MEMORANDUM

TO: Mr. Whitelaw June 2, 1975

FROM: J. J. Polak

SUBJECT: The Financial Structure of the General Account

The attached paper approaches some of the questions we were discussing at lunch from the angle of the Fund's income.

J. J. P.

The Financial Structure of the General Account

April 25, 1975

Recent discussions of the Executive Directors and recent staff papers[1] indicate the high degree of complexity of the financial structure of the General Account. That structure is also unsatisfactory from a number of points of view. It tends to create wide swings in the balance between the Fund's operational income and expenditure; it gives uneconomic incentives for members to use the gold tranche in preference to SDRs; and it is inequitable in the distribution among members of the cost of financing of the Fund's assets (see below).

This note analyzes briefly the financial structure of the General Account and suggests an alternative and perhaps more satisfactory structure.

It is instructive to take as a reference point for the analysis the extremely simple financial structure of the Special Drawing Account. Measuring from the net cumulative allocation (NCA) of each participant, the Special Drawing Account can be seen as involving an extension of credit to those participants whose holdings of SDRs are below their NCA and by those participants (and other holders, including the General Account) whose holdings of SDRs are in excess of their NCA. Since the Special Drawing Account operates by the transfer of balances among participants (and other holders), the aggregate amount of holdings in excess of NCA must equal the aggregate shortfall of holdings below NCA. Participants with a deficit position in SDRs

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1/ SM/75/59, "Payment of Members' Own Currencies in Excess of 75 per cent of Quota Increases," March 20, 1975 and SM/75/65, "Recent Developments Affecting Fund Income and Expense," March 24, 1975.

pay interest at the same rate as that received by others on excess holdings. Identical amounts at identical rates produce equality between the net receipts and the net payments of interest of the Special Drawing Account, whatever the extent of use of SDRs, either in absolute amount or in per cent of NCA.[1/]

Neither of these two identities of the Special Drawing Account--that of interest rates and that of the amounts to which they apply--prevails in the General Account, and the complexities of that Account can suitably be discussed in terms of (i) differential interest rates and (ii) interest free assets and resources.

Differential interest rates

Until 1969 the Fund paid no credit interest on any of the resources used in its transactions except on resources obtained from borrowing. When remuneration on the creditor positions that are the counterpart of outstanding drawings was introduced in 1969, it was at a low rate (the same as the interest rate on borrowing under the GAB) and well below the average debit interest rate charged by the Fund (although that rate itself was low too). Under this structure of rates the Fund was almost bound to make a large operational income if it had substantial drawings outstanding.

Recent changes have moved the structure of the Fund's charges, rates of remuneration, and interest rates on borrowing towards approximate equality between effective debit and credit interest rates, so that in this respect the General Account has begun to approach the structure of the Special Drawing Account. Thus, the normal rate of charges now runs from 4 per cent to 6 per cent, with an average of about 5 per cent, while the normal rate of remuneration

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1/ The balance of interest receipts and expenditure leaves no residual to defray the operating cost of the SDR system; this is taken care of separately by "assessment" of all participants in proportion to their NCA. With operating cost of the SDR account estimated at about SDR 1 million per year, the assessment current is in the order of one hundredth of 1 per cent of NCA per year.

at the present time equals 5 per cent. (The lower rate of remuneration of 2 1/2 per cent on the first 25 per cent of the super gold tranche is not intended to be a permanent feature of the Fund's financial structure.) The 1974 oil facility was based on money borrowed at 7 per cent and relent at approximately the same rate. The recent amendment of the General Arrangements to Borrow incorporates the principle of a "pass through" of interest from users to lenders.

The charges set for the 1975 oil facility introduced a further and important change. These charges are still closely related to the interest paid by the Fund on amounts to be borrowed but a differential of approximately 1/2 per cent per annum has been introduced. The purpose of this differential is to make a contribution to the cost of running the Fund. A modest differential between debit and credit interest rates applied to all of the Fund's transactions would suffice to meet a considerable part of the Fund's administrative expenditure. For example, a differential of 1/2 per cent on drawings of SDR 5 billion would yield SDR 25 million per annum, approximately half the Fund's current administrative expenditure.

The Fund has a second major source to meet its administrative expenditure in the income earned on its reserves, which constitute an interest-free source of funds. The investment of these reserves (which amount to approximately SDR 700 million) in the Fund's own business yields approximately SDR 35 million at the current average rate of charges on ordinary transactions.

It would appear from the preceding that--subject to what is said in the next section--taking one year with another and provided that the average level of outstanding drawings of the Fund remains reasonably high, it should be possible to cover the administrative expenses of the Fund in the main from

the two sources mentioned.[1/] It should be noted that this could be achieved in spite of payment of remuneration on the full amount of subscribed currencies used--i.e., on the amount of the excess of 100 per cent of quota over holdings of any currency. Over time the upward trend in transactions could probably take care of the upward trend in expenditure. The level of reserves might also have a tendency to grow insofar as, on average, income might be expected to be somewhat in excess of expenditure. A possible further modest addition to the Fund's income is suggested below.

Interest free assets and resources

These arrangements would not ensure a reasonable balance between the Fund's income and expenditure, because the Fund's assets are not limited to outstanding drawings on which interest is earned (plus some holdings of SDRs, received in lieu of gold or currency, on which interest is also earned), and the Fund's sources of funds are not limited to currencies on which credit interest has to be paid, and reserves. The Fund's assets also include gold on which it earns no interest, and it has an interest-free source of finance in members' basic gold tranche positions.

The annexed table indicates that, except at the end of 1971, the Fund's holdings of gold were somewhat larger than the amounts of undrawn basic gold tranche positions and that the difference between the two was subject to substantial year-to-year fluctuation. Insofar as the Fund's gold holdings exceed the interest-free resources available in the basic gold tranche, interesting-costing resources are tied up in holding gold, and the Fund's overall financial results tend to move into deficit. Thus, one of the reasons for the Fund's deficit in recent years has been related to factors that could

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1/ The Fund also receives a significant amount of income from transaction charges.

not reasonably be expected to be corrected through adjustment of the Fund's debit or credit interest rates.

An Alternative Financial Structure for the General Account

This analysis suggests a change in the financial structure of the General Account in such a way as to provide a more stable basis of revenue for the Fund. Such a change could at the same time eliminate the inequity of the present structure under which some members of the Fund support the institution by maintaining an interest-free deposit equal to 25 per cent of their quotas, while other members do so only partially or not at all. At the same time, the suggested change takes into account a widespread feeling that it would be incompatible with the reserve character of the gold tranche to remove this inequity by making the use of any part of the gold tranche subject to the payment of either a transactions or an interest charge.

The suggestion would be that as long as, and to the extent that, the Fund continued to hold gold, its members should on an equitable basis make available to the Fund interest-free resources to finance the holding of this asset. If all members held a basic gold tranche position, this could be achieved by making part of this position interest-free. Since only part of the members hold such a position, the objective sought can most conveniently be attained by paying creditor interest (remuneration) on the whole gold tranche and levying a charge on all members in proportion to quota, at the prevailing rate of remuneration, on an aggregate amount equal to the Fund's holdings of gold. At SDR 5.3 billion, these holdings will be a little over half of a full tranche of aggregate quotas equalling SDR 39 billion. If

the amount subject to the charge were set slightly above the Fund's actual gold holdings at the time of the amendment (e.g., at SDR 5.5 billion to be adjusted for any subsequent changes in the Fund's holdings of gold[1]) the charge on the additional amount would provide some further leeway for the Fund's finances.

If the financial structure of the General Account were recast along these lines, the balance of the Fund's income and expenditure would no longer be affected by fluctuations in the use of the gold tranche or by the sale of gold for currencies. It would also only be marginally affected by variations in the mode of payment of the "gold portion" of quota increases. Payment of this portion in SDRs would give the Fund an interest-earning asset against a decrease in interest-earning outstanding drawings or an increase in remuneration-costing gold tranche positions; payment in currency would leave unchanged the member's position in relation to quota, and hence also the amount subject to remuneration or to the payment of charges.

1/ Abstraction is made here from possible acquisition of gold by the Fund under a substitution arrangement; gold so acquired would in any case require separate financing.

General Account

Interest-Free Sources of Finance[1/] and Assets

(In millions of SDRs)

Date	Basic Gold Tranche Positions	Gold Holdings	Difference
	(1)	(2)	(1) - (2)
As of April 30:			
1968	2515	3816	-1301
1969	3259	3371	-112
1970	3289	3565	-276
1971	4894	4738	156
1972	4657	5331	-674
1973	4241	5370	-1129
1974	4523	5370	-847
December 31, 1974	5041	5370	-329

1/ Not including Reserve Accounts.

MEMORANDUM

TO: Managing Director April 25, 1975

FROM: J. J. Polak

SUBJECT: The Financial Structure of the General Account

I believe that the attached would be helpful to Directors in clarifying some issues that are clearly in need of clarification.

cc: Deputy Managing Director
Mr. Gold
Mr. Habermeier

The Financial Structure of the General Account

A Note by the Economic Counsellor

April 25, 1975

Recent discussions of the Executive Directors and recent staff papers[1] indicate the high degree of complexity of the financial structure of the General Account. That structure is also unsatisfactory from a number of points of view. It tends to create wide swings in the balance between the Fund's operational income and expenditure; it gives uneconomic incentives for members to use the gold tranche in preference to SDRs; and it is inequitable in the distribution among members of the cost of financing of the Fund's assets (see below).

This note analyzes briefly the financial structure of the General Account and suggests an alternative and perhaps more satisfactory structure.

It is instructive to take as a reference point for the analysis the extremely simple financial structure of the Special Drawing Account. Measuring from the net cumulative allocation (NCA) of each participant, the Special Drawing Account can be seen as involving an extension of credit to those participants whose holdings of SDRs are below their NCA and by those participants (and other holders, including the General Account) whose holdings of SDRs are in excess of their NCA. Since the Special Drawing Account operates by the transfer of balances among participants (and other holders), the aggregate amount of holdings in excess of NCA must equal the aggregate shortfall of holdings below NCA. Participants with a deficit position in SDRs

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1/ SM/75/39, "Payment of Members' Own Currencies in Excess of 75 per cent of Quota Increases," March 20, 1975 and SM/75/65, "Recent Developments Affecting Fund Income and Expense," March 24, 1975.

pay interest at the same rate as that received by others on excess holdings. Identical amounts at identical rates produce equality between the net receipts and the net payments of interest of the Special Drawing Account, whatever the extent of use of SDRs, either in absolute amount or in per cent of NCA.[1/]

Neither of these two identities of the Special Drawing Account--that of interest rates and that of the amounts to which they apply--prevails in the General Account, and the complexities of that Account can suitably be discussed in terms of (i) differential interest rates and (ii) interest free assets and resources.

Differential interest rates

Until 1969 the Fund paid no credit interest rates on any of the resources used in its transactions except on resources obtained from borrowing. When remuneration on the creditor positions that were the counterpart of outstanding drawings was introduced in 1969, it was at a low rate (the same as the interest rate on borrowing under the GAB) and well below the average debit interest rate charged by the Fund (although that rate itself was low too). Under this structure of rates the Fund was almost bound to make a large operational income if it had substantial drawings outstanding.

Recent changes have moved the structure of the Fund's charges, rates of remuneration, and interest rates on borrowing towards approximate equality between effective debit and credit interest rates, so that in this respect the General Account has begun to approach the structure of the Special Drawing Account. Thus, the normal rate of charges now runs from 4 per cent to 6 per cent, with an average of about 5 per cent, while the normal rate of remuneration

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at the present time equals 5 per cent. (The lower rate of remuneration of 2 1/2 per cent on the first 25 per cent of the super gold tranche is not intended to be a permanent feature of the Fund's financial structure.) The 1974 oil facility was based on money borrowed at 7 per cent and relent at approximately the same rate. The recent amendment of the General Arrangements to Borrow incorporates the principle of a "pass through" of interest from users to lenders.

The charges set for the 1975 oil facility introduced a further and important change. These charges are still closely related to the interest paid by the Fund on amounts to be borrowed but a differential of approximately 1/2 per cent per annum has been introduced. The purpose of this differential is to make a contribution to the cost of running the Fund. A modest differential between debit and credit interest rates applied to all of the Fund's transactions would suffice to meet a considerable part of the Fund's administrative expenditure. For example, a differential of 1/2 per cent on drawings of SDR 5 billion would yield SDR 25 million per annum, approximately half the Fund's current administrative expenditure.

The Fund has a second major source to meet its administrative expenditure in the income earned on its reserves, which constitute an interest-free source of funds. The investment of these reserves (which amount to approximately SDR 700 million) in the Fund's own business yields approximately SDR 35 million at the current average rate of charges on ordinary transactions.

It would appear from the preceding that--subject to what is said in the next section--taking one year with another and provided that the average level of outstanding drawings of the Fund remains reasonably high, it should be possible to cover the administrative expenses of the Fund in the main from

the two sources mentioned.[1/] It should be noted that this could be achieved in spite of payment of remuneration on the full amount of subscribed currencies used--i.e., on the amount of the excess of 100 per cent of quota over holdings of any currency. Over time the upward trend in transactions could probably take care of the upward trend in expenditure. The level of reserves might also have a tendency to grow insofar as, on average, income might be expected to be somewhat in excess of expenditure. A possible further modest addition to the Fund's income is suggested below.

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These arrangements would not ensure a reasonable balance between the Fund's income and expenditure, because the Fund's assets are not limited to outstanding drawings on which interest is earned (plus some holdings of SDRs, received in lieu of gold or currency, on which interest is also earned), and the Fund's sources of funds are not limited to currencies on which credit interest has to be paid, and reserves. The Fund's assets also include gold on which it earns no interest, and it has an interest-free source of finance in members' basic gold tranche positions.

The annexed table indicates that, except at the end of 1971, the Fund's holdings of gold were somewhat larger than the amounts of undrawn basic gold tranche positions and that the difference between the two was subject to substantial year-to-year fluctuation. Insofar as the Fund's gold holdings exceed the interest-free resources available in the basic gold tranche, interesting-costing resources are tied up in holding gold, and the Fund's overall financial results tend to move into deficit. Thus, one of the reasons for the Fund's deficit in recent years has been related to factors that could

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This analysis suggests a change in the financial structure of the General Account in such a way as to provide a more stable basis of revenue for the Fund. Such a change could at the same time eliminate the inequity of the present structure under which some members of the Fund support the institution by maintaining an interest-free deposit equal to 25 per cent of their quotas, while other members do so only partially or not at all. At the same time, the suggested change takes into account a widespread feeling that it would be incompatible with the reserve character of the gold tranche to remove this inequity by making the use of any part of the gold tranche subject to the payment of either a transactions or an interest charge.

The suggestion would be that as long as, and to the extent that, the Fund continued to hold gold, its members should on an equitable basis make available to the Fund interest-free resources to finance the holding of this asset. If all members held a basic gold tranche position, this could be achieved by making part of this position interest-free. Since only part of the members hold such a position, the objective sought can most conveniently be attained by paying creditor interest (remuneration) on the whole gold tranche and levying a charge on all members in proportion to quota, at the prevailing rate of remuneration, on an aggregate amount equal to the Fund's holdings of gold. At SDR 5.3 billion, these holdings will be a little over half of a full tranche of aggregate quotas equalling SDR 35 billion. If 9

the amount subject to the charge were set slightly above the Fund's actual gold holdings at the time of the amendment (e.g., at SDR 5.5 billion to be adjusted for any subsequent changes in the Fund's holdings of gold[1]) the charge on the additional amount would provide some further leeway for the Fund's finances.

If the financial structure of the General Account were recast along these lines, the balance of the Fund's income and expenditure would no longer be affected by fluctuations in the use of the gold tranche or by the sale of gold for currencies. It would also only be marginally affected by variations in the mode of payment of the "gold portion" of quota increases. Payment of this portion in SDRs would give the Fund an interest-earning asset against a decrease in interest-earning outstanding drawings or an increase in remuneration-costing gold tranche positions; payment in currency would leave the member's position in relation to quota unchanged. and hence also the amount subject to remuneration or to the payment of charges.

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SOURCE COPY

General Account

Interest-Free Sources of Finance[1/] and Assets

(In millions of SDRs)

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1974	4523	5370	-847
December 31, 1974	5041	5370	-329

1/ Not including Reserve Accounts.

MEMORANDUM

TO: Managing Director
Deputy Managing Director

February 26, 1975

FROM: J. J. Polak

SUBJECT: The Financial Structure of the General Account

I refer to Mr. Habermeier's comments.

The paper does not propose a new amendment and there is no difference of view that we should not actively pursue the ideas contained in the paper as a new amendment.

I doubt that our chances of members taking a reasonable view on such major issues as return of the Fund's gold or gold sales and investment of the proceeds would be reduced by Executive Directors having a clear understanding of the income and expenditure structure of the General Account.

The editorial suggestions implied in Mr. Habermeier's memorandum can be accommodated. In particular, now that you are on record in favor of a half per cent margin on the oil facility (which would yield SDR 25 million a year on an assumed total of SDR 5 billion) it would be reasonable to say that the Fund's finances could approximately be covered without investing the proceeds of gold sales at interest. This would permit considering any such investment without regard to its effect on the Fund's finances, e.g., in a trust fund at a zero or minimal rate of interest.

cc: Mr. Gold
Mr. Habermeier

MEMORANDUM

TO: Acting Managing Director | February 21, 1975

FROM: J. J. Polak

SUBJECT: The Financial Structure of the General Account

The attached paper is relevant to a number of amendment issues being discussed. I should like it to be issued, therefore, as soon as possible.

The paper has benefited considerably from comments by the Legal and Treasurer's Departments on an earlier draft.

cc: Managing Director
Mr. Gold
Mr. Habermeier
Mr. Green

SUBJECT COPY

The Financial Structure of the General Account

Prepared by the Research Department

(In consultation with Legal and Treasurer's Departments)

Approved by J. J. Polak

February 21, 1975

In connection with various areas of amendment (such as the role of the gold tranche payments for quota increases, charges and remuneration, and investment) numerous questions have arisen concerning the financial structure of the General Account. This paper attempts to shed some light on these questions; it also derives a possible alternative method to arrange the Fund's system of charges and remuneration in such a way as to give the Fund a more nearly stable and predictable operational income. The frequency with which questions have arisen on this subject is evidence of its complexity.

One way to get a grip on this subject is to start out from the extremely simple financial structure of the Special Drawing Account. Taking the net cumulative allocation (NCA) of each participant as a pivot, the structure of the Special Drawing Account can be seen as involving an extension of credit _to_ those participants whose holdings of SDRs are below their NCA and _by_ those participants (and other holders, including the General Account), whose holdings of SDRs are in excess of their NCA. Since the Special Drawing Account operates by the transfer of balances among participants (and other holders) the aggregate amount of holdings by participants in excess of NCA and by other holders must equal the aggregate amount of holdings by participants below NCA. Members with deficit holdings pay net interest at the same rate as the net interest rate received by others on excess holdings. Identical amounts at identical

SUBJECT COPY

rates produce equality between the net receipts and the net payments of interest of the Special Drawing Account, whatever the extent of use of SDRs, either in absolute amount or in per cent of NCA.[1/]

The financial structure of the General Account is far more complicated and, as a consequence, there have been wide fluctuations in the Fund's net operational income. The structure has, moreover, undergone frequent changes in recent years, such as the termination of the gold investment, the introduction of remuneration on super gold tranche positions, and the increase in the rate of remuneration by substantially more than the increase in the rate of charges. Further complications arise from the fact that, unlike the Special Drawing Account, the net financial position of the General Account has also been affected by changes in the amount of Fund credit outstanding and by changes in quotas.

