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ON BEING GRANDMOTHERLY: THE EVOLUTION OF IMF CONDITIONALITY

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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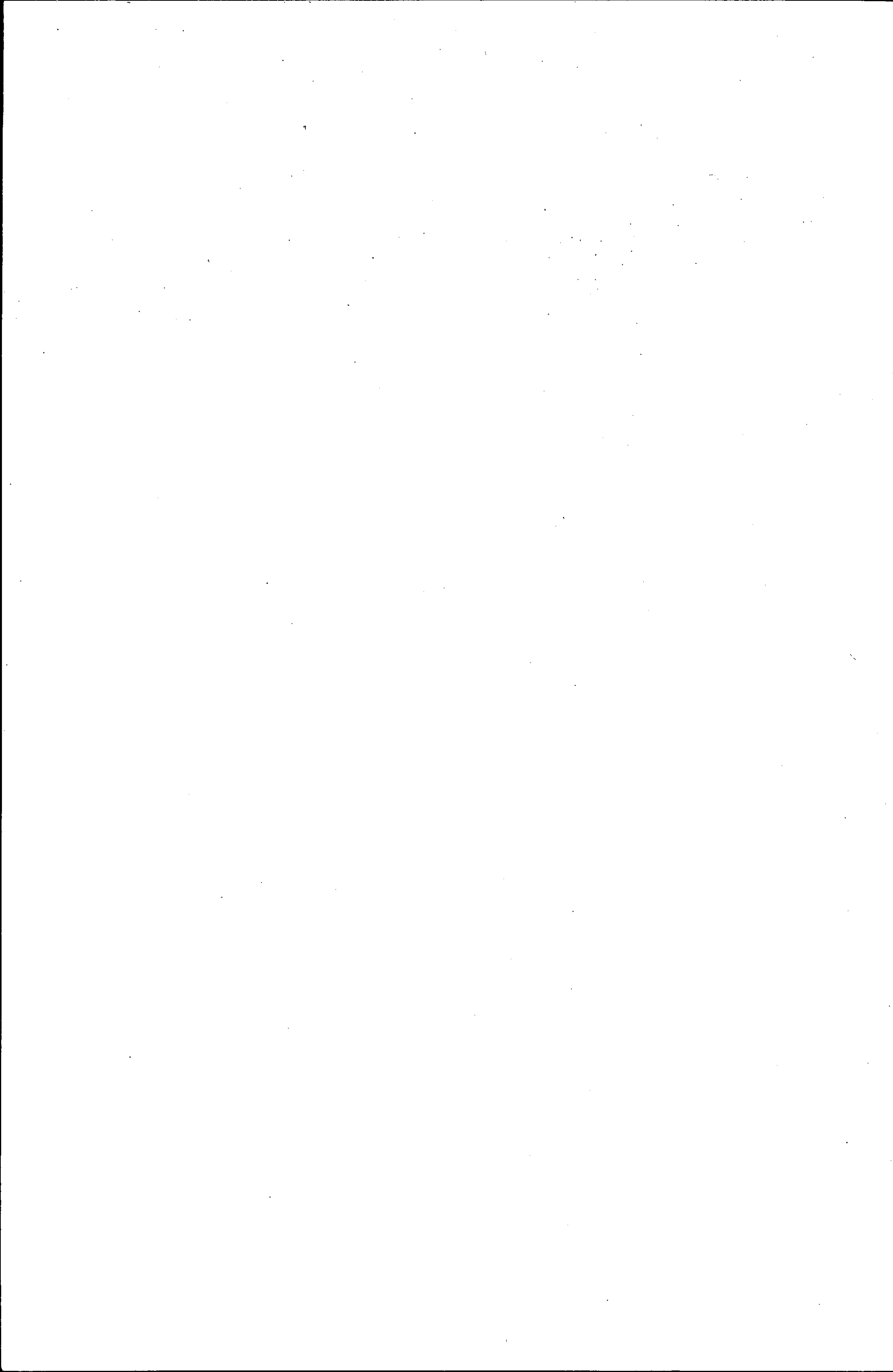

