on United States resources resulting from the assumed universal acceptability of Fund certificates. True, the proposals would eliminate the potential drain on the United States gold reserves resulting from a withdrawal of foreign-held dollar balances; but it would increase the potential drain on United States goods and services. At present, the United States faces such a drain resulting hypothetically from (a) the utilization of foreign-held dollar balances for the purchase of United States goods and services, and (b) the possible sale of foreign-held gold to the United States Treasury and the subsequent utilization of the dollar proceeds by the foreign sellers. Both of these amounts are clearly defined and limited; on June 30, 1957, they totaled $32-1/2 billion.

Under the proposals, all Fund certificates held by foreign countries would be added to the foreign-held gold and dollar assets that could hypothetically be utilized for the purchase of United States goods and services. Initially, these certificates would be equal in volume to the gold, dollar, and sterling assets transferred to the Fund by foreign countries. Moreover, as soon as foreign countries would start to use the "overdraft facilities" of the Fund, the volume of outstanding Fund certificates would be correspondingly increased. Finally, while under present arrangements total potential dollar drawings from the Fund are strictly limited by the amount of the United States quota (which is included in the amount of foreign-held dollar balances mentioned in the preceding paragraph), the proposed "overdraft facilities" could not be so strictly limited if they were to fulfill their function of guaranteeing the redemption of all outstanding sterling liabilities.

The effect of the proposals would thus be to subject the United States at least to the same hypothetical additional drain on goods and services (though not on gold) that would result from a United States guarantee of the dollar convertibility of all outstanding sterling balances. While reasonable people might differ in their judgment of whether or not the advantage of sterling convertibility might justify such a potential drain on the United States, it is hardly possible to doubt that the United States could insure the convertibility of all outstanding sterling balances more simply and with less danger of further costs and complications by an outright guarantee than by this proposed reform of the International Monetary Fund.

Unsolved problems

Apart from the questions of whether the advantages of the proposals would outweigh their costs to the United States, and whether the main advantage -- the convertibility of sterling -- could not be achieved by some simpler method, three main problems remain unsolved. The first concerns some technical points of minor importance, but the others touch on basic matters, namely, the potential contributions of the proposals to the elimination of the alleged present "dollar shortage" and to the avoidance of a threatened future inadequacy of international liquidity.

Technical problems -- (a) Should the certificates be denominated in dollars; in both dollars and sterling; or in some kind of "bancor" or "ecu"? In practice, the currency probably would be identical with the dollar, just as has been the case of the "units of account" of the European Payments Union. (b) Should the assets of the Fund be invested, like its present balances, in non-interest-bearing notes of the countries involved, or like present foreign monetary reserves, in interest-bearing securities? In the first case, the countries holding reserves would be deprived of substantial revenue; in the second case, the Fund would become by far the largest single holder of United States and United Kingdom government securities (apart from domestic government agencies), and its operations could deeply affect the debt management problem of these countries.

Elimination of present "dollar shortage"? -- By making foreign-held sterling balances fully convertible, the proposals might help to alleviate an alleged "dollar shortage" of the sterling area insofar as members of the outer sterling area would no longer have to consider the dollar position of the United Kingdom in planning the utilization of their sterling holdings. Apart from such cases, which are of doubtful practical importance, the proposals would not solve the so-called dollar problem, since (at least outside of the sterling area) a country's "dollar shortage" invariably reflects either an over-all inadequacy of foreign reserves or (more frequently and more importantly) an over-all imbalance in its current international payments. Neither phenomenon is affected by the kind of currency in which international reserves are expressed or international transactions executed.

It is true that the mere lack of reserves could, to some extent, be overcome by large "stabilization" credits. However, the availability of such credits is not primarily limited by institutional difficulties: the United States has given many billions of such credits (such as the credit to the United Kingdom) without channeling them through new institutions. The availability is rather limited by the extent to which potential creditor countries are willing to risk that the borrowing country, instead of using the credit merely to bolster its reserves, might utilize all or part of the amount to increase its excess imports; this risk would hardly be lessened by channeling the credits through an intermediary international institution.

The more urgent problem of imbalances in current international payments would be completely impervious to the proposed institutional changes; unless it were believed that the new institution would have a better chance than any existing agency to induce deficit countries to pursue proper domestic and international financial policies.

Avoidance of future inadequacy of international liquidity? -- The threat of a shortage of international means of payments (mainly gold and dollars) in the event of further rapid growth in world output and world trade, although not pressing at this time, is nonetheless a legitimate object of concern. It stems from the relatively slow increase in gold supplies, and more important, from fears of the (real or imagined) dangers that a continuous or large accumulation of dollars in the hands of foreign holders might pose to the internal monetary stability or the external solvency of the United States.

The proposed institutional reforms cannot be expected to facilitate the solution of these problems. The monetary authorities of the United States would certainly be unwilling to grant convertibility to an unlimited issue of Fund certificates, and even if they were prepared to do so, the Congress would not permit them such generosity (see Bretton Woods Agreements Act, Sec. 5). Therefore, the issue of the certificates would have to be limited either by a backing of dollars or by other means which would involve the consent of the United States monetary authorities. The United States monetary authorities, however, would presumably not consent to letting the circulation of such certificates increase more rapidly that at the rate at which they would be willing to let foreigners accumulate dollars, or at most, to permit the total circulation of dollars to rise.

In other words, there is no simple institutional solution to the basic problem of how to reconcile full convertibility of international means of payments into dollars (or any other currency) with a rapid rate of increase in the circulation of those means of payments.

Conclusions

The main complaints against the International Monetary Fund -- whether raised by Professor Triffin, Sir Oliver Franks, or other critics -- usually boil down to one or more of the following accusations: (a) The assets of the Fund are insufficient. (b) The Fund is too strict in granting accomodation to its members. (c) The Fund intervenes -- in an anti-expansionary direction -- too drastically in the domestic monetary policies of its members.

Every international institution would sooner or later be confronted with similar complaints, whatever the amount of its initial resources. These complaints could be avoided only if the institution engaged in an irresponsible and eventually self-defeating policy of unrestricted credit extension.

Professor Triffin and Sir Oliver Franks would presumably be willing to call a halt to the issue of Fund certificates as soon as their basic demand -- the guarantee of dollar convertibility of existing sterling balances -- is satisfied. There can be no doubt, however, that as soon as this point is reached, other interests would press further demands, and such further demands might indeed be more important to many Fund members than the convertibility of sterling. The most obvious instance would be the virtually

unlimited need of underdeveloped countries for means that would enable them to divert resources of developed countries to their own use.

The lack of a solution of these problems does not necessarily mean that the proposals of Professor Triffin and Sir Oliver Franks should not be given serious consideration. It would be utopian, however, to expect institutional changes to solve problems inherent in the management of scarce resources for human needs which by their very nature exceed those resources. There is no magic in economics, and least of all in the establishment of new financial institutions.