
Balance of Payments Adjustment, 1945 to 1986

The IMF Experience

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PART

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Adjustment Under the Par Value System, 1945–72

One of the basic problems of international economic policy is to find effective means for restoring external balance to a country whose balance of payments is seriously in surplus or in deficit. But this problem . . . is closely bound up with the problem of maintaining a high and stable level of economic activity [and] full employment, in the country suffering from the disequilibrium in its balance of payments.

James E. Meade, 1951

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Forming and Implementing Initial Policies, 1945–61

With the creation of the International Monetary Fund, balance of payments adjustment became a matter for public policy. Previously, under the classic gold standard applicable from 1870 until World War I and to a large extent under the gold standard as partially resurrected in the 1920s, balance of payments adjustment, at least in theory, was to be attained through settlements in gold. According to the quantity theory of money, then dominant among economists, the supply of money in a country determined the general levels of output, income, and prices prevailing in that country. The size of the money supply, in turn, was determined by a legally fixed relation between money and a country's gold stock. Changes in a country's gold reserves had repercussions on the general level of domestic prices, output, and incomes in both the country with the external deficit and the ones with external surpluses. A country with an overall current and capital account deficit settled the deficit by payment in gold to the trading partners with surpluses. Because of the loss of gold, the country in deficit would have to reduce its money supply. This decline in money supply had a downward effect on the country's output, income, and prices, causing it to export more and import less, thereby reducing its external payments deficit. The reverse took place in the country with the external payments surplus. The importation of gold would cause expansion of its money supply, raising its output, income, and prices, causing its exports to fall and imports to rise, reducing its external surplus. Because of the close connection between gold and the level of domestic activity, especially the general level of prices, the gold standard was often referred to as the price-specie flow mechanism. Balance of payments adjustment was to be effected automatically. Monetary authorities were merely to take measures to support the external flows of funds, that is, to follow "the

rules of the game.” No separate decisions concerning special policies for balance of payments were supposed to be needed or expected.

In practice, as has been well documented, the gold standard did not work so simply or so smoothly. An appropriate balance of payments—one that did not disturb economic equilibrium—meant a balance that resulted in a sufficient import (or export) of gold to provide for a country’s industrial and monetary needs. Import of gold was necessary to permit a growth of reserves so that reserves could be used to settle external payments deficits arising in downswings of the business cycle. The world stock of monetary gold, however, grew at too low a rate to enable nations, especially the large traders such as the United States and the United Kingdom, to import sufficient gold. Hence, monetary authorities did not always play by the rules. Moreover, after World War I some countries fixed their exchange rates in relation to gold at unrealistically high levels. In particular, economists later generally agreed that when the authorities of the United Kingdom fixed the exchange rate for the pound sterling in terms of gold in the mid-1920s, they set it too high. These exchange rates could not be changed without undermining confidence in the system. The United Kingdom had difficulty in exporting, and from the late 1920s onward considerable domestic unemployment and deflation resulted. Indeed, some economists contend that it was the unemployment in the United Kingdom of the late 1920s that became a prime cause of the subsequent world depression of the 1930s.

The gold standard in which balance of payments adjustment was to be automatic and in which monetary authorities had few policy decisions to make thus became identified with deflation and unemployment.¹ In fact, Edward M. Bernstein, later Director of the Research Department of the Fund, writing in 1940, developed a theory attributing great depressions back to 1815 to the onset of inflation and the derangement of the monetary system and the consequent depreciation of the external values of countries’ currencies brought about by a major war followed by countries returning to the gold standard after the war and setting their exchange rates at the levels that prevailed before the war. Such rates were usually unrealistically high given the inflated prices and incomes prevailing in the aftermath of the war.² A further difficulty with the gold standard in practice and another cause of its collapse was

¹ For expositions of the gold standard, see Further Reading under the heading “Gold Standard.” The definition of a proper balance of payments given above is in Bernstein (1935, p. 503). Gold shipped from the United States as settlement for a current account deficit in 1930 is to be noted in Bernstein (1935, p. 393).

² See his, “War and the Pattern of Business Cycles,” in Bernstein (1940, especially pp. 532–35).

capital flight, which put additional pressure on each country in turn, the United Kingdom, the United States, France, and the gold bloc countries—Belgium, the Netherlands, and Switzerland.

After the breakdown of gold standard arrangements in the early 1930s, monetary authorities, now freer to take policy measures, took unilateral actions, country by country, that led to exchange rate instability, competitive depreciation, extensive use of exchange controls, inconvertibility of currencies, and bilateral payments arrangements. By restricting imports and using unfair exchange practices to promote exports, countries in effect tried to “export their unemployment.” Later studies of experience in the period between World War I and World War II demonstrated the self-defeating nature of these “beggar-thy-neighbor” policies.³ In effect, no system of balance of payments adjustment existed.

The experience of the 1920s and 1930s was the background against which a new system for balance of payments adjustment was created at Bretton Woods in 1944.

Nature of the Policy Problem

The creation of the International Monetary Fund established an entirely new framework for balance of payments adjustment. A major reason for the creation of the Fund was to help its members avoid the excessive cyclical swings in their domestic economies caused by the need to correct balance of payments disequilibria inherent in the gold standard. The downward swings that produced severe involuntary unemployment had been very worrisome, especially in the Great Depression of the 1930s. Financial officials therefore sought alternatives to domestic deflation as a way to correct balance of payments deficits. They wanted to be able to pursue domestic policies designed to obtain full employment and economic development in their national economies and wanted these policies to be as free as possible of the balance of payments constraint.

The new objective of public officials was to simultaneously attain and maintain internal equilibrium (full employment) and external equilibrium (balance of payments equilibrium). Internal equilibrium was to be obtained by fiscal and monetary policy. Balance of payments adjustment was to be effected by (1) changes in exchange rates, (2) use of reserves, supplemented by the temporary use of the secondary line of reserves furnished by the Fund’s resources while adjustment was being effected,

³ The reader is referred particularly to the League of Nations (1944), a classic study written mainly by Ragnar Nurkse.

(3) limited use of restrictions on exchange transactions, and (4) where necessary, restrictions on capital flows.

An alternative way of looking at the balance of payments adjustment process of the Bretton Woods system described to the author recently by Edward M. Bernstein, a principal founder of the system, shows how the process was intended to overcome the defects of the gold standard. In essence, the Bretton Woods system was designed to provide stability of exchange rates without the restrictions on money supply imposed by the gold standard. Under the system, an appropriate balance of payments position was much the same as under the gold standard, as defined above, but countries had more time to adjust payments imbalances caused by cyclical fluctuations. The system assumed that the large trading countries would be able to maintain stable costs of production in their export industries by limiting increases in wages in these industries to increases in productivity. Under such a policy, there would be no change in price competitiveness among the large trading countries. This policy, however, would have to take account of trend changes in reciprocal demand. A country whose trend demand for imports increased more than the world demand for its exports would have to increase wages somewhat less than the increase in productivity in its export industries, and vice versa in the country with an improvement in reciprocal demand. Internal equilibrium in aggregate demand and costs was thus expected of itself to minimize imbalance in international payments. Temporary seasonal and cyclical deficits could be financed by use of reserves. (Surpluses would involve some reserve accumulation.) More persistent imbalances, requiring a longer period of adjustment, could be met for a time by control of capital flows and, if necessary, by restrictions on current transactions. A country that had a persistent balance of payments surplus or deficit, on an official reserve basis, could change the par value of its currency, in contrast to the immutability of par values under the gold standard.