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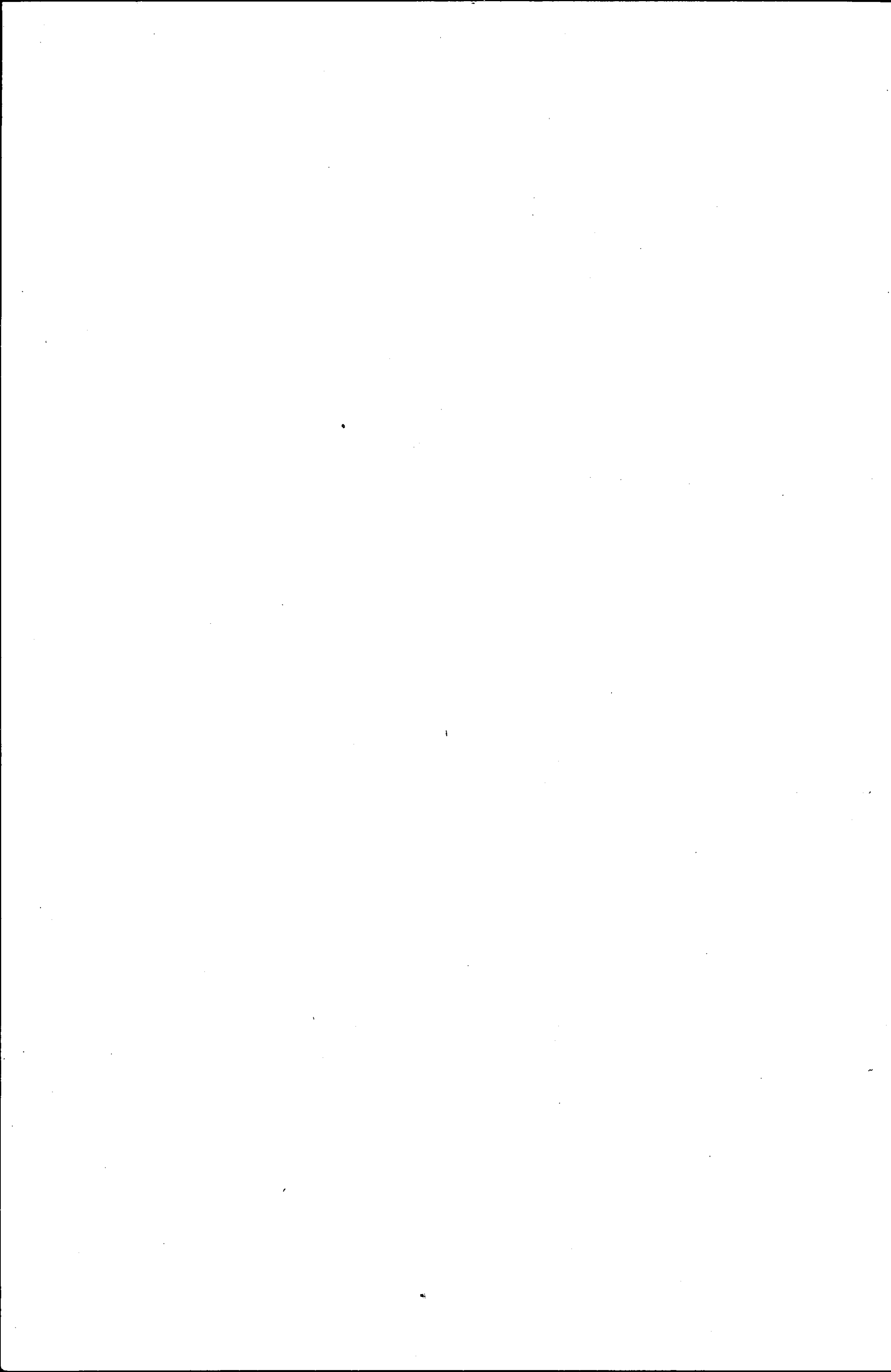

On Being Grandmotherly: The Evolution of IMF Conditionality

Introduction

On March 2, 1979, the International Monetary Fund adopted a set of guidelines regarding the conditions to be accepted by member countries wishing to draw on the resources of the Fund. The guidelines were intended as a positive response to previous expressions of concern by the developing countries on this matter, but they were only the first step in a process of change. As Sir Joseph Gold, former General Counsel of the Fund, put it in his 1979 Fund pamphlet on conditionality: "There is no reason to believe . . . that debate on this subject is at an end."

