

1.5: International Macroeconomic Institutions- The IMF and the World Bank

learning Objectives

1. Learn about the origins of the World Bank and the International Monetary Fund.
2. Understand the purpose of the International Monetary Fund both during the fixed exchange rate regime from 1945 to 1973 and after 1973.

After the Great Depression, one of the things policymakers thought was important was to return the international economy to a system of fixed exchange rates. Before the Depression (i.e., in the 1920s and before), the world mostly maintained a gold standard. Under such a system, a country establishes two rules: first, it fixes its currency value to a weight of gold; second, it establishes convertibility between the currency and gold. This means that any individual holding the national currency is allowed to cash in the currency for its equivalent in gold upon demand.

In essence, the gold standard derives from a system in which gold itself was used as a currency in exchange. Since gold was sufficiently rare and because it was inherently valuable to people, it was an ideal substance to use as a store of value and a medium of exchange (as was silver). However, once trucking gold around became more difficult, it became easier for governments to issue paper currency but to back up that currency with gold on reserve. Thus currency in circulation was just a representation of actual gold in the government's vault, and if a person ever wished to see that actual gold, he or she could simply demand conversion.

There is much that can be said about how a gold standard operates, but that discussion is reserved for a later chapter. For our purposes here, it is sufficient to explain that the gold standard was a system of fixed exchange rates. For example, before the 1930s the United States fixed the dollar at \$20.67 per ounce of gold. During the same period, the United Kingdom fixed its currency at £4.24 per ounce. As a result of the gold-currency convertibility in both countries, this meant the dollar and pound were fixed to each other at a rate of \$4.875/£.

During the Depression years, most countries dropped off the gold standard because the loss of confidence threatened a complete conversion of currency to gold and the depletion of national gold reserves. But, as World War II drew to a close, experts were assembled in Bretton Woods, New Hampshire, in the United States in 1944 to design a set of institutions that would help establish an effective international monetary system and to prevent some of the adjustment catastrophes that occurred after World War I. One such catastrophe occurred in Germany in 1922 to 1923 when a floating German currency resulted in one of the worst hyperinflations in modern history. Photos from that period show people with wheelbarrows full of money being used to make basic purchases. One way to prevent a reoccurrence was to establish a system of fixed exchange rates. As will be shown later, an important benefit of fixed exchange rates is the potential for such a system to prevent excessive inflation.

The **Bretton Woods Conference**, more formally called the United Nations Monetary and Financial Conference, was held in July 1944. The purpose of the conference was to establish a set of institutions that would support international trade and investment and prevent some of the monetary instabilities that had plagued the world after World War I. The conference proposed three institutions, only two of which finally came into being.

The unsuccessful institution was the International Trade Organization (ITO), which was intended to promote the reduction of tariff barriers and to coordinate domestic policies so as to encourage a freer flow of goods between countries. Although a charter was drawn up for the ITO, the United States refused to sign onto it, fearing that it would subordinate too many of its domestic policies to international scrutiny. A subagreement of the ITO, the General Agreement on Tariffs and Trade (GATT), designed to promote multilateral tariff reductions, was established independently though.

The two successfully chartered institutions from the Bretton Woods Conference were the **International Bank for Reconstruction and Development (IBRD)** and the **International Monetary Fund (IMF)**.

The IBRD is one component of a larger organization called the World Bank. Its purpose was to provide loans to countries to aid their reconstruction after World War II and to promote economic development. Much of its early efforts focused on reconstruction of the war-torn economies, but by the 1960s, its efforts were redirected to developing countries. The intent was to get countries back on their feet, economically speaking, as quickly as possible.

The second successfully chartered organization was the IMF. Its purpose was to monitor and maintain the stability of the fixed exchange rate system that was established. The system was not the revival of a gold standard but rather what is known as a gold-exchange standard. Under this system, the U.S. dollar was singled out as the international reserve currency. Forty-four of the forty-

five ratifying countries agreed to have their currency fixed to the dollar. The dollar in turn was fixed to gold at \$35 per ounce. The countries also agreed not to exchange officially held gold deposits for currency as had been the practice under the gold standard. However, countries agreed that officially held gold could be exchanged between central banks.

Another important requirement designed to facilitate the expansion of international trade was that countries agreed not to put any restrictions or controls on the exchange of currencies when that exchange was intended for transactions on the current account. In other words, individuals would be free to exchange one currency for another if they wanted to import goods from another country. However, currency controls or restrictions were allowed for transactions recorded on the financial accounts. This allowed countries to prevent foreign purchases of businesses and companies or to prevent foreign banks from lending or borrowing money. These types of restrictions are commonly known as **capital controls** (also, currency controls and/or exchange restrictions). These controls were allowed largely because it was believed they were needed to help maintain the stability of the fixed exchange rate system.

The way a fixed exchange system operates in general, and the way the Bretton Woods gold exchange standard operated in particular, is covered in detail in Chapter 11. For now I will simply state without explanation that to maintain a credible fixed exchange rate system requires regular intervention in the foreign exchange markets by country central banks. Sometimes to maintain the fixed rate a country might need to sell a substantial amount of U.S. dollars that it is holding on reserve. These reserves are U.S. dollar holdings that had been purchased earlier, but sometimes a country can run what is called a balance of payments deficit—that is, run out of dollar reserves and threaten the stability of the fixed exchange rate system.

At the Bretton Woods Conference, participants anticipated that this scenario would be a common occurrence and decided that a “fund” be established to essentially “bail out” countries that suffered from balance of payments problems. That fund was the IMF.