Changes in exchange rates and the use of restrictions on exchange transactions were to be subject to approval by the Fund as was, of course, use of the Fund's resources. Restrictions on imports were also to be subject to approval by the international community (eventually by the CONTRACTING PARTIES to the General Agreement on Tariffs and Trade, the GATT). Since a prime goal of the new system was a liberal trade regime and a multilateral system of payments as free of restrictions as possible, measures involving restrictions were subject to international approval and were meant to be exceptional. A country with a balance of payments deficit could, on its own decision, thus only draw on its reserves or impose controls on capital movements. Reserves were to consist not only of gold but also of a few national currencies, such as

the pound sterling and the U.S. dollar, supplemented by the Fund's resources. A fundamental disequilibrium, viewed by most economists at the time as a long-term disequilibrium that could not be corrected by aggregate demand policy in a reasonable time without an excessive degree of unemployment or inflation, was to be corrected by a change in the exchange rate. Temporary disequilibrium was to be financed by use of reserves.

The "Questions and Answers on the International Monetary Fund" prepared by the U.S. Treasury in June 1944 affirmed this conceptual framework, at least in the minds of the U.S. negotiators. That document states that

under the Fund, corrective measures can be taken to adjust an adverse balance of payments which need not involve domestic contraction and a drastic reduction of imports. Under adequate safeguards, the Fund will provide the necessary exchange to maintain imports while more fundamental adjustments are being made. Likewise, in the case of member countries with a favorable balance on current account, the operations of the Fund will enable them to maintain their exports while adjustments are made, instead of being forced to undertake a sharp reduction in exports with the resulting adverse effects on domestic employment.⁴

Stability of exchange rates was also a prime objective. Changes in exchange rates were to be made *only* to correct fundamental disequilibrium. Since exchange rate changes would be relatively rare, some economists, for example, Ragnar Nurkse, of Columbia University and Jacob Viner, of the University of Chicago, believed that the main function of the Fund would be to create an addition—a substantial addition—to aggregate international liquidity, which would provide safeguards against deflations, either within a country or in the world economy, originating in national balance of payments difficulties.⁵ A few critics who preferred the strict discipline of the gold standard were even convinced that the Fund would be a large source of inflation and strongly opposed its creation.⁶

Balance of payments adjustment was now a policy problem. Policymakers, including those in the newly established Fund, had to find answers to several questions concerning the main policy instruments (use of reserves, including those offered by the Fund, domestic financial

⁴ See Horsefield (1969, Vol. III, p. 139). Additional discussion of the reasoning of the founders of the Fund can be found in M.G. de Vries (1985, Vol. I, pp. 84–90).

⁵ Nurkse (1945, p. 13); Viner (1943, p. 13). A similar view was expressed by Alice Bourneuf, who joined the Fund staff shortly after writing the article, in her "Lending Operations of the International Monetary Fund." See Bourneuf (1946, pp. 237–47).

⁶ See, for example, editorials in the *New York Times* on June 1, June 24, June 26, July 1, July 18, and July 24 of 1944, reprinted in Hazlitt (1984).

measures, exchange restrictions, controls on capital movements, and changes in par values) with which balance of payments deficits and surpluses might be remedied. To find these answers, they had to address related questions. How was fundamental disequilibrium to be distinguished from temporary disequilibrium? Under what conditions would changes in par values correct balance of payments disequilibria? What use, if any, should be made of restrictions on imports for balance of payments purposes? What policies should govern use of the Fund's resources? Policymakers also had to determine what domestic macroeconomic policies would best achieve the twin goals of full employment and balance of payments equilibrium. Whether the simultaneous pursuit by the industrial countries of domestic policies to achieve full employment would be consistent with a satisfactory array of balance of payments positions among industrial countries was unknown. In a study well ahead of its time, James E. Meade, a professor at Cambridge University, was among the first to treat adjustment of the balance of payments as a policy problem, examining the kinds of economic policies a country might pursue to attain both full employment domestically and equilibrium in the external account.⁷ About this time, too, in the early 1950s Jan Tinbergen, a professor at the Netherlands School of Economics (later Erasmus University), developed a basic premise of economic policy that each policy objective required a separate policy instrument.⁸ This premise meant that to achieve both full employment and balance of payments equilibrium a country had to employ some means of control over both its aggregate expenditure, for example, macroeconomic policies, *and* its international trade and payments, for example, the exchange rate or exchange and trade restrictions.

The Elasticities Approach Since a change in par values, under international approval, was a main feature of balance of payments adjustment under the new arrangements, most economists at the time centered attention on the remedial effects of exchange rate devaluation on a trade deficit. The usual approach since the late 1930s to ascertain the effect of a devaluation of an exchange rate on the trade balance of the devaluing country was to examine the supply and demand conditions both in the devaluing country and in the rest of the world. It was presumed that a devaluation initially tended to reduce the foreign prices of the country's exports in proportion to the devaluation. At these reduced prices, foreign demand for the country's exports would be increased, thus tending to bid up the foreign prices of these exports

⁷ See Meade (1951).

⁸ See Tinbergen (1952).

part way back toward their predevaluation levels. How much the foreign currency proceeds of the country's exports would change then depended upon the elasticity of foreign demand for the country's exports and the elasticity of domestic supply of export goods. Similarly, on the import side, the initial effect of a devaluation was to raise the domestic price of imports, presumably leading to some reduction in the country's demand for imports, which in turn might tend to reduce the world price for imported goods. The size of these reactions to imports depended upon the elasticity of domestic demand for imports and the elasticity of foreign supply of imports. As of the 1940s the total effect of the devaluation on the foreign trade balance was being expressed in a formula that involved principally these four relevant elasticities, two on the export side and two on the import side.⁹ This approach was thus known as the elasticity approach.