An interesting attempt to present the various elements of the Fund's accounts in such a way as to permit an analysis of the net financial position of the General Account was presented nearly 2 years ago in a paper by the Treasurer's Department entitled "Factors Affecting Fund Income and Expenditure, 1968-1973" (EBAP 73/81, April 13, 1973). In Table 3 of that paper the balance sheet of the Fund was rearranged in such a way as to distinguish "interest earning" from "non-interest earning" uses of funds, and "interest costing" from "interest free" sources of funds. Table 1 of the present paper has been derived from this presentation by some further rearrangement, intended to bring out the balance (positive or negative) between interest earning assets and

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1/ The balancing of interest receipts and expenditure leaves no residual to defray the operating cost of the SDR system; this is taken care of separately by "assessment" of all participants in proportion to their NCS. With operating cost of the SDR account estimated at about SDR 1 million per year, the assessment currently is in the order of one hundredth of 1 per cent of NCA per year.

interest costing sources. In this rearrangement items have been sorted out on the basis of their present status under these various headings, not on the basis of their actual status on the various dates shown. Thus, the gold investment that continued to exist through part of 1971 has throughout been assumed to have been liquidated, and creditors positions have been classified as interest costing even though they did not actually become so until 1970.

There is a justification for drawing this balance which did not exist at the time when the earlier paper was written. It lies in the fact that the structure of the Fund's charges, rates of remuneration and interest rates on borrowing has moved to approximate equality between effective debit and credit interest rates, so that in this respect the General Account has moved towards the structure of the Special Drawing Account. Thus, the normal rate of charges runs from 4 per cent to 6 per cent, with an average of about 5 per cent, while the normal rate of remuneration at the present time equals 5 per cent. (The lower rate of remuneration of 2 1/2 per cent on the first 25 per cent of the super gold tranche is not intended to be a permanent feature of the Fund's financial structure.) The 1974 oil facility was based on money borrowed at 7 per cent and relent at approximately the same rate. The recent amendment of the General Arrangements to Borrow was specifically based on the principle of a "pass through" of interest from users to lenders.

The sign (positive or negative) of the balance in line 3 of Table 1 indicates whether, on the dates shown, the Fund's operations would have yielded a surplus or a deficit if at those dates debit and credit interest rates had been equal (which, as mentioned above, they were not). Even on that assumption the indication would only be approximate, because the Fund's income is based in part on current activity (transaction charges and charges for stand-by arrangements) rather than on balances outstanding only. In order for the Fund's

Table 1

The Balance between Interest Earning Assets and Interest Costing Sources
(In millions of SDRs)

		As of April 30							Dec.
		1968	1969	1970	1971	1972	1973	1974	1974
(1)	Interest earning assets	2442	3292	4230	3045	1743	1578	1551	4156
	Use of credit tranches	2442	3292	4018	2555	833	961	1052	3699
	SDR holdings	--	--	212	490	910	617	499	457
(2)	Interest costing sources	3224	2812	3811	2101	1622	1929	1646	3762
	Borrowing	740	1096	1065	399	--	--	--	1716
	Creditor positions	2484	1716	2746	1702	1622	1929	1646	2046
(3)	Balance (1) - (2)	-782	480	419	944	121	-351	-95	394

Table 2

The Financing of Non-Interest Earning Assets out of Interest Free Sources
(In millions of SDRs)

		1968	1969	1970	1971	1972	1973	1974	Dec. 1974
(1)	Interest free sources	5799	5900	6032	7907	7997	8070	8039	8020
	25 per cent of quotas	5280	5308	5337	7119	7202	7292	7297	7297
	Reserves 1/	519	592	695	788	795	778	742	723
(2)	Non-interest earning assets	6581	5420	5613	6963	7876	8421	8134	7626
	Gold								
	Gold	3816	3371	3565	4738	5331	5370	5370	5370
	Use of gold tranche	2765	2049	2048	2225	2545	3051	2764	2256
(3)	Balance (1) - (2)	-782	480	419	944	121	-351	-95	394

1/ Including (small) other assets and liabilities.

operations to yield enough income to cover its administrative expenditure, the balance would have to be a substantial positive amount--say in the order of SDR 1 billion to yield, at a 5 per cent rate of interest, SDR 50 million which is the order of magnitude of the current administrative expenditure of the Fund. The table shows that the balance has approached this amount only once the last 7 1/2 years; usually it has been much smaller and indeed on three of the dates shown it was a substantial negative number.

The fluctuations of this balance in the past have been due to a number of factors. These can be identified in Table 2, the components of which net out to the same balance as in Table 1. One of these were changes in the Fund's gold holdings, another the extent to which members' ~~positions~~ used the "basic gold tranche"--an area where no interest is charged and no remuneration paid. The third main factor was quota increases. If use of the basic gold tranche had a marginal cost in terms of interest or remuneration like use of all other tranches, the portion of quota increases paid in gold would reduce the balance by an amount equal to the gold payment, and the same portion paid in SDRs or in currencies would leave the balance unaffected; but with a basic gold tranche free of interest or remuneration, quota increases reduce the balance by less than the full amount of the "gold portion" if this is paid in gold, increase the balance if this portion is paid in SDRs and increase it also, though to a smaller extent, if the portion is paid in each member's own currency. This point is discussed in an Annex. Finally, the balance is affected by the initial growth and subsequent decline of the reserves.

The analysis is relevant to the issue of the Fund "investing" up to an amount equivalent to its reserves. Of course, as the table shows, the Fund's reserves are in a sense already invested in the Fund's own business; if the amount of about SDR 700 million of past surpluses had not been accumulated in reserves, but distributed in currencies or SDRs (not in gold), the balance

would have been that much more unfavorable. It is clear from the table that the investment of an additional SDR 700 million would not bring the balance to the required level of about SDR 1 billion for at least some of the dates in the past. In considering the amount to be invested as an addition to the balance, it is implicitly assumed that the investment would yield the same net interest rate as the bulk of the Fund's interest earning assets, e.g., about 5 per cent. This would be a reasonable assumption if the investment were made on the basis of the sale of gold, itself a non-interest earning asset. If, however, the investment were made by the use of currencies, thus adding to the interest cost of the General Account, it would be quite unlikely to produce a 5 per cent net yield.

Whatever may be achieved in terms of strengthening the balance as a result of investment, the financial position of the General Account would still remain subject to substantial fluctuations. For example, the balance could decline to minus SDR 1.5 billion from the average balance of close to zero shown for the last four dates in the table if use of the gold tranche rose from its present low level to the same percentage of quotas as in 1968. It would increase substantially as a result of the forthcoming quota increase, assuming that the "gold portion" would not be paid in gold.

It would be possible to change the financial structure of the General Account in such a way as to provide a more stable basis of revenue for the Fund. Such a change could at the same time eliminate the inequity of the present structure arising from the fact that some members of the Fund contribute to the institution by maintaining an interest free deposit equal to 25 per cent of their quotas, while other members do so only partially or not at all. The main interest free source of finance for the Fund is the 25 per cent of quotas on which

members do not receive remuneration, and which is to a large extent necessary to finance the holding of non-interest earning gold. A substantial but varying proportion of this amount is, however, absorbed by use of the gold tranche, the effect of which is that for this amount members do not provide the Fund with interest free resources. There is a widespread feeling, however, that it would be incompatible with the reserve character of the gold tranche to remove this inequity by making use of any part of the gold tranche subject to the payment of either a transactions or an interest charge. Indeed, the suggestion has been made that it would be desirable to extend remuneration to the whole of the gold tranche. A further point to be borne in mind is that one should, if possible, avoid making the Fund's net operating income dependent on periodic decisions; while assessment is satisfactory for the small cost of running the Special Drawing Account, it would raise considerable problems if applied to the much larger cost of the General Account.

The preceding analysis, in conjunction with the experience gained in devising the financial structure of the Special Drawing Account points to a possible solution to these divergent desiderata. Since all SDR holdings are reserve assets, it was considered desirable that participants should receive interest on the full amount of their SDR holdings. But since the finances of the SDR account had to be self balancing, it then became necessary to introduce a charge, at the same rate, on net cumulative allocations. The net result of this arrangement is that participants pay net interest on the shortfall of their holdings below NCA and receive net interest on their holdings in excess of NCA. Transposition of this approach to the General Account could be achieved by the introduction of two changes.

SUBJECT COPY

(a) Payment of remuneration on amounts by which the Fund's holdings of any currency were below 100 per cent, as against the present 75 per cent, of quota;

(b) A charge, at a rate equal to the rate of remuneration, levied on all members in proportion to quotas, on a total amount equal to the Fund's holdings of gold. With gold holdings of SDR 5.3 billion this would be about 14 per cent of quotas of SDR 39 billion.

At equal debit and credit interest rates, the Fund would then receive a net income equal to the rate of remuneration applied to the reserve or, on present figures, about SDR 36 billion. This would not fully cover the Fund's administrative expenditure. The income could, however, be reinforced by a conbination of the following:[1]

1) transactions charges and any small excess of debit over credit interest rates;

2) the investment of the proceeds of the sale of a relatively small amount of gold. For example, the sale of SDR 100 million of gold valued at the official price might, at current prices, produce an investible profit of some SDR 300 million.[2] This amount, taking in conjunction with that of the reserve, would give the net income earning balance mentioned above (in the order of magnitude of SDR 1 billion) required to cover the Fund's expenditure.

The financial effects on individual members of a charge on 14 per cent of quota would be as follows:

1/ It may be noted that if the percentage were rounded up to 15 per cent from the actual 13.6 per cent, an amount of more than SDR 500 million would be added to the balance.

2/ The fact that the book value of the gold sold would also contribute to the Fund's income would be offset by a reduction in the charge on account of the reduction in gold holdings.

(1) All members using the Fund in the credit tranches would have to pay an additional charge, which at the present rate of remuneration would equal 0.70 per cent of their quotas (5 per cent of 14 per cent).

(2) All members with creditor positions would benefit on balance by 0.55 per cent per annum of quota per annum, viz. the difference between remuneration on their basic gold tranche (5 per cent of 25 per cent) and the new charge (5 per cent of 14 per cent).

(3) The breakeven point would be for members of whose currency the Fund held 86 per cent. Those members whose currencies were held between 75 and 86 per cent would have some benefit, but less than 0.55 per cent of quota, and those between 80 and 100 per cent, some net cost, but less than 0.70 per cent of quota per annum.

The net effect on all members would be to distribute among all, in proportion to quota, the cost of keeping a stock of gold, while the cost of running the Fund would be broadly covered ~~and~~ from income on the reserves and some gold investment.

The approach here described might also make it easier to drop the term "gold tranche," with its sub-dividions of "basic gold tranche" and "super gold tranche," that indicate an important distinction in the present financial structure of the Fund. In a General Account in which at least for interest purposes debtor and creditor positions were measured from the quota, it would seem only natural to have a single expression to describe the excess of the quota over the Fund's holdings of currency. The approach would not require moving the 75 per cent level in other provisions of the Articles, although that would seem a logical counterpart of it as far as all provisions on repurchase were concerned.

Annex

Effect of Quota Increases on the Balance of Interest Earning Assets

In the present financial structure of the Fund quota increases affect the balance between interest earning assets and interest costing sources, and hence the Fund's net income.

Table 3 indicates these effects, for four modes of payment and three segments of the Fund's holdings of currencies.

Table 3
Effect of Quota Increases on
Net Interest Earning Balance

\+ Increase in balance
0 Balance unchanged
\- Decrease in balance

Holdings as Per Cent of New Quota	Mode of Payment		
	Gold	SDR or Creditor Currency	Own Currency
0 - 75	0	+	+
75 - 100	0	+	0
100	-	0	0
All quota increases	-	+	+

Notes:

1. The amount of any change in the balance equals in each case one-fourth of the quota increase.

2. Since it is the new quota which will determine whether and to what extent a given absolute position falls in the gold tranche, the distinction between segments has to be made in terms of that quota. Quota changes that spill over from one segment to another will have effects partly in one segment, partly in another.

When gold is paid, the balance is reduced for each quota increase of a member using the Fund in the credit tranches: the member pays off its interest bearing credit tranche use with non-interest paying gold. A member in the super gold tranche acquires for its gold a position subject to remuneration but here the negative effect on the Fund's income is offset by the equivalent increase in the interest free gold tranche which the member has to maintain.

The effect of the payment of SDRs is throughout to improve the balance, because SDRs, unlike gold, earn interest for the Fund. The effect of payment in own currency is the same as that of payment in SDRs below 75 per cent of quota; beyond that level the effect is zero, since the quota increase is matched by an equal increase in the use of the gold tranche.

Table 3 shows that the net effect for all members taken together is negative if all payments are made in gold and positive if all are made in SDRs and also, but to a smaller extent, if all payments are made in a member's own currency. If one wanted to apply these findings to any particular situation one would have to bear in mind that the position of members in the three segments would be affected by the mode of payment considered; for example, payment in own currency would raise holdings as a percentage of new quota, compared to holdings as percentage of present quota, for members with present holdings at or below 75 per cent of quota.

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

Mr. J. J. Polak

Room 9-320 C
#1

SM/74/72

SM/74/72

April 3, 1974

To: Members of the Executive Board

From: The Secretary

Subject: Possible Changes in the General Account

The attached memorandum on possible changes in the General Account has been prepared by the staff in response to a request by Executive Directors.

This subject has been tentatively scheduled for discussion on Wednesday, April 17, 1974.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Possible Changes in the General Account

Prepared by the Staff

April 2, 1974

In response to a request by executive directors, the staff has prepared this memorandum to indicate briefly certain matters in respect of which changes in the General Account could be considered. These changes, which are of different degrees of importance, would require amendment of the Articles. They could be combined with any proposal for other amendments whenever such a proposal were made.

I. Use of Special Drawing Rights in the General Account

It would be desirable to provide a broader role for special drawing rights in the General Account by giving members greater freedom to use them instead of gold or currency in all transactions or operations conducted through the General Account.

In connection with requests for purchases from the General Account that were consistent with the Articles, it could be provided that at the option of the Fund or the purchaser special drawing rights would be made available by the Fund in exchange for the purchaser's currency. The Fund has authority at present to sell special drawing rights if the member requesting a transaction under Article V, Section 3(a) agrees (Article XXV, Section 7(f)). The change would mean that either the Fund or the member could decide to have the transaction carried out in special drawing rights without the agreement of the other party. The option would be limited by the amount of special drawing rights held in the General Account unless the Fund had powers to issue them to finance these transactions and cancel them on repurchase.

In addition, it could be provided that any repurchase obligation that was calculated in any reserve assets under Article V, Section 7(b), or under its successor in amended Articles, could be discharged with special drawing rights. This right could be made to apply to accrued repurchase obligations in gold, whether discharged or undischarged, back to some prescribed date. Members could be given the right to use special drawing rights outside Article V, Section 7(b) in repurchase of their currency above 75 per cent of quota. At present, members can make these repurchases only to the extent permitted by the Fund (Article XXV, Section 7(c)).

As is discussed below, special drawing rights might be accepted in discharge of that part of a subscription payable on an increase in quota that is not payable in the member's currency. In addition, members might be permitted to pay all charges with special drawing rights instead of gold. The Fund could be authorized to pay remuneration and distribute net income in special drawing rights.

Under the present Articles the Fund may require a participant to sell its currency to the Fund in replenishment in return for special drawing rights held in the General Account after consultation with the participant on alternative ways of replenishment and subject to the acceptance limit laid down in Article XXV, Section 4. In addition, replenishment with special drawing rights must be made with due regard to the principles of designation. Some or all of these limitations might be eliminated.

II. Gold

The Fund's present powers to buy gold might be reconsidered. In addition, the Fund might be authorized to sell gold in the market and invest such part of the proceeds as it determined.

III. Exchange transactions

1. Stand-by arrangements

No provision in the Articles deals expressly with stand-by arrangements even though they have become the main instrument for making the Fund's resources available to members. The policies governing stand-by arrangements are embodied in decisions adopted in the period 1952 through 1968 (see Selected Decisions, Sixth Issue, pages 26-34). It would be desirable to make express mention of stand-by arrangements in Article V, Section 3, but without limiting the Fund's authority to adapt its policies in connection with them.

2. Quantitative limits

The limit of 25 per cent of quota for purchases within twelve months in Article V, Section 3(a)(iii) (as applied under Decision No. 451-(55/52), August 24, 1955, Selected Decisions, Sixth Issue, pages 21-22) is commonly waived under Article V, Section 4. The tranche policies have fulfilled the more important functions of the terms that the Fund might have imposed when granting a waiver. The limit could be abrogated, but there would be less reason to dispense with a cumulative limit, whether it be the present 200 per cent or a different limit.

3. Use of currencies in transactions and repurchases

The Fund's policy on the currencies to be used in its transactions is governed by the statement of policy entitled "Currencies to be Drawn and to be Used in Repurchases" (approved by Decision No. 1371-(62/36), July 20, 1962, Selected Decisions, Sixth Issue, pages 36-42). Under that policy a member wishing to make a purchase consults with the Managing Director regarding the currencies to be drawn. It would be possible to adopt a provision requiring the Fund to adopt policies regarding the use of currencies in transactions and to authorize the Fund to specify the currencies to be used by members in purchases and repurchases. With such an amendment, Article V, Section 3(a)(i) could be amended to eliminate the reference to "that currency." In addition, it could be made clear that if a member's currency were purchased, the member would be obligated, on the request of the purchasing member, to convert the currency into its reserve currency at a rate of exchange determined in accordance with such new provision as was adopted.

The same rules with respect to conversion would apply, with appropriate adaptation, to the acquisition by a member of a currency to be used in repurchase. The issuer of a currency acceptable in repurchase would be required to provide its currency in return for its reserve currency on the request of members wishing to repurchase with the issuer's currency.

IV. Repurchase and Monetary Reserves

1. Replacement of system in Article V, Section 7(b)

At present, there are two complex systems of repurchase: under Article V, Section 7(b) and outside that provision. These systems are based on provisions in the Articles and decisions of the Fund. A much simpler system could be substituted under which any increase in the Fund's holdings of a member's currency above 75 per cent of the member's quota would obligate the member to repurchase the increase within a period determined by decision of the Fund, whether the increase resulted from a transaction, the payment of charges, or from some other operation. The appropriate period or circumstances for repurchase in respect of types of increase could be determined by general or special decisions under authority granted by the Articles. Such a system would eliminate two principles of the repurchase system to which the drafters of Article V, Section 7(b) attached importance: pari passu use by a member of its own reserves in the year in which it makes a purchase that increases the Fund's holdings of its currency above 75 per cent of quota, and sharing with the Fund increases in reserves until the Fund's holdings have been reduced to 75 per cent of quota. The principles were designed to support the concept of need and the revolving character of the Fund's resources, but a revised system of

repurchase, together with the application of provisions on the use of currencies under III.3 above, could serve the same purposes. The two limits of 75 per cent of quota would continue to be applied.