The present Essay is intended as a contribution to that debate. It deals with the history of conditionality, emphasizing particularly those aspects that seem to have a special bearing on current concerns. It then proceeds to an analysis of the contemporary issues and makes a tentative evaluation of the recent evolution of Fund policies.

1 The History

The Prelude to Bretton Woods

Writing in January 1944, before the Bretton Woods Conference, Lord Keynes described the views of the U.S. government on the future character of the International Monetary Fund as follows: "In their eyes it should have wide discretionary and policing powers and should exercise something of the same measure of grandmotherly influence and control over the central banks of the member countries, that these central banks in turn are accustomed to exercise over the other banks within their own countries" (Moggridge, 1980, Vol. 25, p. 404).

Keynes believed, however, that as a result of the Anglo-American discussions on this and related matters, "the American representatives were persuaded of the inacceptability of such a scheme of things, of the undesirability of starting off by giving so much authority to an untried institution, and of the importance of giving the member countries as much certainty as possible about what they had to expect from the new institution and about the amount of facilities which would be at their full disposal" (Moggridge, 1980, Vol. 25, pp. 404-405). Keynes thought he had gained acceptance for the view that the Fund's "initiative and discretion" should be limited "to cases where the rules and purposes of the institution are in risk of infringe-

ment" and that the Fund should be "entirely passive in all normal circumstances, the right of initiative being reserved to the central banks of the member countries" (Moggridge, 1980, Vol. 25, p. 404).[1]

It is particularly interesting, in the light of present-day controversy about the policies of the IMF, that in the Anglo-American discussions preceding Bretton Woods, the U.K. negotiators were under explicit instructions from Churchill's War Cabinet that a deficit country should not be required to introduce "a deflationary policy, enforced by dear money and similar measures, having the effect of causing unemployment; for this would amount to restoring, subject to insufficient safeguards, the evils of the old automatic gold standard" (Moggridge, 1980, Vol. 25, p. 143).

As it turned out later, the U.S. government had by no means abandoned the idea of a "grandmotherly" Fund; still less had it acquiesced in the concept of a "passive" Fund. It is also clear that Keynes was far from being alone in his views—and that the United Kingdom had the support of virtually all countries other than the United States in wishing to place strict limitations on the Fund's responsibilities vis-à-vis the economic policies of its members. From an American standpoint, of course, the United Kingdom and most of the countries supporting its views were potential deficit countries seeking to obtain assured access to postwar balance-of-payments support, which could be provided—in the early postwar years at any rate—only from the real resources of the United States.

The Atlantic City Debate

An important episode in the legislative history of Fund conditionality occurred in the course of meetings of the Pre–Bretton Woods Conference Agenda Committee, which were held in Atlantic City at the end of June 1944 and in which seventeen countries participated. The documentation for this meeting included a combined draft in which the Joint Statement by Experts on the Establishment of an International Monetary Fund (prepared jointly by U.S. and U.K. officials and published in April 1944) was reproduced in conjunction with various amendments that had been proposed (Horsefield, ed., 1969, Vol. 3, pp. 131-135).

There was considerable discussion at Atlantic City about the wording of

[1] Sir David Waley and Redvers Opie, who were also involved in the negotiations with the Americans, appear to have taken a more realistic view of the American position, recognizing that credit would be obtained only "so long as the Fund thinks we are behaving reasonably" (see Horsefield, 1969, Vol. 1, p. 73). Keynes may have been unduly impressed by the division of opinion among the U.S. negotiators regarding the imposition of conditions on drawing rights: negotiators both for the State Department and for the Federal Reserve System expressed the opinion, in the presence of British negotiators, that "no great country would submit" to the kind of scrutiny that the U.S. Treasury was envisaging (see Moggridge, 1980, Vol. 25, pp. 344-346).

what later became Article V of the original Fund Agreement.[2] Two phrases in that article had a crucial bearing on the conditions governing the use of Fund resources. The Joint Statement had provided that:

> A member *shall be entitled to buy* another member's currency from the Fund in exchange for its own currency on the following conditions:
> (a) The member *represents that the currency demanded is presently needed* for making payments in that currency which are consistent with the purposes of the Fund [emphasis supplied].