In the late 1940s and early 1950s, some economists were also analyzing the policy option of using restrictions on exchange payments or on imports as a means of reducing a trade deficit. Much of the argument advanced for preferring restrictions of various kinds to exchange devaluation was that devaluation involves an adverse movement in the terms of trade. Hence, economists were undertaking to determine the conditions under which devaluation did or did not cause a worsening of the terms of trade and the conditions under which restrictions might be used with optimal benefit.¹⁰

The Fund's Start

When the Fund opened its doors early in 1946, most of its members were experiencing severe balance of payments deficits, brought about by their abnormal need for imports since their economies were suffering from the devastation of World War II. The counterpart of their deficits was a large surplus in the balance of payments of the United States. Since payments to the United States had to be made in dollars, a world dollar shortage prevailed, which the U.S. Government greatly alleviated through aid programs and other official transfers abroad. To restrict external payments, especially those requiring dollars, many members

⁹ The elasticities approach, based on demand and supply schedules, went back to F.Y. Edgeworth and Alfred Marshall, and indeed to John Stuart Mill. The economist credited with the first statement of the elasticity conditions for stability of the foreign exchange market—or, more accurately, the conditions under which a devaluation will improve the trade balance—was C. F. Bickerdike. See Bickerdike (1920).

In the late 1930s and the 1940s, a number of economists developed further the elasticities approach and derived the formula mentioned in the text. See Further Reading under the heading "Elasticities Approach."

¹⁰ Fleming (1951). Mr. Fleming joined the Fund staff in 1954.

also imposed tight exchange and import restrictions, including discriminatory restrictions against the dollar area.

Expansion of Trade as the Key to Adjustment In line with the philosophy of its founding fathers that the key to world prosperity and satisfactory balance of payments positions lay in a large and growing volume of world trade, the Fund took the position that the widespread balance of payments deficits of its members would be reduced after a transitional period during which these members would be able to reconstruct their economies, expand production, and increase exports. They would then be able to supply more of their own consumption requirements and be better able to pay for needed imports. It was in the general interest that international payments equilibrium be restored by the expansion of exports by deficit countries on the basis of relative prices and costs rather than by the contraction of their imports through restrictions and discriminatory trade and payments practices against the dollar area. Adjustment via the expansion of exports by deficit countries would increase world trade, whereas the reduction of imports to affordable levels would reduce trade. But the Fund emphasized, too, that while the primary responsibility for correcting the balance of payments disequilibrium rested with the deficit countries themselves, surplus countries also had a responsibility: to help absorb additional exports from abroad, they were to keep their economies operating at a high level and minimize trade barriers that restrained imports.

The Fund took the position that its own function in the meantime was to safeguard its financial resources, prevent unnecessary changes in exchange rates, and, wherever possible, see that exchange restrictions on current transactions that hampered the growth of world trade were gradually eliminated. On this basis, as a way to get production and exports moving, in December 1946 the Fund agreed to initial par values that for most members were set at approximately their prewar levels.¹¹ The expectation was, however, that once the war-devastated economies had recovered, these initial par values would have to be adjusted to more realistic levels to stimulate sufficient exports to pay for needed imports.

The Fund was also concerned that in starting operations at a time when much reconstruction remained, it ran the risk that some of its resources might be used for other than temporary assistance. Accordingly, in June 1947 the Fund sent to its members a letter stating its

policy on use of its resources. In effect the policy consisted of a list of circumstances in which the Fund's resources could *not* be used. Because its Articles of Agreement required that the Fund's resources be "presently needed for making payments" in the currency requested, they could *not* be used to increase a member's reserves. Because the Fund's resources had to be used for current account transactions, they could *not* be used for large and sustained capital movements *nor* for emergency aid or for reconstruction of damage after World War II. *Nor* could they be used by a member that was clearly not going to be in a position to repay the Fund. Finally, when a member had a fundamental disequilibrium, aid to meet continuing balance of payments deficits without prospects of a return to equilibrium would be contrary to the Fund's purposes. In short, recourse to the Fund's resources was to be limited and exceptional. As a follow-up to this letter, in March 1948 informal understandings were arranged with 13 members that they would observe certain limitations on their exchange requests to the Fund. In its first two years the Fund also took a number of decisions to clarify the meaning and application of the term "fundamental disequilibrium," but it did not try to define the term and has not done so subsequently.¹²

Early Concern with Inflation Almost at the Fund's start, the Executive Directors, assisted by the staff of the Research Department under the direction of Edward M. Bernstein, realized and agreed that inflation and not deflation was the dominant characteristic of the economies of most of its members and was the most urgent problem to tackle if world trade was to expand and international payments equilibrium was to be restored.¹³ The first *Annual Report*, written only a few months after the Fund began holding Executive Board meetings, already stated that "inflation, in varying degrees of intensity, is in progress throughout much of the world" and that "efforts to maintain and to restore

¹² These early decisions concerning fundamental disequilibrium can be found in M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 21–22, 62, 91–92, 547, 568, and 581).

¹³ Mr. Bernstein has stated more recently that he had long held the view that in the early postwar period the Fund would be confronted by problems of inflation in its members and not of deep depression, as some economists then feared. He based this view on his belief, described above, that deep depressions resulted from the interaction of wartime inflation and the gold standard and from the restoration of historical gold parities in the face of very uneven inflation of prices and incomes in different countries. Because the link between money supply and gold had been broken with the establishment of the Fund, he believed that the only danger of deep depression was that some industrial countries might attempt to perpetuate unrealistic exchange rates by deflation. Mr. Bernstein's view was thus that a depression after World War II could be avoided if countries set a realistic pattern of exchange rates. See Bernstein (1977, pp. 15–17).

¹¹ An explanation of the reasoning underlying the initial par values set in 1946 can be found in Gutt (1948), Horsefield (1969, Vol. I, pp. 154–56), and M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 52–54).

production and international investment cannot have anything like their full effect without a reasonable degree of monetary and exchange stability."¹⁴ By the time of the second Annual Meeting, in September 1947, the Fund was calling for specific actions to curb inflation. In his opening address, the Managing Director, Camille Gutt, specifically called attention to the need for "balancing of the national budget" as the starting point for "internal financial and currency reform."¹⁵ By 1948, concern with inflation was paramount, as was evident in the Fund's *Annual Report* for 1948:

Inflation is a serious handicap to recovery and to the restoration of international economic equilibrium. Waste of resources and misdirection of production have resulted from rapidly rising prices. Much of the investment in some countries has been directed toward escaping the consequences of holding cash rather than toward expanding output and increasing efficiency. The excessive domestic demand that accompanies inflation adds to the difficulty of maintaining an appropriate flow of exports, for output that might have been available for export is otherwise absorbed and prices are pushed to non-competitive levels. Inflationary pressure also stimulates imports, including imports of goods which may not be necessary for essential consumption and investment.¹⁶

The Absorption Approach The concepts, analytical framework, techniques, and methodologies that the Fund staff has developed over the years have almost always evolved out of an immediate practical problem that a member faced. For many problems, no readily available theory or doctrine applied to which the staff could resort. Accordingly, the staff, usually in the course of a mission, often came up with an on-the-spot, ad hoc solution. Back in Washington, particularly when the problem presented was likely to be a general one, the staff from the mission, working with colleagues, formed generalizations describing the problem and explaining the reasons for the suggested solution. At times the staff also devised methodologies to cover similar situations. Thus, the staff, using its practical experiences, expanded the boundaries of economic knowledge, especially in the 1950s and 1960s. It was, accordingly, in actual cases that the absorption approach and, a few years later, the monetary approach to balance of payments adjustment had their roots.

