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Bretton Woods Legislation in Latin American Countries

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Many Latin American countries are, at the moment, preparing enabling legislation for adherence to the Bretton Woods convention and acquisition of membership in the International Monetary Fund and in the International Bank for Reconstruction and Development. It is vitally important that this legislation should be so drafted as to integrate and coordinate relations between the member and these agencies with the member's general economic and financial policies. Only through such integration will member countries reap the full benefits of membership and ensure the smooth and successful functioning of the new institutions. This paper will discuss the main points which national enabling acts might conveniently cover in order to attain those objectives.

(1) Ratification - According to the agreements, a country must accept membership on or before December 31, 1945, if it is to become a charter member. It should be noted that, upon subscribing to the agreements in Washington, a country must be in a position to show that it has taken all necessary steps to implement its membership obligations.

(2) Appointments - It would be convenient to appoint the same person as Governor of Fund and Bank. Since the position is an important one and at the same time one requiring a high degree of technical qualification, the choice might fall upon the President or Manager of the Central Bank. Their appointment would not interfere with their regular duties, since the Board of Governors would meet only at infrequent intervals. These meetings would give the appointees a valuable opportunity for an exchange of views with the top financial men of other countries.

The law itself, however, should better be kept flexible on this point and merely provide that the appointment be made at the recommendation of the Monetary Board or Advisory Council dealt with in the following paragraph.

(3) Policy Decisions - While the Governor should have authority to act on all routine matters, important policy decisions must be reserved to a higher authority. Since all operations with the Fund or Bank are likely to be conducted through the country's central bank and since they involve primarily exchange operations of fundamental significance in the monetary field, it would be logical to confer the policy-making powers on the Board of Directors of the central bank. This solution is especially indicated in countries in which monetary and central banking legislation of the type developed by Dr. Triffin has made such Board -- under the name of Monetary Board -- into a coherent and powerful instrument of national monetary policies. In some countries, where tradition or legislation gives a less prominent role to central bank action, a special

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Advisory Council might be created, in which the central bank should share influence with other economic and financial agencies of the government.

In either case, the Monetary Board or Advisory Council should formulate the country's policy with respect to the Fund and Bank, be in charge of relations with the two agencies, and guide the actions of the Governor. In situations where the Bretton Woods Agreements provide for action by a member, the council should have sole authority to take such action in so far as the national constitution does not reserve the decision to the legislature. A list of the cases in which the agreements specify action by a member is appended.

(4) Financing and Operations - The financing of the contributions and the handling of the operations with both Fund and Bank can be carried out either by the central bank or by the government directly, through the treasury or another agency. For a variety of reasons it would probably be preferable, for most countries, to act through their central banks.

(A) With regard to financing of and operations with the Fund the central bank seems to be the more desirable medium because:

(i) the central bank is the institution responsible for the custody and management of monetary reserves and for the stabilization of the external value of the currency; operations with the Fund are basically similar to those, both as to their nature and purpose;

(ii) the central bank is also the institution responsible for regulating general monetary and credit conditions, and especially the volume of means of payment; operations with the Fund will have, initially, the same effect on monetary circulation as an inflow or outflow of monetary reserves; if such operations were to escape the control of the central bank, there would result a very undesirable division of monetary responsibility, especially as the conversion of the Fund's currency holdings into demand notes might be used as a means of internal inflationary financing.

Operation through the central bank does not mean that activation of the contribution, i.e., its use to pay the member's exporters, would necessarily lead to an increase in the money supply. When this moment comes, the central bank could offset the monetary expansion resulting from the payment to local exporters by means of open market operations, including sale of participation certificates in the contribution it has made to the Fund. The decision whether to monetize part or all of an active balance paid to the member through the Fund, should be left to be decided according to the needs of the moment.

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(B) Financing of and operations with the International Bank likewise could most conveniently be handled through the central bank, although, in this case, exclusively for Government account. This would include the guarantee to be given in case the International Bank facilitates a loan to a non-governmental borrower in the member country.