2. Monetary Reserves

If a new system of repurchase were based to some extent on monetary reserves, there would be no need to retain the complex provisions of Article XIX on the calculation of monetary reserves. The Fund would have to operate with common concepts of reserves, but the present concepts could be improved.

Under the present Articles, the proportion of a member's monetary reserves to quota determines to what extent the member may pay charges in its own currency. If this right were maintained, it too could be linked to a revised concept of reserves.

The proportion of a member's monetary reserves to its quota is also a criterion for the possible reduction in the normal 25 per cent payment in gold on an increase in quota. The Fund could be authorized to determine the proportion of an increased subscription to be paid in special drawing rights on the occasion of each general review of quotas or in connection with the adjustment of an individual quota. The difference between 25 per cent of the increase and the proportion payable in special drawing rights could be made subject to repurchase. Similar provisions might be adopted with respect to original subscriptions.

3. Media of repurchase

It would be desirable to eliminate the complications of the distribution of repurchase obligations among types of monetary reserves under the present system, even if the system in Article V, Section 7(b) were not replaced. Members might be authorized to use gold or SDRs at their discretion, or currencies acceptable to the Fund. The acceptability of currencies would be determined in practice by the level of the Fund's holdings and the criteria for the use of currencies in repurchases. Currencies might be acceptable even though they were not convertible within the meaning of the Articles.

V. Charges on transactions in gold tranche

In Buff Statement 73/130, the Managing Director suggested that periodic charges might be levied on holdings of currency in the basic gold tranche (i.e., on holdings in the range of 75 per cent to 100 per cent of quota) at a rate equal to the rate of remuneration.

VI. Investment of Reserves

It would be possible to confer upon the Fund a power to invest assets equivalent in amount to its reserves for the purpose of meeting deficits or augmenting its reserves for meeting prospective deficits.

MEMORANDUM

TO: Mr. Gold
Mr. Habermeier

April 1, 1974

FROM: J. J. Polak

SUBJECT: Possible Changes in the General Account

I agreed to the March 28th draft going to the Managing Director but there is still one point in it that bothers me considerably. The implications of Sections 1 and 2 of IV seems to be that we envisage the codification of a new definition of monetary reserves for the basis of repurchase. I would expect that this would lead us into the same difficulties which we have experienced in the past. I would, therefore, try to steer Directors in a different direction by the two following changes.

(a) Towards the end of section 1, after "a revised system of repurchase" insert "in conjunction with the application of the proposed provisions on the use of currencies in transactions."

(b) Begin section 2 as follows: "To the extent that the new system of repurchase would be based on data of reserves, it need not arrest ...."

Mr. Polak

The Managing Director

March 28, 1974

Joseph Gold, J. J. Polak, and Walter O. Habermeier

Possible Changes in the General Account

Attached is a memorandum on this subject for your approval. The fact that such a memorandum will be submitted to the Executive Directors very soon was mentioned in the course of yesterday's debate in the Deputies of the C-XX.

cc: The Deputy Managing Director
Mr. Southard

INTERNATIONAL MONETARY FUND

Possible Changes in the General Account

Prepared by the Legal, Treasurer's, and Research Departments

Approved by Joseph Gold, W.O. Habermeier, and J.J. Polak

March 28, 1974

In response to a request by executive directors, the staff has prepared this memorandum to indicate briefly certain matters in respect of which changes in the General Account could be considered. These changes, which are of different degrees of importance, would require amendment of the Articles. They could be combined with any proposal for other amendments whenever such a proposal were made.

I. Use of Special Drawing Rights in the General Account

It would be desirable to provide a broader role for special drawing rights in the General Account by giving members greater freedom to use them instead of gold or currency in all transactions or operations conducted through the General Account.

In connection with requests for purchases from the General Account that were consistent with the Articles, it could be provided that at the option of the Fund or the purchaser special drawing rights would be made available by the Fund in exchange for the purchaser's currency. The Fund has authority at present to sell special drawing rights if the member requesting a transaction under Article V,

Section 3(a) agrees (Article XXV, Section 7(f)). The change would mean that either the Fund or the member could decide to have the transaction carried out in special drawing rights without the agreement of the other party. The option would be limited by the amount of special drawing rights held in the General Account unless the Fund had powers to issue them to finance these transactions and cancel them on repurchase.

In addition, it could be provided that any repurchase obligation that was calculated in any reserve assets under Article V, Section 7(b), or under its successor in amended Articles, could be discharged with special drawing rights. This right could be made to apply to accrued repurchase obligations in gold, whether discharged or undischarged, back to some prescribed date. Members could be given the right to use special drawing rights outside Article V, Section 7(b) in repurchase of their currency above 75 per cent of quota. At present, members can make these repurchases only to the extent permitted by the Fund (Article XXV, Section 7(c)).

In addition, members might be permitted to pay all charges with special drawing rights instead of gold. The Fund could be authorized to pay remuneration and distribute net income in special drawing rights.

Under the present Articles the Fund may require a participant to sell its currency to the Fund in replenishment for special drawing rights held in the General Account after consultation with the participant on alternative ways of replenishment and subject to the acceptance limit laid down in Article XXV, Section 4. In addition, replenishment with special drawing rights must be made with due regard to the

principles of designation. Some of these limitations might be eliminated.

II. Gold

The Fund might be given authority to buy gold from members at market-related prices in return for special drawing rights issued for the purpose. In addition, the Fund might be authorized to sell gold in the market and invest such part of the proceeds as it determined.

III. Exchange transactions

1. Stand-by arrangements

No provision in the Articles deals expressly with stand-by arrangements even though they have become the main instrument for making the Fund's resources available to members. The policies governing stand-by arrangements are embodied in decisions adopted in the period 1952 through 1968 (see Selected Decisions, Sixth Issue, pages 26-34). It would be desirable to make express mention of stand-by arrangements in Article V, Section 3 but without limiting the Fund's authority to adapt its policies in connection with them.

2. Quantitative limits

The limit of 25 per cent of quota for purchases within twelve months in Article V, Section 3(a)(iii) (as applied under Decision No. 451-(55/52), August 24, 1955, Selected Decisions, Sixth Issue, pages 21-22) is commonly waived under Article V, Section 4. The tranche policies have fulfilled the more important functions of the terms that the Fund might have imposed when granting a waiver. The limit could

be abrogated, but there would be less reason to dispense with a cumulative limit, whether it be the present 200 per cent or a different limit.

3. Use of currencies in transactions and repurchases

The Fund's policy on the currencies to be used in its transactions is governed by the statement of policy entitled "Currencies to be Drawn and to be Used in Repurchases" (approved by Decision No. 1371-(62/36), July 20, 1962, Selected Decisions, Sixth Issue, pages 36-42). Under that policy a member wishing to make a purchase consults with the Managing Director regarding the currencies to be drawn. It would be possible to adopt a provision requiring the Fund to adopt policies regarding the use of currencies in transactions and to authorize the Fund to specify the currencies to be used by members in purchases and repurchases. With such an amendment, Article V, Section 3(a)(i) could be amended to eliminate the reference to "that currency". In addition, it could be made clear that if a member's currency were purchased, the member would be obligated, on the request of the purchasing member, to convert the currency into its reserve currency at a rate of exchange determined in accordance with such new provision as was adopted.

The same rules with respect to conversion would apply, with appropriate adaptation, to the acquisition by a member of a currency to be used in repurchase. The issuer of a currency acceptable in repurchase would be required to provide its currency in return for its reserve currency on the request of members wishing to repurchase with the issuer's currency.

IV. Repurchase and Monetary Reserves

1. Replacement of system in Article V, Section 7(b)

At present, there are two complex systems of repurchase: under Article V, Section 7(b) and outside that provision. These systems are based on provisions in the Articles and decisions of the Fund. A much simpler system could be substituted under which any increase in the Fund's holdings of a member's currency above 75 per cent of the member's quota would obligate the member to repurchase the increase within a stated period, whether the increase resulted from a transaction, the payment of charges, or from some other operation. The appropriate period or occasion for repurchase in respect of types of increase could be determined by general decisions. Such a system would eliminate two principles of the repurchase system to which the drafters of Article V, Section 7(b) attached importance: pari passu use by a member of its own reserves in the year in which it makes a purchase that increases the Fund's holdings of its currency above 75 per cent of quota, and sharing with the Fund increases in reserves until the Fund's holdings have been reduced to 75 per cent of quota. The principles were designed to support the concept of need and the revolving character of the Fund's resources, but a revised system of repurchase could serve the same purposes. The two limits of 75 per cent of quota would continue to be applied.

2. Monetary Reserves

A new system of repurchase need not rest on the complex provisions of Article XIX on the calculation of monetary reserves. The

in conjunction with the application of the proposed provisions on the use of currencies in transactions

Fund would have to operate with common concepts of reserves, but the present concepts could be improved.

Under the present Articles, the proportion of a member's monetary reserves to quota determines to what extent the member may pay charges in its own currency. If this right were maintained, it too could be linked to a revised concept of reserves.

The proportion of a member's monetary reserves to its quota is also a criterion for the possible reduction in the normal 25 per cent payment in gold on an increase in quota. The Fund could be authorized to determine the proportion of an increased subscription to be paid in special drawing rights on the occasion of each general review of quotas or in connection with the adjustment of an individual quota. The difference between 25 per cent of the increase and the proportion payable in special drawing rights could be made subject to repurchase. Similar provisions might be adopted with respect to original subscriptions.

3. Media of repurchase

It would be desirable to eliminate the complications of the distribution of repurchase obligations among types of monetary reserves under the present system, even if the system in Article V, Section 7(b) were not replaced. Members might be authorized to use gold or SDRs at their discretion, or currencies acceptable to the Fund. The acceptability of currencies would be determined in practice by the level of the Fund's holdings and the criteria for the use of currencies in repurchases. Currencies might be acceptable even though they were not convertible within the meaning of the Articles.

V. Charges on transactions in gold tranche

In Buff Statement 73/130, the Managing Director suggested that "an interest charge" might be levied on holdings of currency in the basic gold tranche (i.e., on holdings in the range of 75 per cent to 100 per cent of quota) at a rate equal to the rate of remuneration.

VI. Investment of Reserves

It would be possible to confer upon the Fund a power to invest its assets equivalent in amount to its reserves for the purpose of meeting of present and prospective deficits.

Mr. Polak.

Mr. Walter O. Habermeier

March 28, 1974

Joseph Gold

Possible Changes in the General Account

Thank you for your note of March 27, 1974. I have taken account of all your comments except the last one on the first page. The word "allocated" is used already for a different purpose, and in any event would not clearly make the point you are interested in. I suggest that the point might simply be raised in the discussion of the paper.

cc: Mr. Polak

MEMORANDUM

TO: Mr. Gold March 21, 1974

FROM: J. J. Polak

SUBJECT: Changes in the General Account

A paragraph along the following lines might be inserted:

"This approach might be carried one step further if the General Account were authorized, under appropriate safeguards, to create SDRs for use in its transactions in lieu of the use of currencies, with provision for cancellation of SDRs received in repurchases."

The safeguards I have in mind would be two-fold:

(a) An understanding that currency holdings would not be reduced below 75 per cent of quota.

(b) For net use beyond a specified proportion of quotas, selected in such a way as to provide a reasonable demarcation point between the use of SDRs as a substitute for the Fund's holdings of currencies and as a substitute for replenishment, the requirement of a special majority vote, perhaps by the Council.

Office Memorandum

Reform Gen Arcl

TO : Mr. Polak

DATE: March 5, 1974

FROM : John S. Smith JSm

SUBJECT : Maintenance of the Gold Value of the Fund's Assets

Under Executive Directors' Decision No. 321-(54/32) as amended, "The Fund does not intend to ... /adjust/ its holdings of members' currencies having fluctuating rates when there is no practical interest for the Fund or members to do so." This decision remained in effect until May 8, 1972, when it was terminated by Decision No. 3637-(72/41) G/S.

The practical effects of adjustments arise in connection with changes in Fund's holdings through transactions or when the currency enters into the calculation of monetary reserves. (See Joseph Gold, "Maintenance of the Gold Value of the Fund's Assets," IMF Pamphlet No. 6, Second Edition, 1971, pp. 21-23.)

If references to monetary reserves were eliminated from the Articles by amendment, if Fund holdings of all currencies were raised to 75 per cent of quota, and if all drawings and repurchases in the General Account were thereafter carried out in SDRs, the maintenance of gold value provisions would apparently be without practical effects. Under those conditions, the Fund would apparently be justified in deciding, in line with the decision quoted above, that no adjustments need be carried out to maintain the gold value of the Fund's assets.

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EBS/74/53

CONFIDENTIAL

February 26, 1974

To: Members of the Executive Board

From: The Secretary

Subject: The Prospective Liquidity of the General Account

The attached paper on the prospective liquidity of the General Account has been prepared by the staff in response to requests by Executive Directors.

This subject has been tentatively scheduled for discussion on Monday, March 18, 1974.

Att: (1)

INTERNATIONAL MONETARY FUND

The Prospective Liquidity of the General Account

Prepared by the Treasurer's Department

(In consultations with Legal, Research, and Area Departments)

Approved by W. O. Habermeier

February 25, 1974

Introduction

This paper has been prepared in response to requests by Executive Directors for a review of the liquidity of the General Account in the light of the probability that the extensive shifts that have or that are expected to occur in the distribution of balance of payments surpluses and deficits among members will result in a significant increase in the use of the facilities of the General Account. In addition to use of existing reserve positions in the Fund and the credit tranches it has also been assumed that an "oil facility" will be in existence and will substantially increase purchases in the General Account. The illustrative calculations discussed in Section II envisage the use of the currencies of a wider range of members than has hitherto been used in purchases, thus coming closer to the principles of designation used in the Special Drawing Account. It should also be borne in mind that the amounts of borrowing that are implied by these principles of distribution may require some reconsideration of the existing policies and practices of the Fund as regards replenishment.

Section I of this paper discusses the general considerations that will affect the liquidity of the General Account: Section II considers how the Fund might finance purchases in the range of SDR 5-9 billion.

I. General Considerations Affecting the Liquidity of the General Account

1. The assessment of the liquidity of the General Account is essentially concerned with the extent to which members can purchase currencies from the Fund and are prepared to exercise their rights to do so; and the capacity of the Fund to meet these demands by the use of its existing currency holdings, or through sales of gold or the use of SDRs held by the General Account, or through the borrowing of currencies. The demands that can be made on the General Account and its ability to meet these demands will be largely determined by the

distribution of surpluses and deficits among the Fund's membership, the willingness of members in relatively weak positions to use the Fund's resources, the ability of the Fund to use its existing holdings of the currencies of members in relatively strong external positions, and possibly also whether these members would lend to the Fund.

2. The extent to which members experiencing deficits will decide to use the resources of the General Account will depend on whether they will be prepared to run balance of payments deficits, and the availability and cost of alternative forms of finance. In view of the considerable uncertainties involved, no attempt has been made in this paper to forecast the probable use of the General Account over the coming year. The illustrative calculations discussed in Section II set out possible distributions of purchases totaling SDR 5 billion and SDR 9 billion.

3. The ability of the General Account to meet the demands that arise will depend, in the first instance, on the availability of the Fund's holdings of the currencies of those members that are not making, or are not moving rapidly to a position where they might make, demands on the Fund's resources. As in the Special Drawing Account, these members are, of course, likely to be those that are in a relatively strong balance of payments and reserve position, but could also include some members in moderate deficit. The effect of the sale of a member's currency is generally to reduce its holdings of reserve currencies accompanied either by a reduction of its use in the credit tranches if its currency is held in excess of quota, or by the acquisition of a gold tranche position. It has, in fact, been the policy of the Fund to sell the currencies of members in a relatively strong balance of payments and reserve position, and thus the first point to consider in assessing the ability of the Fund to meet demands on the General Account is the size and usability of the Fund's holdings of the currencies of such members.

4. The Fund's ability to use the currencies of members with relatively strong external positions may, in practice, be limited by two technical considerations. The first concerns the conversion of balances of currency received in purchases. Members have generally collaborated in the conversion of balances of their currency purchased from the Fund into their main reserve currency for the benefit of the member making the purchase. The need for such conversion has meant that, with the exception of sales of U.S. dollars, the Fund has sold only currencies whose issuers would convert the balances received by purchasing members. In the Special Drawing Account, the main reason why the list of participants subject to designation is more extensive than the list of members whose currencies are used in the General Account is that participants are obliged to provide currencies convertible in fact and thus no question arises of conversion by designated participants. The second technical consideration concerns the objections that have been raised in the past to sales of currencies

with Article XIV status. One objection has been that as these currencies cannot be used in repurchases the creditor positions created by their sale could be reversed only by drawings by their issuers or through the replenishment of the Fund's holdings by sales of gold or SDRs. This is somewhat less important now in view of the full automaticity of drawings in the gold tranche and the abolition of the service charge on such drawings. Nevertheless, sales of Article XIV currencies result in greater net use of Article VIII currencies in repurchases and this could conceivably lead to an elimination of creditor positions in these currencies, and consequently, repurchases would have to be made in gold or SDRs. In this connection, it will be recalled that the Fund has not sold Article XIV currencies since 1971 because they could not be accepted in repurchase. It is for consideration whether the Fund should deem balances of Article XIV currencies acceptable in repurchases. A memorandum on the legal aspects of this action will be presented to the Executive Directors.

5. Assuming, however, that all members whose currency the Fund would wish to sell will cooperate by converting, at exchange rates that provide "equal value", balances sold by the Fund, the next question concerns the distribution of the amounts of currencies to be sold among individual members in accordance with whatever method of allocation the Fund applies. In the illustrative calculations discussed below, the amounts have been calculated in proportion to members' gold and foreign exchange holdings, which has been the principle of allocation used in the recent past. Since the Fund's holdings of members' currencies are unlikely to reflect their relative levels of reserves, this method of allocation will probably assign to certain members amounts well in excess of the Fund's holdings of their currencies. This will tend to be the case if surpluses are concentrated on members with relatively small quotas at a time when a large number of members are experiencing substantial deficits. Nevertheless, the Fund's existing holdings of usable currencies are not the ultimate limiting factor for the liquidity of the General Account since the ability of the Fund to borrow enables members that are willing to do so to make resources available through the General Account mechanism in amounts in excess of the Fund's holdings of their currencies. Since both the use of the Fund's existing holdings of currency and, <u>a fortiori</u>, the Fund's ability to borrow from a member are likely to be strongly influenced by the willingness of the member concerned to acquire claims on the Fund, the attractiveness of these claims in terms of yield, security, and usability in the case of balance of payments need, will be a significant factor in the liquidity of the General Account.1/

1/ The question of the terms and conditions of borrowing are dealt with in a forthcoming staff paper.