The absorption approach started from the premise, in line with the then new national income accounting, that a country's balance of payments on goods and services reflected the difference between its

total output of goods and services and its absorption, for consumption and investment, of these goods and services. (The taking of goods and services off the market was referred to as absorption.) Using this identity, the effects of any remedial measure for the balance of payments, for example, a devaluation of the exchange rate, could be assessed by ascertaining the effects of the measure on output and on absorption. The analysis was that if a devaluation is to affect the trade and services balance, it can do so in only two ways: (1) It can lead to a change in the production of goods and services in the country; this change will have associated with it an induced change in the absorption of goods and services so that the trade balance will be altered by the difference between the change in income and the income-induced change in the amount of real absorption. (2) The devaluation may change the amount of real absorption associated with any given level of real income.

Thus in an economy operating at full employment an improvement in the balance of payments necessarily requires a reduction in the domestic absorption of goods and services except to the extent that gains are made in productivity and extensions occur in productive capacity as a result of earlier investments. A disinflationary financial policy, acting on domestic consumption or investment demand, could even without inducing a change in relative prices make more goods available for export and at the same time dampen the demand for imports. However, in any instance of a serious balance of payments disequilibrium, disinflationary measures will probably have to induce appropriate changes in relative prices to bring about a reallocation of factors between export, import-competing, and purely domestic industries. Because the mobility of resources is normally far from perfect, this reallocation is a painful process and may involve considerable unemployment unless favored by facilitating circumstances, such as a rising world demand, or assisted by policy measures, such as an exchange rate adjustment.

In a country exporting manufactured goods, especially durable goods, there is likely to be a high degree of substitutability between exports and domestic investment. Nevertheless, in the absence of a rising, or at least a stable, world demand, the main burden of response to a disinflationary policy is likely to fall on imports, the equilibrium in external payments being attained at a reduced level of both domestic economic activity and external trade.

The absorption approach was an important analytical advance over the elasticities approach. The elasticities approach was basically a partial equilibrium analysis and therefore considered faulty because it did not take into account the effects of changes of the exchange rate on income. The absorption approach recognized that a devaluation affects not only

¹⁴ International Monetary Fund (1946, pp. 9 and 11).

¹⁵ International Monetary Fund (1947, p. 8).

¹⁶ P. 18.

the relative prices of traded and domestic goods but also aggregate income and expenditure. It was thus more in keeping with the new Keynesian framework of macroeconomic analysis, viewing the balance of payments on current account as the difference between national income and national expenditure.

The evolution of the absorption approach is briefly as follows. In 1948, Mexico, which has often been a member with which the Fund has pioneered, was suffering from a balance of payments deficit. The serious loss of exchange reserves prompted the Mexican authorities to suspend the par value for the Mexican peso so as to let the rate depreciate by a floating rate and to ask the Fund for a drawing.¹⁷ The staff attributed Mexico's balance of payments problem mainly to a domestic budget deficit and concluded that the solution could not therefore lie in exchange devaluation.

J.J. Polak, of the Research Department, generalized the Mexican situation in an unpublished study "Depreciation to Meet a Situation of Over-Investment," dated September 10, 1948. In it he showed that devaluation cannot be effective in correcting a large and persistent balance of payments deficit that is the result of overinvestment. If wage earners are successful in restoring their previous real income and investment is maintained as before, investment will again become excessive and the balance of payments deficit will reappear. From this case the Fund staff began to increase its understanding of the relation between developments in the aggregate domestic economy of a member and in the member's balance of payments.

By 1948, moreover, the staff was examining the continued appropriateness of the initial par values of several European currencies set in 1946, and the need for, and possible timing of, devaluations of these currencies.¹⁸ Given the inflationary conditions in these countries, the staff inevitably examined the relation between exchange devaluation and inflation. In the course of this examination, the staff also increased its awareness of the relation between developments in a member's overall domestic economy and in its external payments.

The 1949 *Annual Report*, written prior to the devaluations of the Western European currencies of September 1949, developed the relation further. It stated that for exchange adjustment to be successful, its expected benefits should not be dissipated by an offsetting rise in local prices and costs. "If, however, the public is insistent on offsetting by higher incomes even a moderate rise in the cost of living, [that usually

accompanies exchange devaluation] the result will be the almost complete dissipation of the benefits of exchange adjustment."¹⁹ In 1950, S.C. Tsiang, also of the Research Department, showed how international transactions may affect the domestic flow of income directly and indirectly and how at least the direct effects might be measured roughly by the net balance in the current account.²⁰

The first signs of a full-blown absorption approach appeared in the *Annual Report* for 1950. That report discussed the potential effects of the September 1949 devaluations explicitly in terms of their effects on consumption and investment. It pointed out that the devaluations, involving a reduction of export prices, had opened the way for a great expansion of demand for imports in the countries in the dollar area. To meet this demand required in the countries that devalued a corresponding expansion of the supply of goods suitable for export to the dollar area. The resources for this purpose could become available only by increasing production or diminishing consumption or investment.²¹ These ideas examining the effects of exchange devaluation in terms of its effects on aggregate consumption and investment (that is, on the absorption of total resources in an economy) became widely known through a paper published by Sidney S. Alexander, of the Research Department, in 1952.²²

The development of the absorption approach notwithstanding, the responses of the trade balance to the change in relative prices brought about by exchange devaluation were also still critical for assessing a change in an exchange rate, and the Fund staff continued to study them. For example, in the early 1950s the staff used the elasticity approach to examine the expected and actual effects of the devaluations of the Western European currencies of September 1949.²³ One economist, while on the Fund staff, put forward arguments to the effect that statistically estimated price elasticities were unreliable for predicting the effects of an exchange depreciation.²⁴ As time went on, several reconciliations of the elasticities and absorption approaches were undertaken, some of them within the Fund.²⁵

¹⁹ P. 15.

²⁰ Tsiang (1950).

²¹ International Monetary Fund (1950a, p. 23).

²² See Alexander (1952).

²³ See, for example, Polak and Chang (1950), B.A. de Vries (1950) and (1951), and Liu (1954).

²⁴ See Orcutt (1950).

²⁵ One by a Fund staff member is that of Tsiang (1961).

¹⁷ See Horsefield (1969, Vol. I, pp. 227–28) and M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 153–54).

¹⁸ See Horsefield (1969, Vol. I, p. 234).