The main reason for central bank handling of such operations lies again in their direct relation to the balance of payments and to monetary reserves and to their impact upon the domestic money and credit market. On the other hand, while borrowings from the Fund are essentially of a short-term nature and very similar to an inflow of general monetary reserves, borrowings from the Bank are likely to be long-term and to be directed toward specific ends of a non-monetary character. Similar considerations would apply in the case of lending operations. For these reasons, the central bank should not bear the ultimate responsibility for operations so distinct from its natural sphere of action and of which it is not the ultimate beneficiary.

In conclusion, it would be desirable (1) to let the central bank make the contribution to the International Bank, but for account of the government, (2) authorize the Monetary Board or Advisory Council to make special arrangements with the government for speedy amortization by the latter of any portion of the contribution effected by the central bank for its account and actually used in the International Bank's lending operations, and (3) to make good to the central bank, through delivery of amortizable government bonds, any loss that it might incur as the result of guarantees or payments on contribution.

(5) Balance Sheet and Reserve Position - The form in which the Fund contribution and subsequent operations with the Fund are integrated with the central bank's balance sheet and with the calculation of its legal reserves will be a matter of some importance, because of the resulting effect upon central bank reserve ratios and because the handling of this question will, in a sense, express the monetary authorities' basic philosophy of their relations with the Fund.

Two alternative methods may be mentioned here:

(A) Alternative No. 1: On the balance sheet of the central bank, show as an asset, unchanging in amount, the full contribution to the Fund (both in gold and in currency), and as a liability the total current holdings of the country's currency (whether in the form of deposit or of demand notes) by the Fund.

In the calculation of net international reserves, add to gold and foreign exchange assets an unchanging amount, made of:

(1) 100% of the gold contribution to the Fund;
(2) 50% of the currency contribution.

On the other hand, deduct as a liability 50% of the total current holdings of the country's currency by the Fund.

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This procedure will achieve, in a very simple manner, the two following objectives:

(1) Adherence to the Fund will leave net reserves unchanged, since the loss of gold experienced as a consequence of the contribution to the Fund will be made up by the addition of this gold contribution to reserves, and since the currency contribution leads to identical increases in both assets and liabilities.

(2) Later borrowings from the Fund will decrease net reserves by an amount equal to 50% of the borrowings, and any extension of credit through the Fund will increase net reserves by an amount equal to 50% of the credit extended.

The logic of this recommendation is based on the following reasoning. While adherence to the Fund lowers slightly the country's gold reserves, the advantages of membership -- and especially the prospective borrowing right of the member -- more than makes up for the lowering of reserves. On the other hand, it would be improper to consider that net reserves are increased, since any borrowings will be, in a sense, offset by the obligation incurred abroad and since the borrowing right of a member is far from unconditional. Thus, it is recommended that net reserves be so calculated as to be left unchanged by adherence to the Fund.

Secondly, the fluctuations of net reserves should be such as to show a strengthening of the country's international position when it accumulates credits against the Fund, and to show a weakening of that position when the country builds up its indebtedness towards the Fund. On the other hand, the purpose of the Fund would be defeated if borrowings were to be completely assimilated to a loss of reserves. Under the procedure recommended, borrowings from the Fund would lower net reserves by an amount equal to 50% of the borrowing. Similarly, credits extended to the Fund would increase net reserves by an amount equal to 50% of such credits. This result is obtained very simply by deducting 50% of the Fund's current holdings of the country's currency from gross reserves, the original 50% deduction resulting from mere adherence to the Fund being offset by a permanent and corresponding addition to international reserve assets (see examples in Appendix II).

The procedure recommended will tend to moderate fluctuations in net reserves and thus restrain somewhat the expansionary psychology which would result if a creditor position in the Fund were treated as fully equivalent to gold and exchange reserves and, on the other hand, will mitigate the deflationary psychology which would result if a passive balance of payments were met out of gold and exchange resources rather than by drawing upon the Fund. This stabilizing influence of the method appears desirable both from the point of view of the Fund and from the point of view of national monetary policy.