II. Illustrative Calculations of the Liquidity of the General Account

1. Currencies Considered Usable in Transactions

In drawing up the usual quarterly currency budget no estimates are made of prospective balance of payments or reserve changes when selecting the currencies to be used in Fund transactions. Recent changes in members' positions are normally reflected in the distribution of currencies to be used in purchases and repurchases, with greater emphasis being put on repurchases for countries whose external positions might be weakening somewhat. Furthermore, if a member's position weakens within the currency budget period, the Fund would not normally continue to sell that currency. In any event, the quarterly budgets provide opportunities for relatively frequent review of members' external positions. In the present exercise the selection of currencies that might be regarded as usable over the short to medium run involves making a difficult judgement of members' balance of payments and reserves position over, say, a period of twelve to eighteen months. In present circumstances it is particularly difficult in view of rapidly changing external positions arising from the impact of higher oil prices on members' current account positions, on capital flows and thus on changes of external reserves.

As a starting point the countries whose currencies are presently regarded as sufficiently strong to be used in Fund transactions in the General Account and those which were considered sufficiently strong (except for Israel) for designation in connection with the First Designation Plan for 1974 have been considered for inclusion in the illustrative Appendix Tables. In addition, as a further means of improving the liquidity of the General Account, all major oil exporting members have been included.1/

However, except for the major oil exporting members, those members with reserves or quotas of less than the equivalent of SDR 175 million, or whose reserves amounted to less than 150 per cent of quota, have been excluded. These cut off points eliminate countries with absolutely small reserves and which could not, on that account, be expected to finance any measurable expansion in the volume of Fund transactions. Furthermore, although some of those members have recently benefitted from the boom in commodity prices and are in the process of reducing their international short-term indebtedness, they could experience a weakening in their external positions as a result of sharply higher oil prices and of a possible slowdown in the growth of the world economy. Some of the smaller international surplus countries that have not been included in the currency budget such as Lebanon,

1/ It will be recalled that of the major oil exporting countries, Kuwait is included in the present currency budget and Indonesia was considered for inclusion in the designation plan.

Portugal and Singapore, have not been added to the list of potentially usable currencies, but could well be considered if it were deemed appropriate to maximize the list of potentially usable currencies.

2. Prospective Balance of Payments and Reserve Positions

It is acknowledged, of course, that present balance of payments and reserve positions are not necessarily good indicators of prospective strength over the period relevant for the practical purpose of determining the liquidity of the Fund, i.e., the volume of currencies that could be used in Fund transactions, and in view of the large changes in balance of payments positions that may result because of the oil price increases, the difficulty of forecasting members' balance of payments and reserves is even more hazardous than usual. Nevertheless, some indication of possible future reserve and balance of payments positions is needed. Regarding the United States, it has been assumed that gross reserves will remain unchanged from their present levels because the gross reserve position of the United States will not necessarily respond significantly to changes in the balance of payments in present circumstances. For other countries with currencies judged strong enough to be used in Fund transactions in both the General and Special Drawing Accounts, their holdings of gold and foreign exchange reserves have been adjusted by the incremental receipts of the major oil exporting countries and by the incremental payments of the net oil importing countries on the basis of the computed increase in oil import costs as shown in EBS/74/145. This latter measure might be regarded as an extreme assumption of prospective weakness as it takes no account of compensating changes in the current or capital accounts of the balance of payments.

As a possible correction to the size of this adjustment, it has been assumed for the purposes of this paper that countries would not permit their reserves to fall by more than 25 per cent from their present levels.1/ The countries affected by this limitation are Japan, the Netherlands, Belgium, Sweden and Denmark, but it should not be implied that reserves would in fact develop in this manner. Consequently, the currencies of these countries have been included in the lists of usable currencies. However, it is also useful to assume that some of the Fund's creditors would not continue to be sufficiently strong to have their currencies sold, in order to assess the likely impact of such exclusion on the Fund's liquidity and in particular to examine the effects on the use of Fund's holdings of currencies and borrowings on the remaining members. The exclusion of any major creditor would, of course, alter the distribution of the use of currencies in sales and the need for replenishment among both individual countries and groups of countries. In making the estimates in the following pages, it has been assumed that Fund creditor members with quotas of about SDR 1.8 billion would be excluded from the list of usable currencies. In Table 1, the exclusion of Japan, Sweden and

1/ In SM/74/41 it is assumed "that a member would be ready to use 20 per cent of its reserves (as of the end of 1973) to meet the oil impact during the course of 1974".

Denmark is shown in parentheses to show the effect on aggregate positions of the use of Fund holdings of currencies and borrowing. Similar results would be obtained if, for example, Belgium, the Netherlands, Denmark and Sweden were excluded.

With regard to the oil exporting countries, it is assumed that their official external reserves would reflect fully the rise in their current account surpluses arising from higher oil prices, say an increase in their surplus of around the equivalent of SDR 50 billion. This is, of course, unlikely to be the case, especially as some proportion of their current receipts would be offset by higher imports, debt repayment, and capital outflows. It is, however, difficult to redistribute the potential receipts of these countries without further information on the evolution of their current account balances--for example, an increase of 30 per cent in their current payments would not importantly change the order of magnitude of their surpluses--or on the pattern of their international investments. Of course, any marked decrease in the overall surpluses of the oil exporting countries would be reflected in reduced overall deficits of the remaining countries and thus in general ease their financing problems and perhaps lessen demands on the Fund. In this regard, account would be taken of the evolving balance of payments and reserve positions of these and other members in connection with further reviews of the Fund's liquidity and particularly on the occasion of consultations with Executive Directors on the currency budgets which will continue to be presented from time to time. It is emphasized that the present paper is not a currency budget but an explanation of the factors that broadly determine the liquidity position of the General Account.

3. Hypothetical Use of the Fund's Resources

For purposes of this paper, prospective use of the Fund's resources has been put at between the equivalent of SDR 5 billion and SDR 9 billion. The lower figure would be reached if (a) 50 per cent of the present level of reserve positions in the Fund would be drawn upon (approximately SDR 3.5 billion); (b) the balance of outstanding stand-by arrangements would be used (approximately SDR 250 million); and (c) approximately SDR 1.3 billion would be drawn by the developing countries under the Oil Facility (SM/74/41, page 5). The upper figure of SDR 9 billion of drawings would be reached on the assumption that some major industrial countries would not only use their existing gold tranches but also draw in the credit tranches and under the oil facility. It should be stressed that these figures are only broad indications of possible magnitudes and the use of two figures simply illustrates how the proportions between the use of Fund holdings of currency and borrowing would change, adopting the same principle of allocating currencies in proportion to members' gold and foreign exchange reserves. Insofar as the impact of sizeable drawings on Fund liquidity is concerned much depends on which members draw on the Fund, particularly if a member whose currency was regarded as usable in drawings itself decided to use the Fund's resources.

4. Illustrative Sales of Currencies and Borrowing by the Fund

Potentially usable currencies have been grouped into two tables. Appendix Table I lists only the currencies of the non-oil exporting members having Article VIII status and which also appear on the present currency budget or were considered as sufficiently strong to be included in the current designation plan. All of the currencies listed in Appendix Table I have previously been used in Fund transactions. Appendix Table II includes the currencies listed in Table I but is extended to include the major oil exporting countries and also some non-oil exporting countries with Article XIV status which were considered as sufficiently strong to be included in the current designation plan. The Fund has previously sold four of these additional currencies.[1/]

The total number of countries listed in Appendix Table II is 32; the Fund has previously used the currencies of 19 of them in transactions; 12 of the 32 members have at present Article XIV status. The Fund's holdings of all currencies previously used in transactions amount to the equivalent of SDR 11.9 billion; holdings of other prospectively usable currencies amount to SDR 1.2 billion. Of the total of SDR 13.1 billion of usable currencies, Article XIV currencies account for SDR 1.9 billion. As noted earlier, it would be necessary to make appropriate arrangements regarding those currencies that the Fund has not previously used in transactions, including arrangements for conversion.

In both tables drawings totalling the equivalent of SDR 5 billion and SDR 9 billion have been allocated strictly in proportion to adjusted gold and foreign exchange reserves, with the constraint that the Fund would not reduce its holdings below 5 per cent of the quota level. Once this point is reached, it is assumed the Fund would need to replenish its holdings of currency, which it is suggested would in present circumstances be by borrowing rather than by the sale of gold or the use of SDRs. In all cases it has been assumed that the Fund would use some of its existing currency holdings, in proportion to the gold and foreign exchange reserves of the issuing members, before borrowing is proposed.

It might be noted that the allocation of currencies to be used in drawings strictly in proportion to gold and foreign exchange reserves might be somewhat restrictive in present circumstances. For example, more emphasis could be given to actual currency holdings while still remaining fairly close to allocating currencies in proportion to reserves. Another alternative would be to attempt to harmonize countries' total reserve positions in the Fund (i.e., including any liquid loan claims on the Fund arising from Fund borrowing) in relation to their gold and foreign exchange reserves. This principle

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1/ The currencies of Kuwait, Venezuela, Brazil and Spain.

of allocation, which has been used in the past, particularly between 1966 and the summer of 1971, would rather quickly harmonize countries' reserve positions in the Fund to their gold and foreign exchange reserves. It would put more emphasis on the use of holdings of the currencies, including through replenishment by borrowing, of those members whose reserve positions in the Fund are small in relation to their present and prospective gold and foreign exchange reserves. In the circumstances contemplated in this paper, this would mean greater use of currencies of the major oil exporting countries (and also those currencies which have not been extensively used in Fund transactions) than shown in Appendix Table II.1/ It would also mean that the currencies of those members with relatively high ratios of reserve positions in the Fund to gold and foreign exchange reserves would be given lesser emphasis. The Executive Directors have asked the staff to review the principles of the allocation of currencies used in the currency budget and give consideration to emphasizing the use of currencies of members with relatively low holdings of primary reserves to total official reserves. The merits of these different approaches can be discussed in connection with that review.

5. Use of U.S. Dollars

As noted earlier, special emphasis could be given to the sale of U.S. dollars in present circumstances. Such sales could be determined either by using a convention as was done in the present currency budget or, in view of the relatively large amounts involved, on some quantitative indicator such as in some proportion to any fall in the United States official liabilities to foreigners. In any event, greater than proportionate use of some currencies would compensate in part for a possible inability to use some potentially usable currencies either because of their Article XIV status or because of the unwillingness of issuing members to have their currencies used by the Fund or because some of the countries would themselves need to draw. Furthermore, if it was thought to be not desirable or feasible to replenish certain currencies by borrowing, then greater use of other currencies, in particular U.S. dollars, from the Fund's holdings would be necessary. For example, it is conceivable that borrowing of the amount calculated in column 5 of Appendix Table I could be avoided by using from holdings the equivalent of SDR 2.3 billion of U.S. dollars rather than SDR 852 million, and borrowing could be substantially reduced below the figures in column 7 of Appendix Table I by even greater use of U.S. dollars, and possibly some other currencies (e.g., Canadian dollars) from existing holdings. Such flexibility would provide a significant and useful leeway for the Fund's liquidity in the absence of replenishment.

1/ The average ratio of RFP to GFE of the major oil exporting countries at the present is around 3 per cent compared to an average ratio of around 6 per cent for those members included in the present currency budget.

6. Results of the Illustrative Calculations in Appendix Tables I and II

Table 1 below is a summary of the main results of the Appendix Tables and also shows the aggregate effects on the Fund's liquidity of excluding the currencies of three creditor countries noted on page 5 above.

Table 1. Summary of Illustrative Tables on the Financing of Drawings on the General Account

(In millions of SDR equivalents)

	Quota	Fund currency holdings less 5 per cent of quota	Financing of drawings of SDR 5 billion		Financing of drawings of SDR 9 billion	
			Fund holdings	Fund borrowings	Fund holdings	Fund borrowings
Use of currencies shown in:						
Appendix Table I	14,966	10,300	3,638	1,362	5,275	3,725
(excluding Japan, Sweden, and Denmark)	(13,181)	(9,343)	(3,283)	(1,717)	(4,748)	(4,252)
Appendix Table II	17,641	12,249	3,167	1,833	4,726	4,274
(excluding Japan, Sweden, and Denmark)	(15,856)	(11,292)	(2,948)	(2,052)	(4,277)	(4,723)

From the preceding discussion and in the light of results presented in the Appendix Tables, four main conclusions might be drawn:

1. On almost any reasonable assumption regarding the size of the list of usable currencies, the Fund might be regarded as relatively liquid at the present time and could, without undue distortion of the guidelines currently followed in executing the Fund's currency policy, finance net drawings up to the equivalent of about SDR 5 billion. Such drawings could be accommodated without an urgent need to replenish its currency holdings.

2. An extension of the list of usable currencies would be desirable because it would increase the Fund's liquidity. The Fund's holdings of the currencies of the major oil exporting members are, however, small in relation to their external reserves. Extensive use of their currencies would involve substantial borrowing from them because their quotas are small compared with their adjusted external reserves and the present allocative principle of using currencies in drawings would rather quickly exhaust the Fund's holdings of their currencies.

3. The amounts which might be borrowed from the industrial countries are relatively small in the circumstances considered in this paper. The aggregate amounts which might be borrowed, largely deutsche mark, would be of an order of magnitude that, through the use of a different allocative principle and especially one that would emphasize the use of U.S. dollars, could substantially reduce the need to replenish the Fund's currency holdings by borrowing, and in some instances to an extent that replenishment by borrowing might not be necessary.

4. Even on the assumption of comparatively large use of the Fund's resources and including the use of the currencies of the major oil exporting countries, the proportion of their external reserves that most members would take up in the form of Fund positions and claims on the Fund would not, in most cases, exceed 10 per cent of their reserves. By historical standards, this ratio cannot be regarded as high.

Table I. Allocation of Currencies From Fund's Holdings and From Borrowings to Meet Drawings of SDR 5 billion and SDR 9 billion (Short List)1/

(In millions of SDR equivalents)

	Quota (1)	Adjusted gold and foreign exchange reserves (2)	Fund currency holdings less 5 per cent of quota (3)	Allocation of SDR 5 billion purchases in proportion to col. (2)		Allocation of SDR 9 billion purchases in proportion to col. (2)	
				Total allocation (4)	Borrowings from member (5)	Total allocation (6)	Borrowings from member (7)
Article VIII members:							
United States	6,700	9,708 2/	5,793	841	--	1,514	--
Germany	1,600	19,694	400	1,707	1,307	3,072	2,672
Japan	1,200	6,481 3/	624	562	--	1,011	387
Canada	1,100	4,105	766	356	--	640	--
Netherlands	700	3,191 3/	427	276	--	498	71
Australia	665	4,320	464	374	--	674	210
Belgium	650	2,135 3/	150	185	35	333	183
Argentina	440	829	592	72	--	129	--
Mexico	370	703	254	61	--	110	--
Sweden	325	1,442 3/	224	125	--	225	1
Austria	270	1,768	133	153	20	276	143
Ireland	260	609	69	53	--	95	26
Denmark	260	616 3/	109	53	--	96	--
Norway	240	1,082	165	94	--	169	4
Malaysia	186	1,012	130	88	--	158	28
Total	14,966	57,695	10,300	5,000	1,362	9,000	3,725

1/ This table assumes the usability of all Article VIII currencies included for sales in the present currency budget and considered sufficiently strong for inclusion in the present designation plan, but excludes all major oil exporting countries whether or not included in the currency budget or designation plan.

2/ Gold and foreign exchange holdings assumed unchanged from present levels.

3/ Assumed that gold and foreign exchange holdings would not fall below 75 per cent of present levels.

Table II. Allocation of Currencies from Fund's Holdings and from Borrowings to Meet Drawings of SDR 5 billion and SDR 9 billion (Long List)[1/]

(In millions of SDR equivalents)

	Quota (1)	Adjusted gold and foreign exchange reserves (2)	Fund currency holdings less 5 per cent of quota (3)	Allocation of SDR 5 billion purchases in proportion to col.(2) Total allocation (4)	Borrowings from member (5)	Allocation of SDR 9 billion purchases in proportion to col.(2) Total allocation (6)	Borrowings from member (7)
Oil exporting Fund members							
Article VIII members:							
*Saudi Arabia	134	15,253	93	605	512	1,089	996
Kuwait	65	5,182	42	206	164	370	328
*Qatar	20	1,143	14	45	31	82	68
*United Arab Emirates	15	--2/	--2/	--	--	--	--
*Bahrain	10	225	7	9	2	16	9
	244	21,803	156	865	709	1,557	1,401
Article XIV members:							
Venezuela	330	7,200	202	286	84	514	312
*Indonesia	260	2,441	247	97	--	174	--
*Iran	192	10,580	134	420	286	755	621
*Nigeria	135	3,938	95	156	61	281	186
*Algeria	130	2,839	91	113	22	203	112
*Iraq	109	4,063	76	161	85	290	214
*Libyan Arab Rep.	24	4,903	16	194	178	350	334
*Oman	7	695	--	27	27	50	50
	1,187	36,659	861	1,454	743	2,617	1,829
Total	1,431	58,462	1,018	2,319	1,452	4,174	3,230
Other Fund members							
Article VIII members:							
United States	6,700	9,708 3/	5,793	385	--	693	--
Germany	1,600	19,694 4/	400	781	381	1,406	1,006
Japan	1,200	6,481 4/	624	257	--	463	--
Canada	1,100	4,105 4/	766	163	--	293	--
Netherlands	700	3,191 4/	427	127	--	228	--
Australia	665	4,320	464	171	--	308	--
Belgium	650	2,135 4/	150	85	--	153	3
Argentina	440	829	592	33	--	59	--
Mexico	370	703 4/	254	28	--	50	--
Sweden	325	1,442 4/	224	57	--	103	--
Austria	270	1,768	133	70	--	126	--
Ireland	260	609 4/	69	24	--	44	--
Denmark	260	616 4/	109	24	--	44	--
Norway	240	1,082	165	43	--	77	--
Malaysia	186	1,012	130	40	--	72	--
	14,966	57,695	10,300	2,288	381	4,119	1,009
Article XIV members:							
Brazil	440	4,252	301	169	--	304	3
Spain	395	4,250	271	169	--	303	32
*Yugoslavia	207	998	218	39	--	71	--
*New Zealand	202	402	141	16	--	29	--
	1,244	9,902	931	393	--	707	35
Total	16,210	67,597	11,231	2,681	381	4,826	1,044
Grand Total	17,641	126,059	12,249	5,000	1,833	9,000	4,274

*Currency not previously used by Fund in transactions.

1/ This table assumes the usability of the currencies listed on Appendix Table I and the currencies of the major oil exporting countries and also the currencies of some non-oil exporting members with Article XIV status which were considered as sufficiently strong to be included in the current designation plan.

2/ Reserve data not available. Surplus in 1974 estimated by Fund Middle Eastern Department at SDR 2.4 billion. Member has also not yet paid its local currency subscription.

3/ Gold and foreign exchange holdings assumed unchanged from present levels.

4/ Assumed that gold and foreign exchange holdings would not fall below 75 per cent of present levels.

Office Memorandum

TO : Mr. Smith

DATE: November 23, 1973

FROM : John Williamson JW

SUBJECT : Accounts and Balance Sheet of a Restructured Fund

Gen Acc

You may like to note that discussions on reform are seriously considering the introduction of at least one further Account in the Fund. This would be a "Special Account," as proposed by the French in C/XX/DEP/Doc/73/77, designed to hold reserves of countries in excess of a specified maximum level.