The United States proposed an Alternative A to replace the above text, in which the following changes were made in the emphasized words:

> A member country *may buy* the currency of another member country from the Fund in exchange for its own currency subject to the following conditions:
> (1) The member country initiating the purchase *needs the currency requested* for making payments in that currency which are consistent with the purposes and policies of the Fund [emphasis supplied]. (NARS, Box 1, File A-3.)

When the Agenda Committee discussed this matter, Lord Keynes said that the wording of Alternative A left it unclear whether it was the Fund or the member country that would decide whether the payments for which a country sought to purchase currency from the Fund were consistent with the purposes and policies of the Fund. Countries must, he said, have an unqualified right to purchase foreign exchange within the prescribed quantitative limits, subject to the provisions of the Fund Agreement. He therefore favored the wording of the Joint Statement, which made it clear that the decision on a drawing would be that of the member country, not of the Fund.

Edward M. Bernstein replied for the United States that the fact that a country informed the Fund that it needed foreign exchange for purposes and policies consistent with the Fund Agreement did not provide sufficient protection for the Fund against misuse of its resources. The Fund must be in a position to question a country's statement on this point. The U.S. proposal to change "represents" to "needs" had been made because, in the event that a member's use of Fund resources was for purposes inconsistent with the Agreement, the Fund must be able to invoke the subsection of the same Article under which a member could be suspended from making further use of the resources of the Fund.

The U.K. position on this matter was supported by other delegations. Leslie G. Melville, speaking for Australia, took the view that a central bank must be certain that the resources it had counted upon would be available

[2] U.S. National Archives and Records Service, Records relating to the Bretton Woods Conference, General Records of the Treasury Department, Record Group 56 (referred to subsequently as NARS), Box 1, File A-9.

as required. J. W. Beyen of the Netherlands considered that there could be no question of having to convince the Fund on such matters and that the wording of Alternative A was "impossible."

In the event, the two draft amendments proposed by the United States were dropped, and the key words "entitled" and "represents" were included in the final text of the Bretton Woods Agreement.[3]

Given the foregoing legislative history, most countries probably ratified the Bretton Woods Agreement in the belief that British views on conditionality had prevailed and that the Fund would have no right to challenge a member's "representation" that it needed to draw resources from the Fund in order to effect payments consistent with the Agreement. In the Fund history, Horsefield (1969, p. 72) argues that Keynes had recognized in October 1943 that the use of the word "represents" did not imply that the Fund would automatically accept such a representation. He bases his argument on a cable to London in which Keynes mentioned as being still unresolved the question whether the Fund would be able to discipline a country's use of Fund facilities within the relevant quantitative limits. This does not mean, however, that Keynes accepted the U.S. view on the interpretation to be given to the word "represents." In any case, the developments at Atlantic City and Bretton Woods had clearly altered the situation, and it was understandable that Keynes and others should have thought that the British view of the matter had won the day.

When the Executive Board of the Fund eventually came to consider the interpretation of the word "represents" in May 1947, it was decided, in spite of the legislative history, that a member's representation under Article V, Section 3(a)(i), could be challenged by the Fund "for good reasons." As Horsefield (1969, p. 189) points out, in reaching this decision the Board was effectively rejecting the concept of an automatic right to draw within the quantitative limitations specified in the Articles.[4] The decision was therefore a turning point in the campaign for conditionality.

Silence at Bretton Woods

At a meeting held on July 1, 1944, at which members of the American delegation to the Bretton Woods Conference were briefed by Harry White, Assistant to the Secretary of the U.S. Treasury, on the U.S. government's position on questions likely to arise, the continuing conflict of views on conditionality was made clear, as was the fact that the United States stood

[3] A quite different Alternative A was put before the Bretton Woods Conference, involving much less significant deviations from the text of the Joint Statement than those discussed at Atlantic City. The new Alternative A was presented jointly by the United States and the United Kingdom and included the key words "entitled" and "represents" (see U.S. Department of State, 1948, Vol. 1, pp. 28-30).