Implementing the Policies

By the early 1950s world output was exceeding the levels attained before World War II, and the devaluations of September 1949 had established a more appropriate pattern of exchange rates for the main currencies. Nevertheless, many members were still encountering continued or recurrent balance of payments deficits. The Northern European members, in particular, were vigorously pursuing full employment policies, with spillover effects on their balances of payments. Also, many members were still making heavy use of restrictions on imports and on external payments. A few members, including Canada, had resorted to fluctuating exchange rates and others, including Belgium, were thinking of introducing them.²⁶ The Bretton Woods system did not seem to be working as planned.

In the interest of a speedier attainment of its objectives, the Fund intensified its pursuit of the policies it had been forming in the previous few years. With the start of regular annual consultations with members still retaining Article XIV status, the Fund could express its views directly to monetary authorities regularly and more candidly.²⁷ The Fund urged members to relax their restrictions on current transactions on the grounds that such relaxation would help world trade expand more rapidly and thereby facilitate balance of payments adjustment. The Fund thus effectively ruled out the use of restrictions on imports as an option for keeping balance of payments deficits in check. It also spelled out the economic costs to a member of continuing to rely on restrictions. Because they reduced a member's ability to compete in world markets, restrictions tended to perpetuate themselves. They encouraged high costs and an undesirable and unfavorable allocation of resources and did not solve the difficulties that had led to their use. Ultimately, fundamental remedial measures would have to be taken.

The Fund also stressed repeatedly that, although the deflation of the 1930s had been partly responsible for the Fund's creation, the actual problem after World War II was *inflation*. It urged members to intensify measures to reduce internal inflationary pressures to help make the devaluations effective and to strengthen their balances of payments positions so that they could relax restrictions. The Fund noted pointedly

²⁶ See M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 155–62).

²⁷ Article XIV gives a member the right, among other things, to avail itself of transitional arrangements whereby it may "maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which it became a member." The Article in effect permits the temporary retention of certain restrictions without the Fund's explicit approval. At the time 47 out of 54 members were in Article XIV status.

that to improve their balance of payments positions, members had to rely on measures that would combat inflation within their own economies rather than on changes in exchange rates.

The Executive Directors, assisted by the management and staff, searched for explanations of why balance of payments deficits continued or frequently arose, and why members were so hesitant to relax restrictions, despite the attainment by most industrial members of levels of output exceeding those of 1939. The search produced a number of explanations. The productivity of most industries in the United States exceeded that of other industrial members. An inadequate level of foreign exchange reserves in most members meant that there was little or no cushion available for financing deficits that might emerge if restrictions were relaxed. The disruption of private capital markets, both short-term and long-term, meant that most of the burden of financing deficits had to be borne by official financing. Since official financing had to be regarded as temporary, the absence of private capital inflows meant that members with current account deficits had to reduce these deficits virtually to zero. East-West political tensions also added to the difficulties Western European members faced in eliminating balance of payments deficits because these tensions limited outlets for trade.

While recognizing these additional explanations for prolonged payments deficits and continued use of restrictions, Fund officials nevertheless believed that it was the inflationary impact of domestic fiscal and monetary policies that was by far the most important cause of continued and recurrent payments deficits. In most members excessive demand existed that weakened incentives to undertake the transfers of productive resources necessary for long-term external equilibrium. The tie-in between inflation and persistent balance of payments deficits was stressed repeatedly by the Managing Director. For example, in 1950 Mr. Gutt told the Board of Governors that "once inflation has been injected into the economy, the disruption it causes will destroy the balance of international payments."²⁸ In 1951 Ivar Rooth, the second Managing Director, told them that the "pervasiveness and the untractability of the payments problem indicate that it is fundamentally a by-product of inflation. Despite the great rise in output the inflation problem remains acute."²⁹ In the meantime, the Fund's conclusions about the adverse consequences of inflation were being supported by further staff analysis.³⁰

²⁸ International Monetary Fund (1950b, p. 16).

²⁹ International Monetary Fund (1951b, p. 13).

³⁰ William H. White, for example, analyzed the impact of governmental fiscal activity on a country's employment, income, and prices. See White (1951).

The Fund also made two pronouncements that are noteworthy inasmuch as a prime reason for creating the Fund only a few years before had been to help prevent domestic unemployment. One, a high and stable level of employment does not require such an inflated level of demand that it must inevitably give rise to external payments difficulties. Indeed, there is no greater threat to employment than inflationary policies which lead to balance of payments difficulties. Two, the main purpose of monetary policy is to keep domestic demand within proper limits and, in particular, in members with balance of payments deficits, to limit it in such a way so as to contribute to an improvement in the balance of payments.³¹

New Policies on Resources and New Efforts Regarding Restrictions To assist members with balance of payments difficulties, the Fund, in 1952, also introduced a new policy on use of its resources. Under the “tranche policy” introduced, the Fund’s resources were to be available to members in four equal tranches of 25 percent of quota. In addition, members had a “gold” tranche position to the extent that Fund holdings of their currency were less than the quota. Drawings in the gold tranche were to be automatic; drawings in the four credit tranches were to be conditional on a member’s economic policies intended to correct its balance of payments disequilibrium. The aim of the new policy was to ensure that resources would be made available to members undertaking practical programs of actions designed to achieve the purposes stated in the Fund’s Articles, especially the relaxation and removal of restrictions and the convertibility of currencies.³²

In addition, in the early 1950s the Fund took other steps to encourage members to relax restrictions and establish convertibility. In 1950 a new Exchange Restrictions Department, under the direction of Irving S. Friedman, was created that was charged with the responsibility of helping members meet their obligations under the Fund’s Articles of Agreement for relaxing restrictions and establishing convertibility of their currencies. In March 1950, as required by Article XIV of the Articles, the *First Annual Report on Exchange Restrictions* was published. To produce this report the Fund for the first time surveyed in detail the restrictions in force in all members still retaining the transitional provisions of Article XIV. Article XIV also required that beginning five years after the start of operations, the Fund hold annual consultations

³¹ The expressions of the Fund’s policies just described can be found, for example, in the International Monetary Fund (1950a, pp. 22–24), (1951a, p. 36), (1952a, pp. 2–7), (1952b, pp. 13 and 184), and (1953, pp. 35–37).

³² This policy is described in Horsefield (1969, Vol. I, pp. 321–26) and M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 401–10).

with each member still maintaining exchange restrictions. Those consultations were begun on March 1, 1952. Both in these reports and through these consultations, Fund officials undertook to encourage members to reduce their restrictions and to move closer to the Fund’s objectives. To this end, Fund officials offered members technical and financial assistance. Fund officials especially endeavored to ensure that improvements in members’ balance of payments positions were accompanied by an appropriate lessening of their restrictions on trade and payments, by reduced discrimination against their purchases from the United States and other members in the dollar area, and by adequate steps toward convertibility of their currencies.