I suppose there is also the possibility that the introduction of an Extended Fund Facility would involve the introduction of a separate Account, and if the link were to be introduced along Type B lines that Fund assets would come to include the bonds of DFIs.

cc: Mr. Polak
Mr. Fleming
Mr. Schwartz

Office Memorandum

TO : Mr. Polak

DATE: November 20, 1973

FROM : John S. Smith

SUBJECT : Accounts and Balance Sheet of a Restructured Fund

The strong similarity between the Fund's General Account and Special Drawing Account has been pointed out in SM/73/128. The similarity would be increased if the General Account were restructured along the lines indicated in that paper. Nevertheless, it does not follow that the retention of separate accounts would be contrived or arbitrary. The flows into and out of the accounts are quite different in significant respects. Balance sheet accounts may well be established on the basis of the types of flows into and out of them; they need not always refer to a particular kind of asset or liability.

As a concrete case in point, the setup of the IMF Staff Retirement Fund can be cited. That Fund is maintained in three accounts--Participants', Accumulation, and Retirement Reserve--which are defined in terms of the items to be credited and charged to each. The three accounts figure separately on the liabilities side of the Retirement Fund's balance sheet, together with items for reserve against investment and accounts payable. On the assets side of the balance sheet, no distinction by account is made, the items shown being cash, investments, and accrued interest.

A similar procedure can readily be envisaged for the reformed and restructured Fund itself. The General Account could be replaced by a Credit Account, whose liabilities would be the SDRs to be created when the Fund extends credit to members. The liabilities would also include any SDRs that might be created in repayment of members' subscriptions, if it were decided that the Fund should retain part or all of the present General Account's holdings of gold and SDRs, rather than using them to repay Reserve Positions in the Fund. In addition, it could be decided that the Credit Account's liability side should include the Fund's General and Special Reserves, although it would perhaps be more logical to establish a separate account or accounts for those items.

The Special Drawing Account could be retained, perhaps under the title of an Allocations Account. From the Fund's standpoint, this account has no assets or liabilities, since the Fund is neither a recipient of SDRs by allocation nor a debtor with respect to those SDRs which are allocated to participants. Nevertheless, a contra entry for this account could be made on both sides of the balance sheet.

Finally, a Substitution Account would be needed to show the claims on reserve centers that were turned over to the Fund by members, in exchange for SDR balances held with the Fund.

The assets side of the Fund's overall balance sheet would in effect be a consolidation of the assets side of each of the individual accounts. A sample format for such a balance sheet is attached. In addition, schedules for each account could be presented to support the overall statement, giving balance sheet data and information on sources and uses of funds.

Attachment

cc: Mr. Fleming
Mr. Schwartz
Mr. Williamson

IMF Balance Sheet
as at April 30, 19__
Amounts expressed in special drawing rights

Assets	Liabilities, SDR Allocations, and Reserves
Gold with Depositories	Credit Account
SDR Holdings	Substitution Account
Credits to Members	Allocations Account (Contra)
Substitution Claims on Reserve Centers	General and Special Reserves
SDR Allocations (Contra)	Other Liabilities
Investment of Reserves	
Other Assets	
Total Assets	Total Liabilities, SDR Allocations, and Reserves

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

November 23, 1973 - 73/125

RESTRUCTURING THE GENERAL ACCOUNT OF THE FUND

Executive Board Seminar, Friday, November 16, 1973

Comments by Mr. Palamenghi-Crispi

The staff's exploratory paper (SM/73/128) before us today is an ingenious and stimulating approach to the restructuring of the General Account. The suggested approach would not only greatly simplify the operations of the Fund but would also emphasize the pivotal role of SDRs in the reformed system, as it would become the only Fund-generated asset.

Obviously the adoption of such a new structure will depend, as the staff rightly points out on page 1, "on the extent to which it may prove necessary to overhaul the Articles of Agreement." If, as I think, the monetary reform will require an extensive redraft of the Articles, we should not miss this historic opportunity to reform the General Account as well; there would be little justification in preserving its present cumbersome structure, which was mostly the product of the climate prevailing at Bretton Woods. But I think that there is more in the proposed approach than the desire to simplify and streamline the General Account. Clearly a General Account based on the creation and cancellation of SDRs, while preserving the important aspects of conditionality and the short-term nature of Fund credit, would alleviate the liquidity problems that obliged the Fund to implement the General Arrangements to Borrow and to resort to bilateral borrowing. The problem of the liquidity of Fund assets has not been felt for some time now, but we cannot exclude the possibility of circumstances arising in the future in which liquidity constraints might hamper the smooth functioning of the Fund. And it is well known that an increase in quotas can alleviate this problem only to a limited extent.

Some argue that in the absence of the present built-in constraints there could be an undue expansion of credit by the General Account. But this is not necessarily the case as the creation of international liquidity by the General Account, whether "new look" or "old look" is always taken into consideration in determining the volume of liquidity to be created through SDR allocations. I do not see therefore any great need for special constraints on the overall volume of loans by the General Account. All we would continue to need are proper lending policies, which, I might add, many feel are currently too conservative, witness the very low volume of Fund credit outstanding over the last few years (i.e. SDR 1 billion, as compared with over SDR 150 billion of total reserves).

A restructured General Account would not only make the Fund much more efficient and allow for an infinitely simpler system of Fund accounting, but would also eliminate almost all the problems that have arisen in connection with currency budgets, replenishment, mitigation, maintenance of value, not to mention the problems of the currency composition of repurchases under Article V, Section 7(b).

This approach raises serious problems as regards interest payments by the General Account. At present, only net creditor positions are remunerated, not basic gold tranches. If the General Account were to create SDRs to absorb RPFs, it would be paying interest--via the Substitution Account--not just on the super gold tranches but also on basic gold tranches. The staff suggests avoiding this problem by having interest paid on members' holding of SDRs minus 25 per cent of their quota (i.e. the basic gold tranche). Of course, this technique would run into problems should a country run out of SDRs. I presume the staff suggested it as a way to increase substantially the Fund's income. If I have fully understood the obscure first paragraph on page 11, the Fund's extra income would result from placing a charge on "gold tranche" drawings. I have reservations as to the desirability of such an approach.

There is another approach which I should like the staff to examine. The General Account would create SDRs only to the extent that its holdings of gold and SDRs were insufficient to cancel reserve positions in the Fund. A numerical example may be helpful in this connection. At the end of September 5, the General Account's holdings of gold and SDRs stood at SDR 5.9 billion, and would thus have been insufficient to cancel completely all reserve positions in the Fund, which amounted to SDR 6.2 billion. It would therefore be necessary for the Substitution Account to issue SDR 300 million in exchange for the remaining super gold tranche positions. The new style balance sheet of the General Account would now be:

Liabilities	Assets
SDR 0.3 billion (to Substitution Account)	SDR 1.0 billion (Loans)
SDR 0.7 billion (Reserves)	
SDR 1.0 billion	SDR 1.0 billion

That is to say, the General Account's assets would consist only of SDR loans to its members, while its liabilities would be the SDRs issued to it to cancel RPFs and the Fund's reserves.

What would happen to the General Account's income? It would increase. Total RPFs of SDR 6.2 billion include SDR 1.7 billion of super gold tranches on which the Fund pays interest of 1.5 per cent. Under this approach, it would pay the same interest on the SDR 300 million the Substitution Account had issued to the General Account; moreover, the General Account would cease earning interest on the SDR 500 million it would have transferred to members. Interest payments on net credit positions, i.e. remuneration, would thus be cut in half, a net saving of some SDR 14 million. It should be underscored that this saying would not result from an increase in payments by debtors to the General account.

Under neither of these approaches--the staff's and mine--would present debtor countries reacquire any part of their gold subscriptions. This might be considered somewhat inequitable given that the market price of the metal is more than twice its official price. One remedy to this could consist in selling gold to all members in proportion to their gold subscriptions. Creditor countries would buy gold against their RPFs, while debtor countries would buy gold against SDRs. The General Account would then use the SDRs obtained from debtor countries to acquire RPFs of creditor countries. The balance sheet of the technique I have proposed would of course not be affected if the General Account used its gold holdings in this way.

I should now like, Mr. Chairman, to comment briefly on two additional points: 1. Remuneration of net creditor positions is now at the same rate as SDRs, a very low 1.5 per cent. What would happen if the rate of interest on SDRs were raised substantially, say, to 5 per cent? As the Executive Directors' Reform Report argued "....large differences between interest rates payable on the two Fund-created assets would give rise to certain difficulties...Thus the remuneration paid on net creditor positions might have to rise to some extent along with that on SDR" (page 55). Therefore, if the structure of the General Account remained unchanged and the rate of interest on SDRs were raised substantially, there would have to be a large increase in remuneration and, almost certainly, in charges. If we switched to an SDR-based General Account, and the rate of interest on SDRs were raised, there could be serious problems with the staff approach which creates large amounts of SDRs, unless we used the proceeds of sales of the General Account's gold to cover the interest shortfall. With the approach I have suggested, this problem would not be a very serious one since there would be only a very small creation of SDRs to cancel reserve positions in the Fund.

2. On page 11, point 4, the staff says that in an SDR General Account members would no longer be able to pay charges in their own currency. This is certainly true, but they could pay charges by simply increasing their outstanding SDR balance, which is of course similar to what happens when they use their own currency.

In conclusion, Mr. Chairman, the international community has already decided that the SDR should be the numeraire and the main reserve asset of the reformed system. Careful consideration should now also be given to making the SDR the only asset of the General Account. I think that the bold approach suggested by the staff deserves further study and I would be grateful for a second, more detailed draft. I do not think that furthering the study of this approach is in any way incompatible with the more moderate proposal of undertaking a thorough review of the provisions regarding the General Account in the Articles and the Decisions of the Executive Board. In fact the two approaches might well coexist and I would expect that the proposed review would provide useful material for consideration, irrespective of the extent to which the General Account will in fact be restructured.

Mr. Polak

Office Memorandum

Res. Inv. changes Gen. Account

TO : Mr. Gold
Mr. Polak ✓

DATE: November 16, 1973

FROM : R. J. Familton RJH

SUBJECT : General Account

Attached is a short note listing possible operational and accounting changes in the General Account. In the light of the seminar today, we will give further thought to distinguishing the important changes from the desirable ones and to possible papers on particular changes that might be recommended.

Attachment

cc: Mr. Sturc
Mr. Thorson

DRAFT
11/16/73
RJF:spb

Changes in the General Account of the Fund

Introduction

This paper briefly sets out possible changes in the General Account which could be considered either in conjunction with changes directly consequent upon the reform of the international monetary system, or as a separate matter not necessarily dependent upon reform or a major restructuring of the General Account. The changes discussed below include several which do not entail pronounced shifts in the Fund's policies or operations but which would simplify the conduct of the Fund's business with members; other possible ones, however, involve important considerations and, as necessary, detailed papers could be prepared analyzing and describing the implications of a change in a particular policy or procedure. It should be noted that not all the possible changes would entail amendments to the Articles of Agreement but could be implemented by alterations in the Fund's Rules and Regulations or by Decisions.

While possible changes in rules governing the use of SDRs are discussed in a separate paper which elaborates on the suggestions made in paragraph 29 of the First Outline of Reform, this paper also includes references to the use of SDRs in General Account operations.

For convenience, the changes which could be considered are grouped in broad categories.

1. Fund's Operations with Members

a. Drawings on the Fund

Several questions arise under this heading:

(i) should there be any changes in policies and procedures, for example changes in the present limits governing total drawings on the General

Account without a waiver, or drawings under the compensatory financing facility.

(ii) Drawings under the compensatory and buffer stock financing facilities "float" above a member's other drawings, the former irrespective of the member's position in the Fund, the latter only in the credit tranches. In view of the fact that gold tranche drawings are not subject to challenge by the Fund, drawings under either of these two facilities could be made subject to the member first drawing the full amount of its gold tranche. Drawings would, however, retain their "floating" character.

(iii) Should members be able to draw against gold tranche positions for the purpose of making payments without a representation of need?

(iv) Would it be desirable to have a general rule that permitted the Fund to require members to use SDRs or a certain currency in particular circumstances?

(v) Six categories of exchange rates are presently recognized under the Fund Agreement and by Executive Board Decision - par values, central rates, provisional rates for payment of currency associated with a quota increase, rates pursuant to Article IV, Section 8(b)(ii), representative rates, and provisional rates agreed for pre- par value transactions. The question is whether the exchange rate structure in the Fund should be simplified and, in particular, whether the establishment of a par value or a realistic market rate should be a precondition for the use of the Fund's resources.

b. Repurchases under Article V, Section 7(b) and Schedule B

Several possible changes may be envisaged:

(i) One would be the abrogation of these provisions and their replacement by a provision under which a member drawing from the Fund would

be committed to repurchase within a period [of 3-5 years];

(ii) If it were considered essential to retain the basic concept of temporary use of the Fund through a provision for obligatory repurchases, it might nonetheless be considered useful to abrogate Schedule B (which determines the media in which obligations are incurred).

c. Other repurchases

Repurchases which are "voluntary" in character are subject to approval by the Executive Board. The need for such approval might be dispensed with by an amendment to Article V, Section 7(a).

d. Use of currencies and conversions

One question is whether the present practices regarding the use of currencies in drawings and repurchases, which are governed by an Executive Board decision, should be expressly provided for in the Articles. This raises the further question of whether present practices should be modified, for example to permit the use of Article XIV currencies in repurchases, or to implement a principle of harmonizing holdings of all primary reserve assets.

Another aspect is whether the Fund should have authority to regulate the rates at which currencies used in transactions with the Fund are acquired by a repurchasing member or converted by the issuer for a drawing member so as to avoid exchange profits or losses. For instance, there might be a Rule that all acquisitions and all conversions should be made at the rates used by the Fund, or at rates that should otherwise correspond to internationally agreed rules.

e. Subscription payments and the Fund's currency accounts

(i) Another major question is whether the subscription payments by new members and payments in respect of quota increases (Article III, Section 3(b)) should be changed in either one of two ways; to allow a member either an option

to pay the full amount in its currency or an option to pay SDRs in lieu of the gold component;

(ii) As regards the currency payments, questions have been periodically raised about the necessity for the Fund to maintain a minimum of 1 per cent of a member's quota on deposit in the Fund's No. 1 Currency Account, the need to take into account the balance in the Fund's No. 2 (administrative) Currency Account for various calculations, and the form of securities that members may substitute for currency (Article III, Section 5). In connection with the No. 1 Currency Accounts the percentage limit could be reduced upon the request of a member, or uniformly, or minimum balances established at the discretion of the Managing Director. Another possibility would be to abolish the Accounts on the undertaking of members to encash securities and transfer funds upon demand.

The No. 2 Currency Accounts are used for administrative payments (e.g., publications) and the balances, subject to Rule 1-4(b)(ii) which establishes a ceiling of 1/10 of 1 per cent of quota, are maintained in the light of the Fund's use of the Accounts. One change would be to eliminate the ceiling, and also to exclude the balances in the No. 2 Accounts from all calculations (e.g., gold tranche, remuneration payments) relating to a member's position in the Fund. This would considerably simplify both computations and operations.

Similar simplication would be achieved if currency valuation adjustments (Article IV, Section 8) were calculated on the basis of the Fund's holdings of a currency as shown in the Fund's books of account rather than in a member's books, which may differ because of items in transit.

f. Settlement of charges

The option members have to pay charges in SDRs rather than gold is governed by an Executive Board Decision under Article XXV, Section 7(c)(i). It may be

desirable to incorporate this option in the Articles and also to review the provisions regarding the payment of charges with currency.

g. Maintenance of the gold value of the Fund's currency holdings

The present procedure regarding the revaluation of the Fund's holdings of currencies on the occasion of each use of a currency in a transaction could be simplied if the members concerned would agree to the Fund advising them of the calculations and amounts, not on the occasion of each adjustment, but, say quarterly.

Any basic change in the Fund's method of valuation that would increase the frequency and number of valuation adjustments would make simpler procedures even more desirable.

2. The General Accounts' Holdings and Use of Primary Reserve Assets

A principal issue for consideration is whether the Fund should have wider authority to use its gold and SDR holdings for additional purposes than those permissible at present. At present the use of gold is confined to the payment of remuneration, certain charges (e.g., on borrowing) and sales to replenish the Fund's currency holdings: should the use be extended to enable the Fund to lend or sell gold to members or sell gold in the market? Similar questions arise in regard to the use of the Fund's holdings of SDRs.

3. The Fund's Finances

Questions concerning the financing of the Fund's expenditures are dealt with in separate papers and are not repeated here.

4. The Fund's Financial Year, Accounts and Audit

Another possible change in the General Account is in the Fund's fiscal year: at present it commences on May 1 and there would be some advantages in

changing this to April 1. This could be associated with a review of the Fund's accounting practices and budgetary presentation and perhaps also with a review of the external audit and a possible change from a specially appointed Committee to the employment of an audit firm.

5. Definitions

In General Account operations international reserves are differently defined for different purposes. There is the definition of monetary reserves for Article V, Section 7(b) calculations which differs from the concept of reserves reported in International Financial Statistics and used in currency budget and designation plan calculations. The question of a change to consistent definitions for General Account (and Special Drawing Account) purposes would appear to warrant examination.

1. There is not much point in selling the Fund's gold to the Substitution Account, as you suggested, unless the power to sell gold and invest the proceeds is to be given to that Account rather than the General Account. If it were not, the Substitution Account would have no source of income to pay the interest on the SDRs issued against gold.

2. If no gold was transferred back to members on conversion to the new General Account structure, the following would be the situation:

(i) SDR 6,223 million would be issued against existing gold tranche positions[1]

(ii) The use of credit tranches would become SDR 1,082 million of debt.

(iii) The balance sheet of the General Account would look like this:

	Liabilities		Assets
SDRs issued	6,223	Gold	5,366
Reserves	738	SDRs	513
		Loans	1,082
	6,961		
			6,961

Personally, I prefer the simplicity of the General Account never actually holding SDRs, but cancelling all it receives and issuing all it uses. That would reduce the balance sheet by the same amount (SDR 513 million) on each side. (it would leave net income unaffected, of course)

3. Clearly this structure would be totally out of line as regards income and expenditure. Interest-earning assets (i.e., loans) would be too small a proportion of the total. For example, suppose we have a 5 per cent SDR interest rate;

Expenditure would be	
Interest on SDRs issued	SDR 311 million
Administrative Expenditure (Budget 1974)	46 million
Total Expenditure	357 million
Income would be	
Interest on SDR holdings	SDR 26 million
Interest on loans at 2 per cent above SDR rate	76 million
Total	102 million
Deficit	~~205~~ 255 million

4. But this is not such a substantial problem when one considers that we are sitting on SDR 5,366 of gold with a market value presumably at least twice its book value.

[1] End September data.