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The 50% effect on net reserves, allowed above to transactions with the Fund, is, of course, arbitrary. This percentage might be raised or lowered uniformly depending on whether a country wishes to assimilate more fully operations with the Fund to changes in reserves or to neutralize them to a larger extent than is here recommended.

(B) Alternative No. 2: The case for alternative No. 1 is especially strong in countries which calculate their reserve ratio in the manner recommended by Dr. Triffin.[1] In other countries, borrowed funds are usually fully assimilated to owned reserves, with no deduction except for sight or short-term obligations to foreign correspondents. If it be desired to handle operations with the Fund in the same manner, and to give to reserve calculation a more definite expansionary bias, a second alternative might be followed. A creditor position in the Fund might be assimilated fully to gold or sight deposits abroad, while a debtor position would be treated as a medium- or long-term obligation and would not require any deduction from reserves. Thus, any extension of credit to the Fund would increase net reserves by the full amount of the credit granted, while borrowings from the Fund would leave reserves unchanged, except for the exception now to be mentioned. In accordance with Article V, section 7, and Schedule B of the Fund Agreement, each country is obliged, when certain conditions are realized, to repurchase from the Fund at the end of each financial year a certain portion of the Fund's holdings of its currency. Such repurchase obligations, calculated as of the end of each month, should clearly be deducted in full (or at least to the extent of 75%) from legal reserves at the end of each month, in preparation for the lump payment to be made to the Fund at the end of the current year (see examples in Appendix II).

The asymmetrical treatment of credits and debits toward the Fund imparts to alternative No. 2 a stronger expansionary impact on net reserves than would be allowed under alternative No. 1. On the other hand, it takes into account the difference between indebtedness subject to the repurchase obligation and indebtedness of more indefinite maturity. While clearly illogical for central banks which already deduct from their legal reserves all or part of their indebtedness abroad, it may be adopted by countries in which such deductions are not customary and in which the central bank deems it desirable to emphasize further expansionary significance of operations with the Fund and to avoid, as far as possible, any contractionary impact on net reserves.

In any case, it is important to note that the choice between the two methods is of rather secondary importance. The differences

1/ A certain percentage of the central bank's indebtedness abroad, varying with the maturity of the obligation, is deducted from gross gold and foreign exchange holdings in order to arrive at net reserves. The reserve ratio is then calculated by dividing net reserves by average annual payments abroad -- or total sales of exchange -- rather than by sight obligations of the central bank. See Ley Orgánica del Banco del Paraguay y Ley de Bancos, Asunción, Paraguay, 1944, pp. 38-40 and 44-45.

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between the two procedures are confined to the calculation of net reserves and thus to any psychological influences that they may have on the attitude of the public and on central bank policy. An active balance of payments -- whether it takes the form of gold or foreign exchange inflow, or of credits against the Fund -- tends to expand the domestic volume of money and commercial bank reserves. A passive balance of payments -- whether financed by loss of reserves or by borrowings from the Fund -- has the opposite effect. Far more important than fluctuations in an arbitrarily defined legal reserve ratio will be the central bank's attitude toward this internal impact of balance of payments fluctuations and its decision to accept it passively, reinforce it or neutralize it through domestic monetary and credit policies. Such decision should vary with the nature of the fluctuations and the central bank's estimate as to their probable duration and as to their fundamental or non-fundamental character.

The contribution to be made to the International Bank, if it is made by the central bank, can in no case enter into the central bank's reserves, since membership in the Bank does not give any individual country any clear-out presumption that it will be able to borrow a specified amount of foreign exchange resources from the Bank. Since the gold contribution to the Bank is no more than 2% of the quota, however, the weakening of the central bank's reserve position is insignificant. The central bank should be appointed as the sole depository of the Fund and the Bank for the respective country.