Circumstances of Economic Development As the staff analyzed the implications of inflation, they inevitably examined the relation between inflation and the economic development of the developing members and the implications for their balance of payments. Like the analysis of the relation between inflation and balance of payments adjustment in industrial members, the analysis of inflation and economic development and external payments positions of developing members was based largely on the staff’s increasing involvement and experience with its members. By the early 1950s it was already clear that most developing members were placing major emphasis on the need for them to take special measures and even comprehensive plans to accelerate their economic development. These special measures and comprehensive plans customarily involved a considerable stepping up of government spending for investment, with either actual or potential inflationary consequences.

At the time two schools of thought existed about the best way to finance economic development domestically. On one side were those who held that if development was to be effected, investment had to be greatly accelerated, even if it meant inflation. In their view, a policy of monetary and financial stability was incompatible with development, and they were resigned to the idea that inflation and disequilibrium in the balance of payments were inevitable if there was to be any development at all. On the other side were those who favored what was being called balanced growth, in which an attempt was made to allocate resources in an optimal way among domestic investment and consumption and for export. In general, they concluded that a policy of financial stability was the best way to attain balanced growth. The Fund staff, examining the experience of its members, supported the latter view. The Fund’s experiences were revealing that economic development did not require inflationary means of financing and, indeed, that there were great social and economic costs to inflation, especially serious misallo-

cation of resources. Therefore, economic development with financial stability, although not easy, was not only possible but preferable.³³

That economies had to be stable, that is, without distortions caused by inflation, to foster balanced economic development became a prevalent view in the Fund. For example, in his opening address to the Board of Governors at the Tenth Annual Meeting in Istanbul in 1955, Ahmed Zaki Saad, Chairman, centering his remarks on economic development as “the universal need,” but especially in “underdeveloped countries,” pointed out that economic development required “financing, technical skills, and stable economies.” He noted that “the Fund’s chief intent has been to help members to achieve and maintain sound currencies, and to deal effectively with inflation, particularly under the stress of aggressive development programs.”³⁴

Progress by the Mid-1950s

By 1954 industrial production in most of the European members had attained levels about 50 percent above those of pre-World War II and the volume of world trade was about 65 percent larger than before the war. With the restoration of production and the moderation of investment, inflationary pressures had also been greatly reduced. A main factor in curbing inflation, however, had been a revival of monetary policy following the almost sole stress on fiscal policy in the 1930s. For the first time in years, the central banks of most industrial members were using changes in discount and rediscount rates, bank reserve requirements, and open market operations to control credit expansion by commercial banks. Interest rates, both short-term and long-term, moved up and down as central banks tightened or eased monetary policies.³⁵

Gradually, too, the persistent balance of payments difficulties of industrial members had been reduced. Some Western European members—notably Belgium, France, the Federal Republic of Germany, Italy, and the Netherlands—and Japan had even achieved payments surpluses. In fact, they were rapidly accumulating reserves. The Fund credited the improvement largely to sounder economic and financial policies. Mr. Rooth, for example, in his opening address to the Board of Governors in 1954, stated that stronger budgetary positions, stricter credit controls, and more suitable exchange rates had made it possible

for many members to restrain excessive demand and to place their economies on a competitive basis in world markets.³⁶ The Fund stressed that, in contrast to the members that had attained satisfactory balance of payments positions, most of the members with adverse payments positions were still suffering from internal inflationary pressures. The Fund pointed out, moreover, that internal disinflation did not cause members to suffer unduly. Since foreign markets were sufficiently buoyant to absorb easily any resources released by internal disinflation, conditions in general were favorable for the application of corrective internal measures. The Fund also continued to emphasize that members with balance of payments surpluses also had a responsibility: they should take steps to expand their domestic economic demand so as to increase their imports. This point was directed particularly to the United States, which had just gone through the recession of 1954–55.

In this way, by the mid-1950s the Fund had accumulated a decade of experience with balance of payments adjustment. It was now able to generalize about the factors most important in determining a member’s balance of payments position. Among industrial members, these were the rate of growth of productivity, the extent of wage adjustments, harvests, or other developments affecting import-competing or export industries, and above all, the intensity of internal demand pressures that affected both imports and exports. The Fund observed further that members had found that they could deal with their external payments deficits as ordinary economic problems that could be met through fiscal and credit policy.

Primary producing members were less inclined than industrial members to rely exclusively on disinflationary policies as a means of securing balance in their external accounts. They were more likely to make adjustments in their exchange rate structures or in their export or import taxes, sometimes supplemented by internal monetary or fiscal measures. Many primary producing members, especially in Latin America, suffered from chronic inflation that led to overvalued currencies and increasingly severe import restrictions.

In working with developing members, the Fund staff emphasized the need for realistic exchange rates. They stressed to the authorities the importance of better linkage of the developing member’s economy to the outside world. Containing domestic inflation was not sufficient. Members also had to correct the overvaluation of their currencies that had resulted from their inflation. Fund staff emphasized that exchange rates did make a profound difference in encouraging exports, reducing excessive imports, and in encouraging inward flows of capital and

³³ See, for example, Bernstein and Patel (1952), Pazos (1953), and International Monetary Fund (1954a, pp. 313–86).

³⁴ International Monetary Fund (1955b, pp. 4–7).

³⁵ See, for instance, International Monetary Fund (1954a, pp. 63–69) and (1955a, pp. 63–69).

³⁶ International Monetary Fund (1954c, p. 12).

discouraging capital flight. They also urged developing members to eliminate, or at least to reduce, their multiple exchange rates. Getting rid of multiple rates usually involved depreciating toward a more realistic exchange rate, which was expected to help foster trade.

Here again, as for industrial members, Fund officials were aiming to promote trade as the main engine of growth. Using the example of the European countries, allied in the Organization for European Economic Cooperation (OEEC)—later the Organization for Economic Development (OECD)—some Fund staff even began thinking of a similar arrangement among the Latin American countries. An integrated market might induce the same prosperity in Latin America as was occurring in Europe. By the mid-1950s some Latin American members—for instance, Argentina, Bolivia, Chile, and Paraguay—were attempting to escape from the vicious circle of inflation and exchange depreciation by eliminating their multiple exchange rates and introducing a much more depreciated single fluctuating exchange rate.³⁷ Although Fund officials recognized that cyclical swings in aggregate demand in industrial members had especially significant effects on the balance of payments of members exporting raw materials, they believed that the real threat to the balance of payments positions of most developing members did not arise from this source. For example, in his opening address at the Eleventh Annual Meeting, in September 1956, Mr. Rooth stated that “it [the balance of payments threat to members exporting raw materials] arises rather from tendencies toward a persistent price and cost inflation which originate in excessive public and private expenditure for consumption and investment, and in an increase in money incomes that exceeds the increase in productivity.”³⁸

Review of a Decade of Experience After the Fund's first ten years, Mr. Bernstein, convinced of the uniqueness of the Fund's experience, formed generalizations on the means by which balance of payments deficits could be remedied.³⁹ While he identified three types of balance of payments problems—those due to current inflation (manifested by excessive spending), those due to price and cost disparity (reflected in inflated home prices and costs), and those due to structural changes in the economy (which resulted from a deterioration in the real international economic position of a country)—he stressed that in most cases

³⁷ By June 1957 this trend had become sufficiently pronounced that the Fund considered the time right for an intensification of its efforts to eliminate multiple exchange rates and introduced a new policy to foster their simplification. See M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 141–43).