In any event, it would be a highly artificial situation. For example, at one extreme, we could simply redeem SDRs by getting rid of all the gold. We could offer to make sales against SDRs in proportion to past amounts of gold paid to the Fund in subscriptions. Then we would reduce the balance sheet to:

(SDR millions)

Liabilities			Assets
SDR issued (i.e. net of redemption)	857	Gold	--
Reserves	738	SDRs	513
		Loans	1,082
	1,595		1,595

Income (at 7 per cent) from loans	76
Income from SDR holdings (5 per cent)	26
	102
Less Administrative Expenditure	46
Less interest on SDRs in issue (5 per cent)	43
Surplus	13 million

I don't, of course, support the return of gold in this way, because I think it can obviously be used much more effectively by the Fund than it is likely to be used by individual members. But this is just to illustrate that there is considerable scope for manipulating the situation to deal with a deficit or to build up a surplus.

Office Memorandum

TO : Mr. Polak

DATE: November 16, 1973

FROM : John Williamson

SUBJECT : The Liquidity Constraint and the General Account

It occurred to me during this morning's discussion in the Board that Mr. Schleiminger's fears might be allayed by a provision under which the SDR allocations on January 1 each year would automatically be reduced from the level predetermined at the start of the basic period by an amount equal to the net extension of credit that had taken place through the General Account during the previous year.

cc: Mr. Fleming

INTERNATIONAL MONETARY FUND

Schleminger

TO : Silent reform of GAB.

FROM: Comments on conditionality are hollow.

What devices for this?

Liquidity constraint ≠ conditionality

P. 8. Likes present constraint. Precondition

should also apply to external ...

Minimum paper for ...

by operators

Start from other end.

Ossola - Single ... asset - merit

We'll have to overhaul anyway.

No reason to keep old style.

Would do away with GAB

No need for special constraint. Need more generous lending powers.

Does away with all nonsense.

How to introduce this?

GAB holdings of SDRs

free 25%

INTERNATIONAL MONETARY FUND

2

1½

Problem of interest on basic gt, pill

TO :

FROM: burden on ~~deficit~~ borr. ctys.

Sell gold to creditors or

Sell gold against SDRs or RAF.
to all

same effect.

What if rate on SDR raised.
Trouble unless you sell gold,

Financial

Further study
More detailed draft.

SCHNEIDER.

Wait for features of new system à la Sohl.

BULL –
UK agrees basically. Anyway certain needs more liquidity to help in certain cases.

Present restraints enough. Wants liberal approach
Likes 25/50 principle of repurchase.

~~[illegible]~~

Capital of its own for DD.

Likes Crispi wants broad new paper.

INTERNATIONAL MONETARY FUND

TO :

FROM:

Beaurain – Too much work,
Don't need the change in G.A.
Would lead to merger of 2 accts –
i.e. drop condition –
demonetizing SDR
Constraint – p. 8

* Opting out no solution

deVries

Exg / Issue Dept.
Good arguments against moving to new scheme.
No practical difficulties in Gen. Acc.
No time. £ sh / pence.
Advantage of present – distinction of technique
underlines difference of substance.
Dutch like 2 baskets – worried about
possibly bad SDRs,
Let's stay where we are.

KAFKA – Skeptical on conversion. EFF difficult to
finance. Policies to take care of
constraint.
Repayable but uncond. liquidity
like this (like gold tranche, ends up a la
Schleiminger

④

INTERNATIONAL MONETARY FUND

TO :

FROM:

BRAND - Some time we'll need this. Can do without.
Bad idea of solving everything by means of SDR creation.
A la Schl.

DALE - Joins Schl. on lack of time.
Eg. compression of p. 11 might help

BRYCE - Rose the mysteries by which we live!
Symbolic issue of too radical changes.
Work further on it.
Can we solve control issue?

increasingly attributes
credit extension
reserve creation
creditor interest
–

questions for disc.
Three aspects of ~~dis~~ paper.

1. Analysis of what Fund operations amount to. Realization that Fd is what economists call a bank, creates (intern.) money (reserves) by extending credit. Once one sees it this way, many operations of Fund become clearer – gold tranche drawings, borrowing of currency, payment of SDRs in lieu of gold etc.

2. Having understood ~~Fund~~ Gen Acc – as few have – does one ~~want~~ proceed to ~~restructure~~ convert the ~~Fund~~ Gen Acc to reflect underlying economics – or does one for various reasons shrink back from the "cost of conversion" at least for the moment

~~3. Apart from this, what other changes would be appropriate~~

3. If one made conversion, many ~~question~~ aspects of Fd operations (would) as a minimum have to be transposed in the new key. Many of those ~~require to be dealt with in any event~~ deserve a 'hard look' in any event – rep. prov – int. free use of gold tr.; pt of charges in own curr; SDR contrib to quota increases; ~~uniform changes in par values~~ use of borrowing

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/73/128

SM/73/128

June 4, 1973

To: Members of the Executive Board

From: The Secretary

Subject: Restructuring the General Account of the Fund - An Exploratory Paper

In his statements to Executive Board Meetings 73/7 (January 31, 1973) and 73/51, (May 14, 1973) the Managing Director made reference to a study undertaken by the staff comparing the methods of operations of the General Account and the Special Drawing Account. The attached paper presents the results of this study.

The Managing Director intends to raise with Directors at some later time whether they desire to have a discussion of this paper either in a seminar or in an informal meeting.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Restructuring the General Account of the Fund
An Exploratory Paper

Prepared by the Research Department in Consultation with Other Departments

Approved by J. J. Polak

June 1, 1973

It was suggested in the Reform Report that an expansion of the role of the SDR might also be the occasion for a broader review of the provisions of the Articles relating to the General Account.1/ As a background to such a review, this paper compares the method of operation of the General Account with that of the Special Drawing Account, and derives from this comparison certain inferences for a possible restructuring of the General Account.

The emphasis in the paper is on analysis, not on recommendation. It may be useful at the present time to sort out certain ideas on a possible restructuring of the General Account, and the consequences that would follow from them. But it would be premature either to come to a view whether it would be advisable to adopt a new (and simpler) structure of the General Account or to attempt to devise a precise form for such a structure. On both issues, much will depend on the extent to which it may prove necessary to overhaul the Articles of Agreement in any event as part of the present reform of the system and on major decisions to be made in the framework of that reform. The exercise in which this paper is engaged is, therefore, exploratory in nature.

The paper assumes no substantive changes in the Fund's conditional operations.2/ The issues discussed here concern in the first instance matters of form. But when form is discussed questions of substance inevitably come

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1/ International Monetary Fund, Reform of the International Monetary System, A Report by the Executive Directors to the Board of Governors, (Washington, D.C., 1972), pp. 53-54. (All references in this paper are to the November 1972 printed version of the Reform Report.)

2/ Suggestions to that effect may arise in other contexts. For example, it has been suggested that there might be an extension of Fund facilities for the purpose of providing resources to developing countries to be repaid over longer periods than at present. (SM/73/25, "Allocation of SDRs and Financing of Economic Development," p. 4.)

up for reconsideration as well; the consequent challenge to certain existing features of the Fund may appeal to some and not to others. Moreover, form itself can be of importance. To cast the conditional operations of the Fund in a form that reveals more clearly their economic content may appear to some as a welcome substantive modernization, to others as an undesirably radical break with established tradition.

Thus, even if there were little doubt that a simpler structure of what is now the General Account would have to be introduced at some time in the future, it could still be an open question whether this transformation should become a part of the present reform, or be reserved for some future occasion.

Comparison between the two Accounts

On a sufficiently general level there is a strong similarity between the financial functions which the two Accounts perform for members: both enable a member in deficit to use financial resources that it had not earned from a previous balance of payments surplus. The effect of use of the resources in either Account on the member that provides the users with foreign exchange (other than its own currency) is also very similar; this member acquires, in both cases, reserves in the form of "Fund related assets": a "reserve position in the Fund" (a gold tranche position or a loan claim on the Fund) when the drawing takes place in the General Account and SDRs when the drawing member uses its position in the Special Drawing Account. There are, of course, important differences between use in the two Accounts. These differences relate primarily to (a) conditionality--use of the General Account (except gold tranche use) being subject to conditions, whereas the use of SDRs is unconditional--and (b) the provisions relative to the need to restore the previous position of the drawing member.

In spite of the fact that transactions in the two Accounts are in many respects similar, both for the user and for the provider of resources, they are executed in entirely different ways. In the General Account, transactions are conducted on the basis of a pool of currencies contributed by all members, with further contributions in gold to enable the Fund to acquire additional amounts of any currency that it might need; there is also a provision to borrow additional amounts of currency. The drawing entitlements are expressed in terms of quotas, but the quotas themselves are not exchange reserves available to the member; such reserves have to be acquired by drawings made within the framework of the quotas. Drawings are made in the currencies of the countries that are selected by the Fund to acquire the reserve positions in the Fund; these currencies are usually at once converted by the drawer, so that the drawee country experiences a reduction in its holdings of foreign exchange equal to the increase it its reserve position in the Fund. In the Special Drawing Account, by contrast, given amounts of SDRs representing an equal percentage of quotas are allocated from time to time to participants. Use of positions in the Special Drawing Account takes place by the transfer of SDRs from one participant to another against convertible currency.

Why this difference between the two Accounts in technical financial arrangements, if it does not reflect any obvious difference in substance between the transactions in these two Accounts? Essentially, the explanation is that the SDR Account is both the newer and the simpler of the two Accounts. The more complicated form in the older Account has clear historical reasons: the U.S. negotiators in the discussions that preceded Bretton Woods argued strongly that a Fund operating on the basis of "a mixed bag of currencies" was more likely to win Congressional approval than one which introduced the unfamiliar concepts of a new international currency and of overdrafts.1/ By now, the concept of an international currency is no longer unfamiliar. While "overdrafts" do not fit into normal U.S. banking practice, negotiated credits do. The question arises, therefore, whether there is a continuing justification for the present form of the General Account.

Perhaps the best way to approach this question is as follows. Suppose that the founders of the Fund had felt it necessary to concentrate their attention on the need for unconditional rather than conditional liquidity and for this purpose had created a mechanism such as that contained in Article XXI and following of the present Articles of Agreement, perhaps combined with regulatory provisions with respect to exchange rates, the avoidance of exchange restrictions, convertibility, etc. Such a Fund would have required quotas both as a basis for the allocation of unconditional liquidity and to determine voting power, but not the financial provisions of the original Articles of Agreement. Assume further that, despite the absence of a learning model which the pre-1969 Fund provided for the SDR mechanism, the provisions on SDRs were exactly those of Article XXI and following Articles (with the exception of references to the General Account). If then, at some later time, when the SDR facility had been running smoothly for a considerable period, the Fund had reached the conclusion that it would be opportune to provide, side by side with the SDR facility, a conditional facility under which members would be entitled to obtain financial resources from the Fund for temporary use, how would it have gone about this?

A General Account Patterned on the Special Drawing Account

It would seem unlikely that in order to provide this new facility the Fund would have found it necessary to ask each member to make a contribution in gold and in its own currency. Rather, it should have appeared natural that the Fund would have made provision for the creation of additional SDRs for the amount of credit it extended, these SDRs to be cancelled when Fund credit was repaid. This would be in line with the proposition that the extension of international credit by the Fund involves an expansion of reserves, and the repayment of such credit a contraction of reserves--a proposition which did not become valid until gold tranche positions began

1/ J. Keith Horsefield, The International Monetary Fund, 1945-1965, Vol. 1, pp. 28-30.

to be regarded as reserves in the early 1960s.1/ By that time the approach originally chosen--i.e., that the Fund would not be a "bank", creating international money by extending "credit"--had been overcome by the economics of the situation. Once the Fund made the transition from the almost exclusive use of U.S. dollars to the use of a number of major currencies, it became necessary in practice to monetize the resources that members made available to the Fund: members whose currencies were used were willing (sometimes eager) to see a change in the composition of their reserves, but not a decline in them. Thus it was found that reserve creation as a by-product to credit extension was a necessary element of a smoothly functioning Fund. At the same time, the attempt never took hold to view transactions through which the Fund made resources available to members in payments difficulties as a mere exchange of one currency for another. Fund transactions (beyond the gold tranche) are now generally regarded as the extension of balance of payments credit. This view is reflected, for example, in the adoption of the concept of "credit tranches" and in the widespread use of the term "repayment" as both more general and more meaningful than "repurchase."

The balance of this paper explores how the equivalent of what is now the General Account of the Fund could be run on the basis of the creation and cancellation of SDRs, and what the consequences of this would be on various features of the Fund.2/ It is assumed throughout that any technical restructuring of the General Account should not affect the balance between conditional and unconditional access to the Fund, which would continue to be determined by quota reviews, the Fund's policies on access to conditional credit, and SDR allocations. It should also be recalled that there would be no effect on reserve creation. The creation and cancellation of reserves that now takes place as the by-product of credit tranche transactions in the General Account, in the form of fluctuations in the amount of reserve positions in the Fund, would be replaced by a similar creation and cancellation in the form of SDRs made available by the Special Drawing Account to the General Account as needed by the latter for its operations. The allowance now made for expected net reserve creation in the form of reserve positions in the Fund in the estimate of the need for reserve creation through the allocation of SDRs would have to be replaced by a similar allowance for the net amount of SDRs that would be expected to be made available to the General Account.

1/ For a brief discussion see J. Marcus Fleming, "The Fund and International Liquidity," IMF Staff Papers, Vol. XI, No. 2 (July 1964) pp. 183-85. A more detailed description is given in Hannan Ezekiel, "The Present System of Reserve Creation in the Fund," Staff Papers, Vol. XIII, No. 3 (November 1966) pp. 398-420.

2/ In the discussion of the Extended Fund Facilities to which reference was made in footnote 2 of page 1, it was suggested that such operations would be financed by means of special issues of SDRs, which would be cancelled upon repayment of loans (cf. SM/73/25, p. 5).

If operation of the conditional side of the Fund took place in SDRs, the country that obtained Fund credit would normally use the SDRs to acquire currencies, for which the designation mechanism could conveniently be used. Nothing new would be required for this purpose, but it would be necessary to create sufficient flexibility in the acceptance obligations so as to ensure that there would be takers for the additional SDRs put into circulation by the Fund's credit operations.

It is possible that a more important new feature might be required to enable countries to repay Fund credit in SDRs. Countries would have to be in a position to acquire such SDRs against the holdings of reserve currencies. If the Reform provided for an open-ended substitution facility, as suggested under the third approach for asset settlement described in the Reform Report,1/ this would take care of the problem. Under different settlement arrangements it might be necessary to introduce into the SDR mechanism a system of what might be called "reverse designation" to regulate which countries would have to make available SDRs against convertible currencies, and in what amounts (in contrast to the designation mechanism that regulates the countries that are to make available convertible currencies against SDRs).2/

The Fund's conditional drawing facilities would remain subject to the prevailing quantitative limitations which include normal maximum use of 25 per cent of quota per year, a normal upper limit of 100 per cent of quota, and, within the latter limit, the tranche policy of increasing intensity of scrutiny depending on the extent of the use of Fund credit in terms of a member's quota. There would, of course, no longer be automatic drawing rights in what is now called the gold tranche, because "gold tranche positions" would not arise. As noted below, existing gold tranche positions would be replaced by holdings of SDRs or, possibly in part, gold.

Credit extended by the Fund in SDRs would naturally be repayable in SDRs, the maximum duration of the credit being subject to the 3-5 year rule. If it were desired to maintain some of the underlying principles of the repurchase provisions of Article V, Section 7(b), there could be provisions for accelerated repayment in the light of the member's balance of payments and reserve

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1/ Op.cit., p. 39.

2/ In the present SDR facility there are only the most rudimentary provisions for "reverse designation" because the need for it is unlikely to arise on any significant scale. In theory, a participant may, on "specification" by the Fund, be obliged to sell SDRs for "currency convertible in fact" for the purpose of enabling another participant to meet its obligations to pay charges and assessments (Article XXVI, Section 5 and Article XXX, Section 3) or its reconstitution obligation under Schedule G, paragraph 1(a); but the stock of SDRs held by the General Account makes it unlikely that these provisions will ever become operative. It should be noted that the sale of SDRs by the General Account against convertible currencies does not avoid the substantive problem, but transfers it to that Account. The question thus becomes the selection of countries that are to give up reserve positions in the Fund, rather than SDRs, against convertible currency.

position. This position is already used as a criterion in the operation of the designation system which affects the reversal of net use of SDRs in a manner somewhat akin to the repurchase provisions in the General Account,1/ using, however, data on reserves based on a more flexible definition than that laid down in Article XIX to guide the repurchase provisions.

The liquidity necessary to meet the needs for convertible currencies of the members that used the credit facility would be ensured by the size of the acceptance obligations, which, as mentioned, would have to be large enough to permit designation in relation to the total amount of SDRs that would at any time exist, whether arising from allocation or from conditional credit operations.

Liquidity Aspects

The technical problem that arises in this connection is not different from that related, e.g., to the issuance of SDRs in substitution for reserve currencies.2/ But there would be a special effect on the liquidity of the General Account. Financing of that account by means of SDRs with a corresponding increase in acceptance obligations would by itself reduce a liquidity constraint that now affects, at least potentially, though by no means precisely, the operations of the General Account. The liquidity of the General Account is proportionally much smaller than that of the Special Drawing Account.3/

1/ J.J. Polak, "Some Reflections on the Nature of Special Drawing Rights," International Monetary Fund Pamphlet No. 16, p. 17.

2/ Cf. Reform Report, pp. 52-53.

3/ The measurement of the liquidity of the two Accounts raised many difficult issues that cannot be treated in any fully satisfactory manner. The most extensive discussion of this question is contained in SM/67/92 of July 25, 1967 ("Drawing Rights and Required Resources in Schemes for Reserve Creation"), on which the following is based. The assets of the General Account consist, roughly, of 25 per cent of total quotas in gold and 75 per cent in currencies. The gold can always be used, but at times (in 1966) only about one third of the Fund's total holdings of currencies (i.e., about 25 per cent of quotas) were considered as suitable for drawing. Thus the Fund's available assets might be as low as half of total quotas, while at the same time potential demands on these might be as high as 125 per cent of quotas (gold tranche plus four credit tranches) of the two thirds (measured in terms of quotas) of the membership that was in a weak payments position, or 83 per cent of total quotas. In the SDR system, on the other hand, the desire of two thirds of the participants (measured in terms of allocations) to use the full amount of their allocation could in theory just be met by the obligation of the other third to accept an amount equal to twice their allocation. Measured on this basis--which clearly involves a number of debatable assumptions--the liquidity of the Special Drawing Account would be 1 2/3 times $(1 \div \frac{50}{83})$ as great as that of the General Account. The liquidity of the General Account as originally envisaged was close to that of the Special Drawing Account, being based on the assumption that U.S. dollars would always be usable and that no allowance need to be made for the contingency of use of the Fund's resources by the United States.

Assimilation of reserve positions in the Fund with SDRs and a corresponding increase in total acceptance obligations would therefore introduce considerably more room for acceptance than exists now with respect to General Account operations. Additional room would be created by the merger of the acceptance obligations of the two Accounts, inasmuch as their "peak needs" might not coincide. This tendency would be reinforced if, as part of the Reform, the absolute size of acceptance obligations were substantially increased to make room for SDRs issued in substitution for reserve currencies. And the possibility has also been mentioned that there might be no limit on the acceptance obligation for SDRs.1/

Concern over its liquidity is not the only--or even the most important--factor limiting the operations of the General Account. Control over the extent of the operations of this Account, and hence on the magnitude of their contribution to reserve creation, is primarily exercised in a number of other ways.