(6) Corrective Measures and Safeguards - To insure smooth collaboration with the Fund, and to avoid indebtedness to the Fund for excessive periods, the Board of Directors of the central Bank or the Advisory Council, as the case may be, might be required to consult with the Fund whenever legal reserves fell below a certain critical level, or, if alternative No. 2 has been adopted, when the country had remained substantially in debt to the Fund for more than two years at a time. Following these discussions, the Board or the Council should be required to suggest to the government such measures as would, in the Fund's and its own opinion, be suitable to restore equilibrium in the balance of payments and, after a period of time which Fund and Council regard as reasonable, bring the country's situation in the Fund back to normal.

The Board or Council should watch over the fulfillment by the country of its obligations toward Bank and Fund. To this purpose the Council should take all measures within its powers and, where these powers are insufficient, should call the attention of the government to the needs of the situation, in which case the government should be obligated to take appropriate action.

(7) Information - Since Fund and Bank may, from time to time, require from a member certain special information essential to their effective operation, it seems appropriate that the respective national

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agencies and individuals in possession of this information be required to supply it, provided that individual affairs are not disclosed thereby.

(8) Status, Immunities and Privileges - The immunities and privileges listed in Article IX, Sections 2 to 9 inclusive, and in the first sentence of Article VIII, Section 2b of the Fund Agreement, and the immunities and privileges listed in Article VI, Section 5i, and Article VII, Sections 2 to 9 inclusive, of the Bank Agreement, should be given full legal force and effect throughout the country. It is of particular importance that the International Bank be given adequate protection, since without this, securities arising out of the Bank's loans to the country concerned will not enjoy the full confidence of private investors.

(9) Use of Stabilization Loans - It might be specifically mentioned that the local currency equivalent of exchange bought from the Fund and of stabilization loans granted by the Bank shall under no circumstances be employed for internal budgetary or similar expenditures without the expressed authorization of these agencies. This injunction is plainly inherent in the Bretton Woods Agreements themsleves but does not seem to be universally appreciated. When the central bank sells to local importers exchange acquired from the Fund, the local currency it receives in return is automatically withdrawn from circulation. But if the treasury handles the operations and pays the Fund with demand notes, it will then have on its hands the local currency received from exchange sales to importers. This currency should in no case be employed for budgetary expenditures, but held for redemption of the demand notes.

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APPENDIX I

Action by Member Countries

The Bretton Woods Agreements specify action by member countries in the following cases:

A. Instances in which a member country may take the initiative:

(1) Propose a modification in the par value of its currency. (Fund IV, 5).

(2) Propose the imposition of exchange control and obtain the approval of the Fund. (Fund VIII, 2).

(3) Propose an adjustment in its quota in the Fund, (Fund III, 2) or its subscription to the Bank, (Bank II, 3).

(4) Propose amendments to the Fund and Bank Agreements and submit differences of interpretation to the Board of Governors of the respective agencies. (Fund XVII, XVIII; Bank VIII, IX).

(5) Decide upon the withdrawal of the country from the Fund, (Fund XV, 1) or Bank, (Bank VI, 1).

(6) Request of the Bank a modification of the conditions governing the payment of loans granted by the Bank to the country. (Bank IV, 4, c).

(7) Make reply to reports which the Fund may issue stating that the country is using the resources of the Fund contrary to the latter's purposes, as well as to any other communication or statement of views which the Fund may make; and to name a representative for the discussions preceding the publication of such reports. (Fund V, 5; XII, 8).

(8) Name a representative to participate in the preparation of a report to explain the causes of an imminent general shortage of its currency and to make recommendations to remedy this shortage, (Fund VII, 1).

B. Cases requiring the approval, agreement or consent of the member for certain decisions by the Fund or the Bank:

(1) Modifications in the quota of the country in the Fund. (Fund III, 2).

(2) Loans to the Fund in local currency by the country or by third parties. (Fund VII, 2).

(3) The supply of additional information to the Fund. (Fund VIII, 5, c).

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(4) With regard to direct loans granted by the Bank out of its own resources:

(a) approve the use for loan purposes of the 18% quota subscribed in local currency or its conversion into other currencies for purchases outside the country, (Bank IV, 2, a),

(b) permit the payment of interest and amortization on loans granted under (a) to be made in other currencies, (Bank IV, 4, b, i),

(c) permit the use or conversion of amortization receipts by the Bank, (Bank IV, 2, b).