³⁸ International Monetary Fund (1956, p. 17).

³⁹ See Bernstein (1956).

payments deficits were attributable partly to each of these causes. Consequently, determining the cause of the balance of payments problem was complex in itself, and it was essential to analyze the payments problem in terms of the economy as a whole.

Before describing the remedies, Mr. Bernstein emphasized the need for balance of payments adjustment: there was a real cost to a country trying to support an untenable payments position. A deficit meant the selling of reserves at an inappropriate exchange rate and the provision of the economy's resources for private use at less than their real value. Serious economic distortions also resulted from the support of an inappropriate exchange rate.

The remedies for balance of payments deficits, of course, depended on the cause. If the cause was inflation, it could not be corrected only by exchange devaluation; emphasis had to be on internal anti-inflationary measures. On the other hand, if the cause was price-cost disparity, the deficit could not be corrected primarily by internal deflation; exchange devaluation was essential. If the cause was a change in the reciprocal supply and demand for exports and imports, part of the remedy would have to include a shift of productive resources from some industries to others, and it might well be necessary to have both internal deflation and exchange devaluation. In essence, Mr. Bernstein's analyses summed up the Fund's experience in the ten years from 1946 to 1955: in any serious balance of payments problem, there would have to be an exchange devaluation, but at the same time, devaluation could have an effect on prices that would have to be taken care of through anti-inflationary measures. In other words, the Fund had discovered that both devaluation and anti-inflationary measures were usually necessary.

In brief, by the mid-1950s, the Fund saw as the great challenge the reconciliation of full employment and of economic development with monetary stability. The answer to the question facing economists and policymakers when the Fund was established a decade earlier—how to reconcile internal equilibrium and external equilibrium—seemed to lie in monetary and price stability. The rediscovery of monetary policy as an indispensable tool of economic policy was commonly viewed as a notable feature of economic developments after World War II.

By the mid-1950s the Fund was starting to make progress also in developing a policy with regard to use of its resources and their relation to balance of payments adjustment. The stand-by arrangement and an accompanying stabilization program had been introduced and were being used for the first time.

Beginnings of the Monetary Approach

Like the absorption approach, the monetary approach to balance of payments adjustment as used in the Fund came about partly as the

Fund staff sought pragmatic solutions to actual situations that they encountered in dealing with a member. An early such case, if not the first, was that of Mexico in 1955. Following three devaluations of the Mexican peso from June 1948 to April 1954, the Mexican authorities, with the help of a six-month stand-by arrangement with the Fund, were trying hard to hold the latest exchange rate of 12.50 pesos per U.S. dollar.⁴⁰ In early 1955, at the request of the Mexican authorities, the Fund sent a mission to Mexico, headed by J.J. Polak, who had a founding role in the monetary approach, as well as in the absorption approach.

The staff concluded that if the new exchange rate was to hold, the rate of increases in prices had to be much less than in 1954. It clearly followed that Mexico's financial, price, and wage policies urgently needed to be oriented toward the attainment of price stability. The staff also concluded that monetary policy should be the principal instrument for limiting the increase of prices. Direct price controls had not been effective in Mexico and nothing would be gained—indeed dangerous illusions might be created—by measures that helped to keep down the price index without having much effect on the actual price level. Nor should the desire to keep the price level low lead the government to continue uneconomically low pricing policies of the state enterprises.

The staff thereupon produced suggested figures for how much the wholesale price index could rise—about 15 to 20 percent over the December 1954 figure over the next few years—and developed calculations with respect to the permissible increase in the money supply. It seemed highly unlikely that the annual rate of expansion of money supply could significantly exceed 5½ percent without pushing up prices. Since at the end of December 1954 the money supply was 8.8 billion pesos, the maximum increase in the money supply consistent with price stability over the next four years would, according to staff estimates, thus be on the order of 450 million pesos a year. The staff, nevertheless, emphasized that monetary policy could not be laid down so precisely that these figures could be taken as exact targets. They stressed also that these figures would certainly require some modification as actual events differed from the assumed trends. The staff also pointed out that the ultimate test for a variation in the overall target for monetary policy had to be the development of the balance of payments. If there should be definite evidence that the country was running a larger payments surplus than the authorities wished, the overall credit policy might be somewhat relaxed. Equally, if the balance of payments developed unsatisfactorily, internal credit expansion should be reduced.

⁴⁰ This stand-by arrangement and devaluation are briefly described in Horsefield (1969, Vol. I, pp. 375–76 and 379–80).

Development of a General Monetary Approach After the experience with Mexico, the staff increased use of techniques relying on monetary variables. Thus, in discussing with the authorities of other members requesting financial assistance from the Fund the adequacy of the stabilization programs they proposed, the staff, particularly of the Western Hemisphere Department, in discussions with the authorities of Bolivia, Chile, Colombia, Guatemala, Paraguay, and Peru, began in the mid- and late 1950s to make increasing use of quantitative ceilings on the volume of credit and on the commitment levels for ordinary and for development budget expenditures.

The analytical basis for the Fund staff's use of monetary variables reflected an analysis called the monetary approach that was already in use in the Netherlands.⁴¹ It had been introduced into the Fund by Robert Triffin, who was then on the Fund staff.⁴² The Fund staff's monetary approach to balance of payments adjustment rested on Professor Triffin's analysis in terms of money of external origin. This approach involved the estimation of the prospective demand for money on the basis of forecasts of real gross domestic product (GDP), an assumption about future price inflation, and any other relevant information. The staff believed that by controlling domestic credit creation during the period of a stand-by arrangement so as to equal the estimated change in the demand for money, the authorities could keep the external accounts in balance and the change in international reserves to zero. If an external surplus was to be achieved, perhaps to permit repayment of indebtedness, domestic credit creation would to that extent have to be kept below the forecast change in the demand for money, and if a deficit could be temporarily tolerated, domestic credit creation could be allowed to exceed the anticipated change in the demand for money.

The effect of an economic change, such as a rise in the rate of inflation or a change in the exchange rate, on the overall balance of payments is analyzed through the money account rather than through the several balance of payments accounts recording the transactions of goods, services, and capital items. The change in the money account—in most instances simply the change in international gross reserves—is directly

⁴¹ See Holtrop (1957).