(a) By decisions on quotas.

(i) The absolute size of quotas provides the scale that determines the amounts that can be drawn under given policies expressed in terms of percentages of quota.

(ii) The distribution of quotas among likely surplus and deficit countries affects the probable size of desired use of Fund resources and the availability of "usable currencies."

(b) By decisions on policies on the use of Fund resources, such as tranche policies, the compensatory financing and buffer stock financing policies, etc.

(c) By decisions on the lending of currencies under the General Arrangements to Borrow that are taken by participants in these arrangements with a special majority. Such decisions are made with respect to individual requests for drawings by such participants, and are preceded by a special scrutiny of these requests.

(d) By the Fund's policies on repurchases.

It should be noted that quota decisions and decisions on the use of resources are subject to various restraints of a legal or conventional character. Changes in quotas proposed as a result of a general review require an 85 per cent majority and other quota changes an 80 per cent majority.2/ As a result of the adoption of Article V, Section 3(d), the

1/ Reform Report, p. 53.
2/ Article III, Section 2.

Fund no longer has the power to create any new facility in the General Account for the unconditional use of its resources.1/ In the design or expansion of nonautomatic facilities, the Fund pays careful attention to the liquidity implications.2/

A question for consideration would be whether the present decision-making process would be sufficient to control the size of the Fund's conditional financing activity in the absence of a potential constraint exercised by the resources available to the Fund; whether this process would need to be strengthened; or whether some other total constraint would need to be introduced, e.g., in terms of a maximum of conditional credit outstanding, with perhaps the possibility of exceeding the maximum if approved by a high qualified majority.

Gold and Quota Aspects

A Fund mechanism based on credit extension in terms of SDRs would not require Fund holdings of gold for liquidity reasons. The Fund could still hold gold as a result of a variety of transactions or operations. The Fund has large gold holdings at present, arising mainly from subscription payments in gold, and it might be felt that no purpose would be served by returning this gold to members. As long as gold remained a reserve asset, members should presumably be able to discharge their obligations to the Fund in gold, as well as in SDRs. There could also be arrangements under which the Fund would acquire gold from members against newly issued SDRs.3/

There would be no technical problem in requiring members to transfer gold to the Fund--against SDRs or a reduction in their use of Fund credit--when they joined the Fund or when their quotas were increased. However, since the Fund would not need the gold for liquidity reasons, the question would arise whether (i) gold payments by new members and (ii) gold (or SDR) payments on the occasion of quota increases, still served a useful purpose.

In the past, gold payments for quota increases have been thought to be useful to restrain undue pressure for such increases; the effectiveness of any such restraint may have been reduced by the fact that, for any country, a larger share in total quotas now entails a larger share in SDR allocations. In any consideration of this question, two facts would in any event need to be allowed for:

1/ International Monetary Fund, Proposed Amendment of Articles of Agreement, (Washington, D.C., April 1968), p. 25.

2/ See, for example, the section on "Changes in the Compensatory Facility and Fund Liquidity" in Compensatory Financing of Export Fluctuations, A Second Report by the International Monetary Fund (Washington, D.C. 1966), pp. 27-28; and a comparable section in the report containing the proposal for Fund financing of members' contributions to commodity stocks (International Monetary Fund, "The Problem of Stabilization of Prices of Primary Products," Scope for Action by the Fund, Washington, D.C. 1969, p. 19).

3/ Reform Report, p. 51.

(a) As part of the Reform, members might well become entitled to use SDRs to pay the "gold component" of their contribution related to quota increases.

(b) Presumably, members in payments difficulties would be able in the future, as they were in the past, to stretch their gold payments to the Fund, or the equivalent of such payments, over a number of years while yet receiving the quota increases at once.1/

In a Fund constructed on an SDR basis, the consideration under (a) would make the requirement to make "gold payments" meaningless for countries that did not use Fund credit: they would--if they used the SDR option--buy SDRs from the Fund with SDRs. Even in the Fund as presently structured countries would be very little affected by an obligation to increase their creditor position in the Fund in exchange for a reduction of their holdings of SDRs. For countries indebted to the Fund the position would also change little--in the sense that, as before, those in a weak payments and reserve position would have the option to make their "contribution" in the context of a quota increase by a modest acceleration in the repayment of their outstanding Fund credit.2/

A Fund that extended conditional credit against the issuance of SDRs could, in addition to gold, hold other assets purchased against SDRs, if that were desired, such as reserve currency balances acquired under substitution arrangements, or claims on development financing institutions arising under "link" arrangements.

Technical Aspects of Transition to a General Account Based on SDRs

Adoption of the approach to credit operations of the Fund outlined above would involve a major amendment of the Articles of Agreement. Some of the present provisions dealing with the General Account would become redundant; there would have to be many consequential changes, e.g., in the provisions that indicate debtor or creditor positions by reference to the Fund's holdings of a member's currency compared to its quota; and the liquidation provisions might need to be completely revised.

1/ In the 1958 and 1964 general quota reviews, this was made possible by allowing members to make a special drawing for an amount equal to the gold payment, the drawing to be repurchased in three (1958) or five (1964) equal annual installments; in the 1969 review, members with low reserves were entitled (under the provisions of Article III, Section 4(a)) to avail themselves of the opportunity to make a reduced gold payment, but were then required to repurchase the resulting additional currency subscription in five equal annual installments.

2/ Quantities are important in this connection. The 1964 and 1969 quota reviews resulted for many members in quota increases by 25 per cent. These would involve normal gold payments of 6.25 per cent of quota, or, if spread over 5 years, annual payments of 1.25 per cent of quota.

Technically, the transition from a Fund in terms of currencies to one in terms of SDRs is not complicated. The transition would involve the Fund repaying members' subscriptions, thus changing the quota from a balance sheet entry into being exclusively a yardstick for members' rights and obligations, as it is already in the Special Drawing Account. The repayment of subscription would be made in the first instance in the member's currency. Where the Fund's holdings were insufficient for this purpose--i.e., where the member had a gold tranche position--the balance could be paid in SDRs created <u>ad hoc</u>, or, to the extent that this were desired, in gold. Total gold tranche positions at the end of 1972 were SDR 6.9 billion, representing an equivalent amount of reserves in the form of Reserve Positions in the Fund. If these were fully paid off, this component of reserves would disappear, being replaced by SDRs and gold to the extent that the Fund used either one, or both. The amount of SDRs used would be made available to the General Account by the Special Drawing Account; the gold would enter countries' reserves from the Fund holdings (where it does not form part of countries' reserves). Where the Fund's holdings of a member's currency exceeded its quota, the excess could be converted into--or considered as--an SDR credit to that member. The magnitude of the Fund's reserves would of course remain unchanged.

<u>Effects on Certain Present Features of the Fund</u>

The preceding summary description of how conditional credit transactions could be arranged on an SDR basis sketches a mechanism that would lack most of the esoteric characteristics of the present Fund and would thus be easier to understand. Thus there would be no need for concepts such as the "gold tranche," the "basic gold tranche," the "super gold tranche," the "currency budget," "reserve positions in the Fund," "Fund positions" (net, gross, and creditor), "remuneration," and "scarce currencies." A reformed mechanism would also avoid some difficult and divisive issues that have arisen in the Fund's history and that may arise again in the future under present provisions. Among these mention may be made in particular of the replenishment provisions (with gold, SDRs and through borrowing), the provisions on the usability of SDRs in payments to and by the General Account, and--unless gold payments on quota increases were eliminated--mitigation of the direct and indirect reserve effects of such payments.

Beyond these general effects, a number of features would, as a minimum, have to be reconsidered on their merits. The present structure of the Fund is responsible for many features that would not necessarily be incorporated if one started from scratch, but that have, nevertheless, acquired a certain status. Some of these would lapse in a restructured Fund--unless a specific decision were taken to introduce their equivalent in a different form. It would be difficult--and perhaps hardly worthwhile at this stage--to give a complete listing of such features; some that come readily to mind are briefly noted below.

1. Absence of remuneration on the basic gold tranche. In the present Fund, members contribute to the cost of the operation of the Fund to the extent that they hold a basic gold tranche position on which they do not receive income, while they receive interest (or its equivalent) on super-gold tranche positions, loan claims on the Fund, and holdings of SDRs. A corresponding arrangement in a restructured Fund would be for the Fund to pay interest on a member's holdings of SDRs only on amounts in excess of 25 per cent of quota. This change would have no financial effect on members that hold a gold tranche position of 25 per cent of quota or more; but it would remove the anomaly in present arrangements that a member can earn interest on SDR holdings while using part or all of its basic gold tranche interest free. The alternative arrangement suggested would, on a recent date (October 31, 1972), apply to some additional SDR 2.5 billion, which would mean an extra net income in the form of saving on SDR interest payments for the Fund as a whole, at 1 1/2 per cent per annum, of about SDR 38 million. The arrangement would create an area of interest-free use of SDRs (up to holdings of 25 per cent of quota). If it were desired to eliminate this, it would be necessary to add to SDR charges rather than subtract from SDR interest payments, and stipulate that charges would be levied not only on the net cumulative allocation but also on an amount equal to 25 per cent of the member's quota; interest would then be paid, as at present, on a member's total holdings of SDRs. This change would subject an additional SDR 0.6 billion (at the same date) to interest payment, from which the Fund would earn (at the rate of 1 1/2 per cent) an additional SDR 9 million.

2. Merger of super-gold tranche positions with SDR holdings. The absence of super-gold tranche positions as separate reserve assets would eliminate the possibility in the present Articles to adjust the Fund's finances by allowing a slight difference between the rate of remuneration and the SDR interest rate.

3. Scarce currency provisions. Under these provisions of the Articles, the Fund is entitled to take action against a country in an extreme creditor position as reflected in the Fund's holdings of that member's currency; and such action then authorizes members to introduce discriminatory provisions with respect to the currency that has been declared scarce (Article VII, Section 3). While this provision in the Articles was initially hailed as an important part of the adjustment process directed against persistent creditor positions, it has since become recognized that it "does not in its present form provide a practical means of applying pressure on surplus currencies,"1/ so that any desired action with respect to extreme creditor countries will in any event have to be based on a different criterion.

4. Payment of charges in a member's own currency. This option, which members have in certain circumstances,2/ and which amounts to adding interest due to the outstanding balance, would lapse in an SDR-based Fund.

1/ Reform Report, p. 18.
2/ Article V, Section 8(f).

5. Effect of the provision for uniform change in par values on the value of positions in the Fund. The present Articles provide a possibility to scale down members' debtor and creditor positions in the Fund as a result of a uniform downward change in par values, accompanied by a decision not to apply the provisions on the maintenance of the gold value of the Fund's assets.1/

6. Effect on non-participants. If all Fund transactions were conducted in SDRs, any of the few members that are not participants might have to be able to hold SDRs when obtaining conditional credit from the Fund and when repaying such credit. The holding of SDRs for this purpose need only be transitional, in much the same manner as many countries now briefly hold currencies that they do not normally have in their reserves in connection with purchases and repurchases in these currencies. Less transitory holdings of SDRs would arise for these members if the Fund repaid their gold tranche positions in SDRs.

7. Special rights for creditors in the General Account. These rights, relating to voting in certain circumstances (Article XII, Section 5(b)) and the appointment of executive directors (Article XII, Section 3(c)), would lapse as there would no longer be a separate creditor position in the General Account. If desired, similar rights could be established as a function of members' positions in the Fund as a whole, expressed in terms of holdings of SDRs compared to net cumulative allocations.

8. Effect on administrative expenditure. The Fund would need a provision to acquire currencies against SDRs for its administrative expenditure. This expenditure is now financed by reserve creation in the form of reserve positions in the Fund; in a restructured Fund it would be financed by reserve creation in the form of SDRs.

1/ Article IV, Sections 7 and 8(d). Both decisions require an 85 per cent majority of the total voting power of the Board of Governors.

MEMORANDUM

TO: Members of the Executive Board May 31, 1973

FROM: The Secretary

SUBJECT: Restructuring the General Account of the Fund
An Exploratory Paper

In his statements to Executive Board Meetings 73/7 (January 31, 1973) and 73/__, (May __, 1973) the Managing Director made reference to a study undertaken by the staff comparing the methods of operations of the General Account and the Special Drawing Account. The attached paper presents the results of this study.

The Managing Director intends to raise with Directors at some later time whether they desire to have a discussion of this paper either in a seminar or in an informal meeting.

Attachment:

Other Distribution:

MEMORANDUM

TO: Members of the Executive Board

April 25, 1973

FROM: The Secretary

SUBJECT: Restructuring the General Account of the Fund
An Exploratory Paper

In his statement to Executive Board Meeting 73/7 (January 31, 1973--Buff 73/12) the Managing Director indicated that the staff had been engaged on a study comparing the methods of operations of the General Account and the Special Drawing Account. The attached paper presents the results of this study.

Attachment:

Other Distribution:

MEMORANDUM

TO: Mr. Hebbard April 25, 1973

FROM: J. J. Polak

SUBJECT: Restructuring the General Account of the Fund
An Exploratory Paper

Please see the attached paper and draft cover note. I would expect that Directors would want to have a Seminar discussion on this paper, but it might be preferable for the Managing Director to bring this up as a question at an early Board Meeting rather than suggest it in the cover note.

Office Memorandum

TO : Mr. Polak

DATE: April 13, 1973

FROM : R.J. Familton

SUBJECT : Reform of the General Account

This is in response to your request for further technical and detailed comments on the draft paper dated December 18, 1972 (with pages 1 and 15 revised). These are set out below:

In Mr. Habermeier's absence and with little time available to reconsider the draft these are not necessarily all that we may have to offer if the draft is to be further discussed before issuance. In this connection I am still dubious about issuing the paper at the same time as other papers are being put up proposing possible additional uses of SDRs (e.g., Consolidation). I have reread your reply of December 19 to Mr. Habermeier's note and I am still hesitant about proposing sweeping changes in the General Account without mentioning the possibility of an alternative, more gradual approach. I would also suggest some discussion of the relationship of a Substitution Account to the present or changed General Account and Special Drawing Account. The detailed comments are as follows:

Page 2, first paragraph: The phrase "on a sufficiently general level" presumably is to cover the point that there are differences as well as a strong similarity between the financial functions of the two accounts. This might be made more explicit. While the Special Drawing Account contrasts with the General Account in terms of reserves being initially allocated rather than having to be earned, "reserve" positions subsequently can be earned in both accounts. Also, SDRs have been used for direct settlement between participants without directly or immediately affecting the reserve assets of others. It would seem to deserve mention that while the use of SDRs is unconditional, an important factor influencing their use is the reconstitution provisions. Finally, a minor point that might also be noted is that SDR holdings exceed gold tranche positions and, for most members, by a significant amount.

Page 3, first main paragraph, first line: The "technical arrangements" are mainly financial in character and this might be mentioned. The use of the word "junior" in the next sentence might be questioned, I would suggest "newer".

Page 5, line 4: Insert after "of" "convertible". This would link up with the reference on page 6 to "reverse designation".

Page 13: The argument in the second paragraph that conceptionally, the transition is not complicated, may not be fully accepted. One could argue that the acceptance of the quotas as a yardstick for rights and obligations in the Special Drawing Account was facilitated by the fact that it had a financial meaning in the General Account. The use of the credit facility (and voting rights) geared to quotas that have no financial expression could lead to pressure for larger quotas, the danger that repayment conditions would be diluted, and possible problems in reconciling the "requirement of need" in relation to use of unconditional SDRs with the conditions governing the use of credit. Moreover, it is unclear when members would be expected to use the conditional credit facility and it would be uncertain how many SDRs would be created or destroyed over a given period.

MEMORANDUM

TO: Managing Director January 9, 1973

FROM: J. J. Polak

SUBJECT: Restructuring the General Account of the Fund
An Exploratory Paper

A version of this paper was circulated on December 18, 1972, and discussed in a meeting chaired by Mr. Southard. I now attach a revision of the first page and of page 15. There are some small changes I would want to make elsewhere in the paper but these do not affect its general character.

We discussed a number of alternative ways of circulating the paper without creating the impression that the staff was pushing a "plan." It was more or less agreed that it would be helpful from this point of view if the paper were presented as being personal rather than on the responsibility of the staff as a whole. A number of possibilities for the form in which the paper might be issued were discussed--as a pamphlet, as an article in Staff Papers, or as a DM. On further consideration, I would be inclined to believe that the best solution might be to circulate it outside of any established series with a covering note from the Secretary indicating its status and suggesting the possibility of discussion in a Board Seminar, if there were sufficient interest for this.

The suggestion was also made that Mr. Morse should be aware of the paper before it was issued; I do not think this would raise any difficulties.

cc: Deputy Managing Director
Mr. Gold
Mr. Del Canto
Mr. Habermeier
Mr. Sturc
Mr. Whittome
Mr. Crockett

SUBJECT COPY

January 9, 1973

Restructuring the General Account of the Fund

An Exploratory Paper

It was suggested in the Reform Report that an expansion of the role of the SDR might also be the occasion for a broader review of the provisions of the Articles relating to the General Account.[1/] As a background to such a review, this paper compares the method of operation of the General Account with that of the Special Drawing Account, and derives from this comparison certain inferences for a possible restructuring of the General Account.

The emphasis in the paper is on analysis, not on recommendation. It may be useful at the present time to sort out certain ideas on a possible restructuring of the General Account, and the consequences that would follow from them. But it would be premature either to come to a view whether it would be advisable to adopt a new (and simpler) structure of the General Account or to attempt to devise a precise form for such a structure. On both issues, much will depend on the extent to which it may prove necessary to overhaul the Articles of Agreement in any event as part of the present reform of the system and on major decisions to be made in the framework of that reform. The exercise in which this paper is engaged is, therefore, exploratory in nature.

The paper does not start out from any notion that it would be desirable to make substantive changes in the Fund's conditional operations.[2/] The issues discussed here concern in the first instance matters of form. But when form is discussed

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1/ International Monetary Fund, Reform of the International Monetary System, A Report by the Executive Directors to the Board of Governors, (Washington, D.C. 1972), pp. 53-54. (All references in this paper are to the November 1972 printed version of the Reform Report.)

2/ Suggestions to that effect may arise in other contexts. For example, it has been suggested that at least some portion of any SDRs allocated for development purposes might be applied to the financing of new types of drawing by developing countries from the General Account. (SM/72/220, "Allocation of SDRs and Financing of Economic Development," p. 5.)

questions of substance inevitably come up for reconsideration as well; the consequent challenge to certain existing features of the Fund may appeal to some and offend others. Moreover, form itself can be of importance. To cast the conditional operations of the Fund in a form that reveals more clearly their economic content may create an impression on some of a welcome substantive modernization, on others of an undesirably radical break with established tradition.

Thus, even if there were little doubt that a simpler structure of what is now the General Account would have to be introduced at some time in future, it could still be an open question whether this transformation should be tacked on to the present reform, or reserved for some future occasion.