[4] The Executive Director from France, Jean de Largentaye, dissented from the Board's decision.

virtually alone on this matter. White informed the delegation that "the foreign countries always speak of [drawings on the Fund] as a matter of right." He also acknowledged that the text of the Agreement was not clear on this point: "It reads in a way that is not too easy to see if you read it quickly." He was confident that the U.S. position was fully safeguarded by a number of provisions, including those, for example, of Article V, Section 5. This Section would enable the Fund to limit a member's right to draw if the member were found to be "using the resources of the Fund in a manner contrary to the purposes of the Fund." "Our lawyers," said White, "have taken the position that beyond question that gives adequate powers." Other delegations, he said, had tried to make it difficult for any Fund management to challenge the right of a member country to draw. But the U.S. negotiators had never yielded on this point, although (as a colleague, Ansel Luxford, pointed out) "we have tried to avoid emphasizing [this] any more than you have to" (NARS, Box 28, File W-5).

In view of the failure in Atlantic City to reach a common position on conditionality, it might have been expected that the subject would generate some lively controversy at the conference proper. In fact, however, the question was scarcely even mentioned at the conference, and certainly not debated.

Since none of the records thus far declassified throws any light on the reason for this silence, any explanation that could be offered is at best conjectural. One possible version might run as follows. The U.S. delegation, having encountered strong opposition in Atlantic City, was anxious that the conflict on conditionality should not surface at Bretton Woods. The fact that other countries interpreted the draft Agreement as authorizing unconditional drawings within certain quantitative limits, would, it might well have been felt, be bound to endanger the prospects of ratification by Congress. Congress was well aware that the United States would, for some time to come, be the only possible source of substantial net credit to the system. Prospects for ratification were already uncertain because of strong opposition to the idea of a Fund by the American Bankers' Association.

On the other hand, the delegations opposed to Fund conditionality had every reason to believe, after Atlantic City, that they had won their point and that, as long as the key words of the Joint Statement were maintained, there was no need to engage in another confrontation with the Americans on the matter. Moreover, Keynes had decided that he would raise as few issues as possible that might be embarrassing to the United States, because he was aware of the Administration's difficulties with Congress and was unwilling to add to them.[5]

[5] Keynes wrote on July 21, 1944, "We and we alone of the other delegations have spent 90 per cent of our time [at Bretton Woods] trying to help [the Americans] and not make trouble for them" (Moggridge, 1980, Vol. 26, p. 106).

One indication that nearly all countries other than the United States assumed that the question of conditionality had been settled along the lines of the view that had prevailed in Atlantic City is given by the fact that, although reservations were filed by governments on many provisions of the Articles of Agreement, there was not a single reservation on conditionality.

Another point of some interest is that, strong as the position of the United States on the principle of conditionality undoubtedly was, its objectives were clearly limited at this time. Members of the U.S. delegation at Bretton Woods might have been surprised if they could have peered into the future and read the text of a typical IMF standby arrangement. In intergovernmental discussions, the U.S. negotiators repeatedly emphasized that "no restrictions should be imposed [by the Fund] unless misbehavior is flagrant," as White put it at a meeting in October 1943. For example:

> The Fund's facilities should not be used to finance either a flight of capital or the issue of foreign loans by a country which could not afford to undertake foreign lending. Again, the Fund would be justified in intervening where a country was using its quota for rearmament. On the other hand, *it would not be justified in the case of an unbalanced budget. In general the Fund would intervene only in extreme cases of violation of qualitative rules, and would bear the burden of proof* [emphasis supplied]. (Horsefield, 1969, p. 69.)