⁴² See, for example, Triffin (1946). Edward M. Bernstein also advanced ideas in the late 1940s concerning the relation between a country's credit expansion and money supply and its balance of payments position. He pointed out, for example, that the expansion of money supplies in most countries during World War II would later cause a rise in their domestic prices and costs and hence aggravate their balance of payments deficits. See Bernstein (1950). In the mid-1950s he also observed that differing degrees of credit expansion in various countries had differing effects on their balance of payments position. See Bernstein (1956).

linked to monetary balance in the national economy by the condition that the change in external reserves must equal the difference between the change in the demand for money and the change in the supply of money of domestic origin.

In developing both the analytical framework and quantitative procedures for the monetary approach to balance of payments adjustment, several members of the Fund staff did considerable innovative work.⁴³ Thus, beginning in the late 1950s, the Fund staff started gradually to develop a financial programming approach to evaluating a stabilization program that a member presented to the Fund in support of its request for use of the Fund's resources. This approach emphasized monetary relationships mainly because money and monetary policy play an important role in a member's balance of payments developments and because data on monetary variables are relatively more accurate and timely than data on real variables.⁴⁴ This financial programming methodology did not imply, however, a monetarist view of economic developments in a member, that is, belief in a strong, or even sole, causal connection between monetary targets and the achievement of balance of payments goals. The absorption approach continued to be reflected in the Fund's emphasis on a member's reducing fiscal imbalance so as to help correct external payments disequilibria and the elasticities approach continued to be reflected in the Fund's emphasis on a member's changing its exchange rate so as to remain price competitive in world markets.⁴⁵

External Convertibility Is Achieved

By the end of 1958 the Western European members had achieved sufficiently strong balance of payments and reserve positions that on

⁴³ An innovative quantitative procedure often noted is that of a small model constructed by J.J. Polak in 1957. See Polak (1957). Later on, from 1960 to 1973, new staff studies developed several analytical refinements to the monetary approach, applied it to a wide variety of members, including industrial members, and incorporated capital markets into the model. The staff papers developing this approach have been published as *International Monetary Fund* (1977b).

⁴⁴ Details of the financial programming methods developed in the Fund and their evolution through the end of 1971 can be found in M.G. de Vries (1976, Vol. I, pp. 363–68).

⁴⁵ With the growing ascendancy of monetarist doctrines in the late 1960s and early 1970s, the monetary approach to balance of payments became increasingly popular among university economists. Its supporters argued that the balance of payments is essentially a monetary phenomenon. See, for example, Frenkel and Johnson (1976).

An explanation of how balance of payments adjustment was supposed to work, combining the Keynesian income effects, the monetary approach, the substitution effects between traded and nontraded goods, and the equilibrating effects of short-term capital movements can be found in Flanders (1986).

December 29, 14 of them—Austria, Belgium, Denmark, Finland, France, the Federal Republic of Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Sweden, and the United Kingdom—made their currencies externally convertible for current transactions; that is, nonresidents would now be freely permitted to exchange their earnings of these currencies from current transactions into any other convertible currency at exchange rates within the official margins. Greece took the same step five months later. Fifteen other members, most of whom associated in a monetary area with one or another of these Western European members, adjusted their exchange control regulations to the new conditions, thereby effectively extending external convertibility; these were Australia, Burma, Ceylon (Sri Lanka), Ghana, India, Iraq, Jordan, Libya, Malaya (Malaysia and Singapore), Morocco, New Zealand, Pakistan, the Sudan, Tunisia, and South Africa. The Fund regarded the introduction of external convertibility as the most signal achievement of the period after World War II in the field of exchange restrictions and as an indication that flexible fiscal and credit policies were in effect the clue to successful balance of payments adjustment.⁴⁶

In February 1961, nine European members—Belgium, France, the Federal Republic of Germany, Ireland, Italy, Luxembourg, the Netherlands, Sweden, and the United Kingdom—and Peru accepted the obligations of Article VIII of the Articles of Agreement.⁴⁷ In March 1961 Saudi Arabia also did so. This move resulted in all the major currencies that had been considered inconvertible becoming legally convertible in the Fund sense. By this time, these members had eliminated all, or nearly all, restrictions on current payments or transfers, although most of them still restricted the making of some payments for capital transactions at official rates of exchange.⁴⁸

By 1961, moreover, many other members had established external convertibility. The Exchange Restrictions Report for 1961 reported that two thirds of the Fund's members permitted nonresidents to transfer freely to other nonresidents the local currency they acquired from current transactions.⁴⁹ The authorities of most of these members believed the balance of payments prospects or remaining restrictions, or both, made it advisable to await further developments before these members

⁴⁶ M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 277–79).

⁴⁷ Article VIII requires, among other things, that a member obtain the Fund's explicit approval for any restrictions it maintains or imposes on the making of payments and transfers for current international transactions.

⁴⁸ Details on the move of several members from the transitional arrangements of Article XIV to the full obligations of Article VIII can be found in M.G. de Vries, Horsefield, and others (1969, Vol. II, pp. 283–91).

⁴⁹ *International Monetary Fund* (1961b, pp. 4–5).

assumed formal Article VIII status. Nevertheless, by 1961 virtually every currency used in financing international trade was convertible in the sense of the Articles of Agreement. Thus, while important obstacles to international trade persisted, relatively few impediments remained to conducting that trade on the basis of a multilateral payments system.

The first period of payments adjustment after World War II had ended. The Fund now turned to examining this experience in detail, to comparing actual experience with the theories prevailing when the Fund had been planned twenty years earlier, and to understanding the circumstances that had made balance of payments adjustment, especially by the industrial members, so successful.

Experience by the Early 1960s: Industrial Members

By the early 1960s the Fund had accumulated considerable experience with members' balance of payments problems and their solution. Since 1946 it had been dealing with a variety of arrangements for exchange rates and many forms of exchange restrictions. Since 1952 it had been holding in-depth annual consultations with all members still retaining the transitional arrangements provided by Article XIV of the Articles of Agreement, and it was starting to hold annual consultations also with members who had assumed the obligations of Article VIII. Since 1956, members had been making frequent use of the Fund's resources, giving the Executive Directors and the Fund management and staff intimate experience with members' balance of payments difficulties and the effectiveness of corrective policies. Several large industrial members, including France, Japan, and the United Kingdom, as well as developing members in all geographic regions, had come to the Fund for financial assistance.

The early 1960s was an appropriate time for Fund officials to evaluate this experience. Economic conditions in most members were changing, and new problems emerging were aggravating balance of payments adjustment. Hence, it was essential that Fund officials understand more precisely how balance of payments adjustment had worked thus far, how the adjustment process compared with that expected when the Fund was created, and how particular policies and circumstances had facilitated balance of payments adjustment.

Adjustment Had Not Worked As Expected

The unusual worldwide balance of payments disequilibria, especially among the major industrial members, that had prevailed in 1945 had