(5) With regard to other direct loans granted by the Bank out of borrowed funds:

(a) permit the Bank to borrow funds in the country,

(b) permit the Bank to make loans denominated in its local currency. (Bank IV, 1, b).

(6) With regard to guarantees given by the Bank for loans granted by private investors: to approve such guarantees when the funds are raised in the country or when the loan is made in the country's local currency. (Bank IV, 1, b).

(7) Approve purchase or sale by the Bank in the national territory of any securities which the Bank has issued, guaranteed or purchased and the raising of loans by the Bank in local currency. (Bank IV, 8).

(8) To approve the liquidation of pending accounts in the case of withdrawal from the Fund or the Bank. (Fund XV, 3; Bank VI, 4).

C. Instances in which certain matters must be submitted to the vote of member countries:

(1) Amendment of the Agreements. (Fund XVII, a; Bank VIII, a).

(2) Uniform modification of parities. (Fund IV, 7).

D. Various other instances of action implicitly required by the member are those connected with the obligations to which reference is made in Section (6) of this paper.

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APPENDIX II

Applications of alternative methods of calculating reserves (see section 5).

It is assumed that before the subscription is made the central bank has reserves of 325. The "normal position" shows the bank's statement after making the subscription to the Fund required by an assumed quota of 100. Under "creditor position" it is assumed that an active balance of payments of 50 has been paid to the country exclusively through the Fund. Under "debtor position" it is assumed that a passive balance of 50 has been paid by the country exclusively by drawing upon the Fund. This gives rise to a repurchase obligation of 25 by the end of the year, the liquidation of which is shown under "After Repurchase".

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Alternative 1.

I. Before adherence to the Fund

Gold and foreign exchange	325.0

II. "Normal" position after adherence to the Fund

Assets: Gold and foreign exchange	300.0	
100% of gold contribution to Fund	25.0	62.5
50% of currency contribution (75)	37.5	
	362.5	
Liabilities: 50% of Due to Fund (75)	37.5	
Net Reserves: 362.5 - 37.5 =	325.0	

III. Creditor position of 50

Assets: as before, i.e., current gold and foreign exchange, plus a fixed item of 62.5	362.5
Liabilities: 50% of Due to Fund (75 - 50 = 25)	12.5

Net Reserves: 362.5 - 12.5 = 350.0, i.e., an increase equal to 50% of the amount lent ($\frac{50}{2}$ = 25)

IV. Debtor position of 50

Before repurchase

Assets: as before	362.5
Liabilities: 50% of Due to Fund (75 + 50 = 125)	62.5

Net Reserves: 362.5 - 62.5 = 300.0, i.e., a decrease equal to 50% of the amount borrowed ($\frac{50}{2}$ = 25)

After repurchase of 25

Assets: Gold and foreign exchange	275.0
Contribution to Fund	62.5
	337.5
Liabilities: 50% of Due to Fund (75 + 25 = 100)	50.0
Net Reserves: 337.5 - 50.0 =	287.5

Note: On its balance sheet proper, the central bank will enter the full amount of its contribution (always 100 in the example) as asset and the full amount of its current indebtedness to the Fund as liability.

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Alternative 2.

	Before Adherence to Fund	"Normal" Position	Creditor Position of 50	Debtor Position of 50	After Repurchase
Assets					
Total legal reserves					
Gold and exchange	325	300	300	275	275
Equivalent of gold contribution	0	25	25	25	25
Creditor position in Fund	0	0	50	0	0
	325	325	375	300	300
Exchange assets earmarked against repurchase obligations	0	0	0	25	0
Currency contribution remaining in Fund	0	75	25	75	75
Other assets	100	100	100	100	100
Total	425	500	500	500	475
Liabilities					
Currency and demand deposits	400	400	450	350	350
Special deposit in favor of Fund or demand notes (This item not subject to reserve requirements)	0	75	25	125	100
Other liabilities	25	25	25	25	25
Total	425	500	500	500	475

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