March 8, 1960

To: Members of the Executive Board

From: The Secretary

Attached for your information is a copy of a paper "The Role of the International Monetary Fund in Connection with Development," which the Managing Director will circulate when he attends a meeting of the Development Assistance Group. The Group is meeting in Washington this week to consider a multilateral approach to economic assistance to the underdeveloped countries.

Att:(1)

The Role of the International Monetary Fund in Connection with Development

The purposes of the International Monetary Fund are set out in Article I of its Articles of Agreement. In connection with development, Article I has this to say:

> "To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy."

The manner in which the Fund contributes to the economic development of the less developed countries is not by making development capital available. Under the established principles of the Fund, its resources are available for from three to five years to assist countries in temporary balance of payments difficulties, with the primary objective of gaining time for the countries concerned to take effective corrective measures. The Fund's contribution to development is, therefore, an indirect one; it is however no less important for that reason.

1. Monetary Stability and Resources for Development

The Fund has now had nearly fifteen years of experience in working closely with its member countries on their monetary problems. By far the larger part of its consultative work has been with the less developed countries. From this extensive experience one conclusion is becoming increasingly more evident, both to the countries concerned and to the Fund. That conclusion is that monetary stability is an essential condition, and indeed the only reliable basis, for sustained growth. Monetary stability increases the resources that can be made available for development in two ways: in the first place, it increases the long-term flow of genuine domestic savings. In the second place, it stimulates the inflow of capital from abroad as countries, by demonstrating their ability to run their domestic financial affairs competently, appear more creditworthy to foreign sources of capital.

At least as important is the fact that monetary stability creates a climate for the proper allocation of resources saved in the economy or contributed by foreign capital. In the absence of monetary stability, i.e., in conditions of inflation, investment tends to be directed towards objects that are considered the best short-run hedges against inflation, rather than towards those that will make the greatest contribution to the economy in the long run. Stability is necessary to translate the available savings into the kinds of investment that will contribute to the balanced development of the economy. As far as aid from abroad is concerned, it is therefore equally in the interest of the countries receiving the aid and those that provide it that monetary stability should be attained and preserved.

Given the scarcity of development capital in less developed countries, there is always a tendency to look to the banks--both the central bank and the commercial banks--as a convenient additional source of capital. But it is obviously absurd to believe that the banking system can create out of nothing the real resources needed for development. All that the banking system can itself do is to create money, not goods. Within the framework of monetary stability, the banking system can increase its total assets only slowly as the needs for currency and deposits rise with the growth of the economy. These annual increases in the resources of the banking system are, broadly speaking, needed to provide the requirements for circulating capital--such as inventories and work in progress--and to increase gradually the country's foreign exchange reserves. The banking system will thus normally not have any significant resources available to sink into development projects.

If the banking system creates more money than is needed by the growth of the economy at stable prices, the first result will be a reduction in the country's foreign exchange reserves. The reduction in these reserves that most countries can stand is very limited, so that no continuing contribution to development can be achieved in this way. Excessive credit creation beyond this point will lead to price increases and the depreciation of the currency. In some of the more developed countries, inflation has been known to make resources available for investment through what is called "forced savings." This was brought about as rising prices reduced the purchasing power of wage earners and the middle class. Even in developed countries, this process would, however, soon get out of hand and cease to have any usefulness as workers began to insist on quick adjustment of their wages to the rising prices, and people generally reduced to a minimum the proportion of their assets kept in the form of ready money. In the less developed countries, where there are no large groups of people with fixed incomes, no lasting contribution to investment can be achieved by means of inflation, even if a country were willing to tread this path.

The fact that an increasing number of countries have over the last few years sought the Fund's assistance in working out stabilization programs testifies to the widespread conviction that inflation, resulting in monetary instability, is a policy that on balance clearly has an unfavorable effect on development. By the determined implementation of these stabilization plans the countries concerned are providing the sound basis for an effective development program.

2. The Fund's Role in Connection with Temporary Balance of Payments Difficulties

While underdeveloped countries seek to devote a good deal of their resources and attention to the problems of long-run economic development, they are at the same time subject to many temporary difficulties which often tend to work themselves out as balance of payments problems. Sudden fluctuations in the volume of production of their main crops or fluctuations in the world market prices for their main exports, as well as irregularities in the rate of supply of capital from abroad or in the rate of expenditure of all kinds--especially on development projects: all these and other factors will at times produce pressures on the balance of payments.

If these pressures are not handled properly, the country will not only experience a serious loss of reserves but may also have to impose import or exchange restrictions; its hard-won monetary stability may be jeopardized, with a consequent setback to development. In a situation of this sort, the Fund has a double role to play. It will consult with the member on the financial and other policies that may be needed to see the country through its temporary difficulties; and it stands ready to make its resources available to the country while the corrective measures take effect, in order to soften the impact of the unfavorable developments. In doing so the Fund acts in accordance with the provisions in its Articles which states as one of the purposes of the Fund:

> "To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

The principles governing the use of the Fund's resources are now well established. Because the Fund's policy toward requests for drawings must be applicable to large and small countries alike, it is expressed in terms not of the absolute amount involved, but of the proportion which this amount bears to the country's quota. Countries are given the overwhelming benefit of the doubt with respect to requests for drawings within the "gold tranche," i.e., the portion of quota which can be regarded as equivalent to the member's gold subscription. The Fund's attitude to requests for drawings within the first credit tranche (equal to the first 25 per cent of the quota above the "gold tranche") is a liberal one, provided that a member wishing to make such a drawing is itself making reasonable efforts to solve its problems. Members' requests for drawings or stand-by arrangements beyond the first credit tranche are likely to be favorably received when they are intended to support well-balanced and adequate programs which are aimed at establishing or maintaining the enduring stability of the currencies concerned at realistic rates of exchange. By the close link that the application of these principles and practices establishes between the Fund's financial assistance and the maintenance or adoption of the necessary remedial measures in the countries concerned, the Fund supports the observance of that degree of financial self-discipline without which the international monetary system cannot function properly.

The Fund's resources made available in such a situation are repayable over a period not longer than three to five years. Seen in the long run, therefore, the Fund's contribution does not consist in making available a net supply of capital, but in helping the country through a particularly difficult phase of its development, thus safeguarding the progress already made and establishing the basis for further future development.

3. Conclusion

In connection with the efforts that are being made to increase the flow of development capital from the main creditor countries to the less developed areas, it follows that the activities of the Fund are useful in particular in two respects:

(a) By the regular contact of the Fund with its members--through consultations and in other ways--the chances are increased that development plans and policies will be worked out within the framework of financial stability, and thus under noninflationary conditions.

(b) Access to the Fund's resources, under the principles and policies worked out for their use, is likely to increase the chances that temporary difficulties encountered in the course of development can be surmounted without harm to the economic structure of the country itself or its trading partners.

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