Similarly, at the private meeting held to brief the U.S. delegation on July 1, 1944, there was no suggestion by any of the participants that the Fund's conditions for drawings would be onerous. A striking remark by White was, "I don't think the Fund should butt into every country's business and say 'We don't like this or that.' "

On the latter point, the wording of Article IV, Section 5(f) of the original IMF Agreement is of particular interest. This subparagraph stated that, so long as the Fund was satisfied that a change in the par value of a particular member's currency was necessary to correct a fundamental disequilibrium, "it shall not object to a proposed change because of the domestic social or political policies of the member proposing the change." This wording (as pointed out to the author by E. M. Bernstein) makes it clear that the intention of the Agreement as a whole was to preclude Fund interference with domestic policies having social objectives such as the subsidization of food or other essential consumption goods for the protection of low-income groups.

At a later stage, when the Bretton Woods Agreement came up for ratification by Congress, Professor Raymond Mikesell drafted the response to be made to the expected Congressional criticism that the Fund would give member countries a virtually automatic right to borrow. Mikesell's brief, used by White, was categorical in asserting the right of the Fund, under the Articles, to refuse a drawing. But it also provided an answer to the

question why the Articles did not explicitly authorize the Fund to pass on each request for a drawing or to require guarantees of good performance from members seeking drawings:

> The reason is that if a member agrees not to impose exchange restrictions on current transactions, and not to depreciate its currency, it must be given assurance of assistance in periods of adversity. . . . If countries are asked to come to the Fund "hat-in-hand" each time they find themselves in need of reasonable amounts of foreign exchange, they are not going to be willing to forego those exchange practices which in the past they have been forced to employ for the protection of their economies. (NARS, Box 8, File E-204. Draft dated June 29, 1945.)

An explanatory document issued to the press on July 21, 1944, at Bretton Woods included the following passage:

> There are many safeguards provided in the Fund to protect its resources from uses that are excessive in amount or in duration. . . . No safeguard provided for the Fund is more important than the provision that the countries' request for foreign currencies must indicate that the uses to which these currencies will be put are consistent with the purposes of the Fund. This means that countries which conduct their affairs in good faith in accordance with the undertaking to act in conformity with the purposes of the Fund will not in any circumstances divert the resources of the Fund to inappropriate uses. *In international agreements between sovereign States no method of enforcement can be as important as reliance on the good faith of the participants* [emphasis supplied]. (U.S. Dept. of State, 1948, Vol. 2, Appendix I, Doc. 508, pp. 1212-1213.)

The Early Years of the Fund

The United States was fully aware that the battle for a "grandmotherly" Fund had not been won at Bretton Woods. Once the Fund was a going concern, however, its Executive Board might be persuaded to introduce the implementing regulations or interpretations necessary to give the institution supervisory functions. Without such safeguards, the United States would not agree to the release of Fund resources. At a meeting of the Board in May 1946, the U.K. Executive Director, George Bolton, put forward his view of the "semi-automatic character of Fund facilities." The U.S. Executive Director, Harry White, on the other hand, while conceding that the text of the Articles of Agreement did not specifically authorize the Fund to exercise supervision, considered that there would have to be some check on the right of a Fund member to draw. He suggested that all applications in excess of a ceiling figure, to be determined later, should come before the Board for comment and decision.[6]

Speaking for Canada, Louis Rasminsky, later Governor of the Central

[6] Telegram from Balfour to Foreign Office, May 28, 1946, U.K. Public Record Office (subsequently referred to as PRO), Treasury File 236/1162.

Bank of Canada from 1961 to 1973, argued that the Fund could not operate if every transaction were to be regarded as an application to the Board. If a member gave the necessary guarantees and carried out its undertakings in good faith, it must be able to use its quota with assurance. Quantitative limitations on drawings had already been set out clearly in the Articles of Agreement, and if a member was fulfilling its undertakings by not purchasing foreign exchange for purposes inconsistent with the Articles, it should not be questioned. The Fund should be aware of the behavior of members and should be prepared to be courageous in its criticisms. But large-scale drawings should be regarded as no more than danger signals (PRO Treasury File 236/1162).