The IMF was created to help stabilize exchange rates in the fixed exchange rate system. In particular, member countries contribute reserves to the IMF, which is then enabled to lend money to countries suffering balance of payments problems. With these temporary loans, countries can avoid devaluations of their currencies or other adjustments that can affect the confidence in the monetary system. Because the monies used by the IMF are contributions given by other countries in the group, it is expected that once a balance of payments problem subsides that the money will be repaid. To assure repayment the IMF typically establishes conditions, known as conditionality, for the recipients of the loans. These conditions generally involve changes in monetary and fiscal policies intended to eliminate the original problems with the balance of payments in the first place.

The role of the IMF has changed more recently though. The fixed exchange rate system, under which the IMF is designed to operate, collapsed in 1973. Since that time, most of the major currencies in the world—including the U.S. dollar, the British pound, the Japanese yen, and many others—are floating. When a currency is allowed to float, its value is determined by supply and demand in the private market and there is no longer any need for a country’s central bank to intervene. This in turn means that a country can no longer get into a balance of payments problem since that balance is automatically achieved with the adjustment in the exchange rate value. In essence the *raison d’être* of the IMF disappeared with the collapse of the Bretton Woods system.

Curiously, the IMF did not fall out of existence. Instead, it reinvented itself as a kind of lender of last resort to national governments. After 1973, the IMF used its “fund” to assist national governments that had international debt problems. For example, a major debt crisis developed in the early 1980s when national governments of Mexico, Brazil, Venezuela, Argentina, and eventually many other nations were unable to pay the interest on their external debt, or the money they borrowed from other countries. Many of these loans were either taken by the national governments or were guaranteed by the national governments. This crisis, known as the Third World debt crisis, threatened to bring down the international financial system as a number of major banks had significant exposure of foreign loans that were ultimately defaulted on. The IMF stepped in to provide “structural adjustment programs” in this instance. So the IMF not only loaned money for countries experiencing balance of payments crises but also now provided loans to countries that could not pay back their foreign creditors. And also, because the IMF wanted to get its money back (meaning the money contributed by the member nations), the structural adjustment loans came with strings attached: **IMF conditionality**.

Since that time, the IMF has lent money to many countries suffering from external debt repayment problems. It stepped in to help Brazil and Argentina several times in the 1980s and later. It helped Mexico during the peso crisis in 1994. It assisted countries during the Asian currency crisis of 1997 and helped Russia one year later when the Asian contagion swept through.

Although the IMF has come under much criticism, especially because conditionality is viewed by some as excessively onerous, it is worth remembering that the IMF makes loans, not grants. Thus it has the motivation to demand changes in policies that raise the chances of being repaid. These conditions have generally involved things like fiscal and monetary responsibility. That means reducing one’s government budget deficit and curtailing the growth of the money supply. It also prescribed privatization that

involves the sale or divestiture of state-owned enterprises. The free market orientation of these conditions came to be known as the **Washington Consensus**.

Also mitigating the criticisms is the fact that the countries that participate in IMF programs are free to accept the loans, or not. To illustrate the alternative, Malaysia was one country that refused to participate in an IMF structural adjustment program during the Asian currency crisis and as a result did not have to succumb to any conditions. Thus it is harder to criticize the IMF's conditions when the countries themselves have volunteered to participate. In exchange for what were often tens of billions of dollars in loans, these countries were able to maintain their good standing in the international financial community.

Although controversial, the IMF has played a significant role in maintaining the international financial system even after the collapse of fixed exchange rates. One last issue worth discussing in this introduction is the issue of moral hazard. In the past thirty years or so, almost every time a country has run into difficulty repaying its external debt, the IMF has stepped in to assure continued repayment. That behavior sends a signal to international investors that the risk of lending abroad is reduced. After all, if the country gets into trouble the IMF will lend the country money and the foreign creditors will still get their money back. The moral hazard refers to the fact that lending institutions in the developed countries may view the IMF like an insurance policy and thus make much riskier loans than they would have otherwise. In this way, the IMF could be contributing to the problem of international financial crisis rather than merely being the institution that helps clean up the mess.

Key Takeaways

- The World Bank and the IMF were proposed during the Bretton Woods Conference in 1944.
- The main purpose of the World Bank is to provide loans for postwar reconstruction and economic development for developing countries.
- The main purpose of the IMF was to monitor the international fixed exchange rate system and to provide temporary loans to countries suffering balance of payments problems.
- Since the breakup of the Bretton Woods fixed exchange rate system in 1973, the IMF has mostly assisted countries by making structural adjustment loans to those that have difficulty repaying international debts.
- The IMF conditionalities are the often-criticized conditions that the IMF places on foreign governments accepting their loans. The free-market orientation of these conditions is known as the Washington Consensus.

exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - The name for the original division of the World Bank that describes its original purpose.
 - The name for the international institution that was designed to assist countries suffering from balance of payments problems.
 - The common name for the international institution whose primary function today is to make loans to countries to assist their economic development.
 - In the Bretton Woods system, these types of regulations were allowed for transactions recorded on the financial account.
 - This type of currency regime was implemented immediately after the collapse of the Bretton Woods system.
 - The term used for the conditions the IMF places on loans it makes to countries.
 - The term used for the type of loans made by the IMF to assist countries having difficulty making international debt repayments.
 - The term used to describe the standard free market package of conditions typically invoked by the IMF on loans it makes to countries.

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