In a statement to the Executive Board on August 29, 1946, the Managing Director, Camille Gutt, said that the Fund could be considered as "a sort of automatic machine selling foreign exchange to members within certain limits and on certain terms, and repurchasing this foreign exchange within certain limits and on certain terms." The Fund could, however, issue warnings to members and, in certain circumstances, declare a member ineligible to draw. In Gutt's view, an Executive Board composed of high-level officials was required not so much for the discharge of such functions as to constitute "a most important monetary policy-making body, consulted by and advising its members during the critical periods they may pass through" (PRO Treasury File 236/1162).

In November 1946, a report to the Bank of England by the U.K. Executive Director stated, "For the time being there is no reason to fear a policy of persistent and irresponsible interference in the domestic affairs of members" (PRO Foreign Office File 371/62340). As late as September 1947, the Treasury brief for the U.K. delegation attending the second Annual Meeting of the Board of Governors of the IMF suggested that the "battle for 'automaticity' may be largely regarded as won" and pointed out the failure of the United States to have the French economic situation discussed by the Executive Board before allowing additional French drawings (PRO Treasury File 236/1174).

But the situation was in reality quite different.[7] The Europeans had the best of the argument, perhaps, but it was the United States that had the resources, and it was resources that counted, especially in the immediate

[7] It is remarkable that for nearly four years—from January 1944 to at least September 1947—the U.K. Government seems to have believed that it was winning a battle that it was, in fact, in the process of losing. It is even more remarkable how deep a misunderstanding can persist in international discussions even as between countries speaking the same language. By October 1948, however, George Bolton was drawing the IMF Board's attention to the "increasing number of interpretations reading into the Fund Agreement limitations which were not in the text. Because of such limitations the Fund was now of no use to its European members; it carried obligations but no benefits" (see Horsefield, 1969, p. 243).

aftermath of World War II. By 1950, the Fund had come to a complete standstill, there being no drawings at all in that year. As the Fund history points out, "Many people, both inside the Fund and in member countries, were disturbed at the small extent to which drawings were being made available to assist member countries in the kind of difficulties which the Articles had envisaged" (Horsefield, 1969, p. 276).[8]

The decline in Fund operations was partly due to the so-called "ERP Decision," adopted over European opposition, whereby countries receiving assistance under the European Recovery Program were only exceptionally to request the purchase of U.S. dollars from the Fund. But an additional factor was the continuing insistence of the U.S. Executive Director that the use of the resources of the Fund must be subjected to close scrutiny. This contention was used to challenge requests for drawings not only by the Netherlands, which had withdrawn its informal undertaking not to draw on the Fund, but by a number of other countries such as Nicaragua and South Africa (Horsefield, ed., 1969, Vol. 2, p. 398).[9]

Deploring "the current tendency to write off the Fund as moribund," Gutt made a proposal in November 1950 to break the deadlock by linking drawings to an engagement by members to take specific steps to overcome balance-of-payments difficulties. The legality of this proposal was immediately challenged by European and other members of the Executive Board. In the end, however, only France and the United Kingdom withheld their approval, the remaining countries considering, as the Fund history puts it, that the Managing Director's plan "offered a useful technique for enabling members to resume drawing from the Fund" (Horsefield, 1969, p. 281).

Similarly, an earlier proposal by the United States to establish a maximum period of five years for the repayment of drawings was adopted despite initial opposition, on legal as well as policy grounds, by most members of the Executive Board (Horsefield, ed., 1969, Vol. 2, pp. 399-400). The view of the Fund staff on this matter was that the Board had no legal authority to set a term for repayment of drawings unless it distinguished between members. If at the time of drawing it seemed to the Board inherently likely that repayment could be made reasonably soon, the Board had no power to impose conditions. If such repayment could not be foreseen, the proper course was to refuse to allow the member to draw at all (Horsefield, 1969, p. 278).

[8] It is ironic that in 1974-79 the Fund again reached a position in which it was often unable to "assist member countries in the kind of difficulties which the Articles had envisaged"—this time because of *too much* conditionality rather than too little.

[9] In a letter to the author, Sir George Bolton, U.K. Executive Director from 1946 to 1952, writes that after the collapse of sterling convertibility in 1947, the activities of the Fund appeared to be a "stonewalling operation designed to protect the American reserves from being too heavily drawn upon as a result of Fund operations."