Effects on Certain Present Features of the Fund

The preceding summary description of how conditional credit transactions could be arranged on an SDR basis sketches a mechanism that would lack most of the esoteric characteristics of the present Fund and would thus be easier to understand. Thus there would be no need for concepts such as the "gold tranche," the "basic gold tranche," the "super gold tranche," the "currency budget," "reserve positions in the Fund," "Fund positions" (net gross, and creditor), "remuneration," and "scarce currencies." A reformed mechanism would also avoid some difficult and divisive issues that have arisen in the Fund's history and that may arise again in the future under present provisions. Among these mention may be made in particular of the replenishment provisions (with gold, SDRs and through borrowing), the provisions on the usability of SDRs in payments to and by the General Account, and--unless gold payments on quota increases were eliminated--mitigation of the direct and indirect reserve effects of such payments.

Beyond these general effects, a number of features would, as a minimum, have to be reconsidered on their merits. The present structure of the Fund is responsible for many features that would not necessarily be incorporated if one started from scratch, but that have, nevertheless, acquired a certain status. Some of these would lapse in a restructured Fund--unless a specific decision were taken to introduce their eqtivalent in a different form. It would be difficult--and perhaps hardly worthwhile at this stage--to give a complete listing of such features; some that come readily to mind are briefly noted below.

MEMORANDUM

TO: Acting Managing Director December 19, 1972

FROM: J. J. Polak

SUBJECT: Restructuring the General Account of the Fund--An Exploratory Paper

I attach a draft paper on the above subject, to which I referred first in my memorandum of November 14th. In the meantime, the paper has benefitted from comments by colleagues in other Departments.

The purpose of the paper is to initiate a discussion in the Board on the subject of a possible new structure of the General Account, that might be introduced as part of the Reform. This is a complicated subject and it would probably be desirable for the Board to give it at least some preliminary consideration in the near future, when the Board has ample time available.

Directors and governments obviously cannot effectively weigh whether it is worth the considerable effort to proceed to a restructuring of the General Account without a rather detailed staff paper spelling out the implications. At the same time, it is difficult to present such a paper without creating the impression that the staff is pushing a plan. I have done my best to avoid this impression by the subtitle and the first page. Some Board members may also recall that I mentioned to the Board, about a year ago, that the present Reform might still be too early an occasion to modernize the General Account. A possible further way to remove any impression of pressure by the staff might be for the Managing Director to raise the question in general with the Board before a paper was circulated. And there might be other techniques to achieve the same end.

cc: Managing Director (on return)
Mr. Gold
Mr. Del Canto
Mr. Habermeier
Mr. Sturc
Mr. Whittome
Mr. Crockett

December 18, 1972

Restructuring the General Account of the Fund

An Exploratory Paper

Prepared by the Research Department in Consultation with
Other Departments

Approved by J. J. Polak

It was suggested in the Reform Report that an expansion of the role of the SDR might also be the occasion for a broader review of the provisions of the Articles relating to the General Account.1/ As a background to such a review, this paper compares the method of operation of the General Account with that of the Special Drawing Account, and derives from this comparison certain inferences for a possible restructuring of the General Account.

The emphasis in the paper is on analysis, not on recommendation. It may be useful at the present time to sort out certain ideas on a possible restructuring of the General Account, and the consequences that would follow from them. But it would be premature either to come to a view whether it would be advisable to adopt a new (and simpler) structure of the General Account or to attempt to devise a precise form for such a structure. On both issues, much will depend on the extent to which it may prove necessary to overhaul the Articles of Agreement in any event as part of the present reform of the system and on major decisions to be made in the framework of that reform. For the time being, therefore, the exercise in which this paper is engaged is exploratory in nature.

1/ International Monetary Fund, Reform of the International Monetary System, A Report by the Executive Directors to the Board of Governors, (Washington, D.C. 1972), pp. 53-54. (All references in this paper are to the November 1972 printed version of the Reform Report.)

SUBJECT COPY

Comparison between the two Accounts

On a sufficiently general level there is a strong similarity between the financial functions which the two Accounts perform for members: both enable a member in deficit to use financial resources that it had not earned from a previous balance of payments surplus. The two main differences between use of the two Accounts relate to conditionality--use of the General Account (except gold tranche use) being subject to conditions whereas the use of SDRs is unconditional--and to the need to restore the previous position after use. For members that provide the users with foreign exchange the effect of any use of the resources of either Account is also very similar; they acquire, in both cases, reserves in the form of "Fund related assets": a "reserve position in the Fund" (a gold tranche position or a loan claim on the Fund) when the drawing takes place in the General Account and SDRs when the drawing member uses its position in the Special Drawing Account.

In spite of the fact that transactions in the two Accounts are so similar, both for the user and for the provider of resources, they are executed in entirely different ways. In the General Account, transactions are conducted on the basis of a pool of currencies contributed by all members, with further contributions in gold to enable the Fund to acquire additional amounts of any currency that it might need; there is also a provision to borrow additional amounts of currency. The drawing entitlements are expressed in terms of quotas, but the quotas themselves are not exchange reserves available to the member; such reserves have to be acquired by drawings made within the framework of the quotas. Drawings are made in the currencies of the countries that are selected by the Fund to acquire the reserve positions in the Fund; but these currencies are normally at once

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converted by the drawer, so that the drawee country experiences a substitution of a reserve position in the Fund for holdings of foreign exchange. In the Special Drawing Account, by contrast, given amounts of SDRs representing an equal percentage of quotas are allocated from time to time to participants. Use is made in the Special Drawing Account by the transfer of SDRs from one participant to another against convertible currency.

Why this difference between the two Accounts in technical arrangements, if it does not reflect any obvious difference in substance between the transactions in these two Accounts? Essentially, the explanation is that the SDR account is both the junior and simpler of the two Accounts. The more complicated form in the senior Account has clear historical reasons: the U.S. negotiators in the discussions that preceded Bretton Woods argued strongly that a Fund operating on the basis of "a mixed bag of currencies" was more likely to win Congressional approval than one which introduced the unfamiliar concepts of a new international currency and of overdrafts.[1/] By now, the concept of an international currency is no longer unfamiliar. While "overdrafts" do not fit into normal U.S. banking practice, negotiated credits do. In the light of this, is there a continuing justification for the present form of the General Account?

Perhaps the best way to approach this question is as follows. Suppose that the founders of the Fund had felt it necessary to concentrate their attention on the need for unconditional rather than conditional liquidity and for this purpose had created a mechanism such as that contained in Article XXI and following of the present Articles of Agreement, perhaps combined with regulatory provisions with respect to exchange rates, the

1/ J. Keith Horsefield, The International Monetary Fund, 1945-1965, Vol. 1, pp. 28-30.

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avoidance of exchange restrictions, convertibility, etc. Such a Fund would have required quotas both as a basis for the allocation of unconditional liquidity and to determine voting power, but not the financial provisions of the original Articles of Agreement. Assume further that, despite the absence of a learning model which the pre-1969 Fund provided for the SDR mechanism, the provisions on SDRs were exactly those of Article XXI and following (with the exception of references to the General Account). If then, at some later time, when the SDR facility had been running smoothly for a considerable period, the Fund had reached the conclusion that it would be opportune to provide, side by side with the SDR facility, a conditional facility under which members would be entitled to obtain financial resources from the Fund for temporary use, how would it have gone about this?

A General Account Patterned on the Special Drawing Account

It would seem unlikely that in order to provide this new facility the Fund would have found it necessary to ask each member to make a contribution in gold and in its own currency. Rather, it should have appeared natural that the Fund would have made provision for the creation of additional SDRs for the amount of credit it extended, these SDRs to be cancelled when Fund credit was repaid. This would be in line with the proposition that the extension of international credit by the Fund involves an expansion of reserves, and the repayment of such credit a contraction of reserves—a proposition which did not become valid until gold tranche positions began to be regarded as reserves in the early 1960s.[1] By that time the approach

1/ For a brief discussion see J. Marcus Fleming, "The Fund and International Liquidity," IMF Staff Papers, Vol. XI, No. 2 (July 1964) pp. 183-85. A more detailed description is given in Hannan Ezekiel, "The Present System of Reserve Creation in the Fund," Staff Papers, Vol. XIII, No. 3 (November 1966), pp. 398-420.

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originally chosen--i.e., that the Fund would not be a~~n international~~ "bank", creating international money by extending "credit"--had been overcome by the economics of the situation. Once the Fund made the transition from the almost exclusive use of U.S. dollars to the use of a wide variety of currencies, it became necessary in practice to monetize the resources that members made available to the Fund: members whose currencies were used were willing (sometimes eager) to see a change in the composition of their reserves, but not a decline in them. Thus it was found that reserve creation as a by-product to credit extension is a necessary element of a smoothly functioning Fund. At the same time, the attempt never took hold to view transactions through whåch the Fund made resources available to members in payments difficulties as a mere exchange of one currency for another. Fund transactions (beyond the gold tranche) are now generally regarded as the extension of balance of payments credit. This view is reflected, for example, in the adoption of the concept of "credit tranches" and in the widespread use of the term "repayment" as both more general and more meaningful than the legal "repurchase."

The balance of this paper explores how the equivalent of what is now the General Account of the Fund could be run on the basis of the creation and cancellation of SDRs, and what the consequences of this would be on various features of the Fund. It is assumed that any technical restructuring of the General Account should not affect the balance between conditional and unconditional access to the Fund. The balance between these would continue to be determined by quota reviews, the Fund's policies on access to conditional credit, and SDR allocations.

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If operation of the conditional side of the Fund took place in the form of credit creation in SDRs, the country that obtained Fund credit would normally use the SDRs to acquire currencies, for which the designation mechanism could conveniently be used. Nothing new would be required for this purpose, but it would be necessary to create sufficient flexibility in the acceptance obligations so as to ensure that there would be takers for the additional SDRs put into circulation by the Fund's credit operations.

It is possible that a more important new feature might be required to enable countries to repay Fund credit in SDRs. Countries would have to be in a position to acquire such SDRs against the holdings of reserve currencies. If the Reform provided for an open-ended substitution facility, as suggested under the third approach for asset settlement described in the Reform Report,[1/] this would take care of the problem. Under different settlement arrangements it might be necessary to introduce into the SDR mechanism a system of what might be called "reverse designation" to regulate which countries would have to make available SDRs against convertible currencies, and in what amounts (in contrast to the designation mechanism that regulates the countries that are to make available convertible currencies against SDRs).[2/]

1/ Op. cit., p. 39.

2/ In the present SDR facility there are only the most rudimentary provisions for "reverse designation" because the need for it is unlikely to arise on any significant scale. In theory, a participant may, on "specification" by the Fund, be obliged to sell SDRs for "currency convertible in fact" for the purpose of enabling another participant to meet its obligations to pay charges and assessments (Article XXVI, Section 5 and Article XXX, Section 3) or its reconstitution obligation under Schedule G, paragraph 1(a); but the stock of SDRs held by the General Account makes it unlikely that these provisions will ever become operative. It should be noted that the sale of SDRs by the General Account against convertible currencies does not avoid the substantive problem, but transfers it to that Account. The question thus becomes the selection of countries that are to give up reserve positions in the Fund, rather than SDRs, against convertible currency.

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The Fund's conditional drawing facilities could be subject to the same quantitative limitations as at present such as a normal maximum of 25 per cent of quota per year and a normal upper limit of 100 per cent of quota, and, within the latter limit, to a tranche policy of increasing intensity of scrutiny depending on the extent of the use of Fund credit in terms of a member's quota. There would, of course, be no occasion for the introduction of automatic drawing rights in what is now called the gold tranche, because "gold tranche positions" would not arise. As noted below, existing gold tranche positions would be replaced by holdings of SDRs.

Credit extended by the Fund in SDRs would naturally be repayable in SDRs. The Fund could set conditions for the duration of the credit such as the present 3-5 year rule. There could further be provisions for accelerated repayment in the light of the member's balance of payments and reserve position. This position is already used as a criterion in the operation of the designation system which affects the reversal of net use of SDRs in a manner somewhat akin to the repurchase provisions in the General Account,[1/] using, however, data on reserves based on a more flexible definition than that laid down in Article XIX to guide the repurchase provisions.

The liquidity necessary to meet the needs for convertible currencies of the members that used the credit facility would be ensured by the size of the acceptance obligations, which, as mentioned, would have to be large enough to permit designation in relation to the total amount of SDRs that would at any time exist, whether arising from allocation or from conditional credit operations.

1/ J. J. Polak, "Some Reflections on the Nature of Special Drawing Rights," International Monetary Fund Pamphlet No. 16, p. 17.

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Liquidity Aspects

The technical problem that arises in this connection is not different from that related, e.g., to the issuance of SDRs in substitution for reserve currencies.[1] But there would be a special effect on the liquidity of the General Account. Financing of that account by means of SDRs with a corresponding increase in acceptance obligations would by itself reduce a liquidity constraint that now affects at least potentially, though by no means precisely, the operations of the General Account. The liquidity of the General Account is proportionally much smaller than that of the Special Drawing Account.[2] Assimilation of reserve positions in the Fund with SDRs and a corresponding increase in total acceptance obligations would therefore introduce considerably more room for acceptance than exists now with respect to General Account operations. Additional room would be created by the

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1/ Cf. Reform Report, pp. 52-53.

2/ The measurement of the liquidity of the two Accounts raised many difficult issues that cannot be treated in any fully satisfactory manner. The most extensive discussion of this question is contained in SM/67/92 of July 25, 1967 ("Drawing Rights and Required Resources in Schemes for Reserve Creation"), on which the following is based. The assets of the General Account consist, roughly, of 25 per cent of total quotas in gold and 75 per cent in currencies. The gold can always be used, but at times (in 1966) only about one third of the Fund's total holdings of currencies (i.e., about 25 per cent of quotas) were considered as suitable for drawing. Thus the Fund's available assets might be as low as half of total quotas, while at the same time potential demands on these might be as high as 125 per cent of quotas (gold tranche plus four credit tranches) of the two thirds (measured in terms of quotas) of the membership that was in a weak payments position, or 83 per cent of total quotas. In the SDR system, on the other hand, the desire of two thirds of the participants (measured in terms of allocations) to use the full amount of their allocation could in theory just be met by the acceptance obligation of the other third for twice the amount of their allocation. Measured on this basis--which clearly involves a number of debatable assumptions--the liquidity of the Special Drawing Account would be 1 2/3 times (1 + 50/[illegible]) as great as that of the General Account. The liquidity of the General Account as originally envisaged was close to that of the Special Drawing Account, being based on the assumption that U.S. dollars would always be usable and that no allowance need to be made for the contingency of use of the Fund's resources by the United States.

merger of the acceptance obligations of the two Accounts, inasmuch as their "peak needs" might not coincide. This tendency would be reinforced if, as part of the Reform, the absolute size of acceptance obligations were substantially increased to make room for SDRs issued in substitution for reserve currencies. And the possibility has also been mentioned that there might be no limit on the acceptance obligation for SDRs.[1]

Concern over its liquidity is not the only—or even the most important—factor limiting the operations of the General Account. Control over the extent of the operations, and hence on the magnitude of its contribution to reserve creation, is primarily exercised in a number of ways.

(a) By decisions on quotas.

(i) The absolute size of quotas provides the scale that determines the amounts that can be drawn under given policies expressed in terms of percentages of quota.

(ii) The distribution of quotas among likely surplus and deficit countries affects the probable size of desired use of Fund resources and the availability of "usable currencies."

(b) By decisions on policies on the use of Fund resources, such as tranche policies, the compensatory financing and buffer stock financing policies, etc.

(c) By decisions on the lending of currencies under the General Arrangements to Borrow that are taken by participants in these arrangements with a special majority. Such decisions are made with respect to individual requests for drawings by such participants, and are preceded by a special scrutiny of these requests in Working Party No. 3 of the OECD.

1/ Reform Report, p. 53.

(d) By the Fund's policies on repurchases.

It should be noted that quota decisions and decisions on the use of resources are subject to various restraints of a legal or conventional character. Changes in quotas proposed as a result of a general review require an 85 per cent majority and other quota changes an 80 per cent majority.[1] As a result of the adoption of Article V, Section 3(d), the Fund no longer has the power to create any new facility in the General Account for the unconditional use of its resources.[2] In the design or expansion of nonautomatic facilities, the Fund pays careful attention to the liquidity implications.[3]

A question for consideration would be whether the present decision-making process would be sufficient to control the size of the Fund's conditional financing activity in the absence of a potential constraint exercised by the resources available to the Fund; whether this process would need to be strengthened; or whether some other total constraint would need to be introduced, e.g., in terms of a maximum of conditional credit outstanding, with perhaps the possibility of exceeding the maximum if approved by a high qualified majority.

Gold and Quota Aspects

A Fund mechanism based on credit extension in terms of SDRs would not require Fund holdings of gold for liquidity reasons. The Fund could still

1/ Article III, Section 2.

2/ International Monetary Fund, Proposed Amendment of Articles of Agreement, (Washington, D.C. April 1968), p. 25.

3/ See, for example, the section on "Changes in the Compensatory Facility and Fund Liquidity" in Compensatory Financing of Export Fluctuations, A Second Report by the International Monetary Fund (Washington, D.C. 1966), pp. 27-28; and a comparable section in the report containing the proposal for Fund financing of members' contributions to commodity stocks (International Monetary Fund, "The Problem of Stabilization of Prices of Primary Products," Scope for Action by the Fund, Washington, D.C. 1969, p.19).

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hold gold as a result of a variety of transactions or operations. The Fund has large gold holdings at present, arising mainly from subscription payments in gold, and it might well be felt that no good purpose would be served in returning these to members. As long as gold remained a reserve asset, members should presumably be able to discharge their obligations to the Fund in gold, as well as in SDRs. There could also be arrangements under which the Fund would acquire gold from members against newly issued SDRs.[1]

There would be no technical problem in requiring members to transfer gold to the Fund--against SDRs or a reduction in their use of Fund credit--when they joined the Fund or when their quotas were increased. However, since the Fund would not need the gold for liquidity reasons, it would have to come to a judgment whether (i) gold payments by new members and (ii) gold (or SDR) payments on the occasion of quota increases still served a useful purpose.

In the past, gold payments for quota increases have been thought to be useful to restrain undue pressure for such increases; the effectiveness of this restraint may have been reduced by the fact that larger quotas now entail larger SDR allocations. In any consideration of this question, two facts would in any event need to be allowed for:

(a) As part of the Reform, members would probably become entitled to use SDRs to pay the "gold component" of their contribution related to quota increases.

(b) Presumably, members in payments difficulties would be able in the future, as they were in the past, to stretch their gold payments to

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1/ Reform Report, p. 51.

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the Fund, or the equivalent of such payments, over a number of years while yet receiving the quota increase at once.1/

In a Fund constructed on an SDR basis, (a) would make the requirement to make "gold payments" meaningless for countries that did not use Fund credit: they would--if they used the SDR option--buy SDRs from the Fund with SDRs. Even in the Fund as presently structured countries would be very little affected by an obligation to increase their creditor position in the Fund in exchange for a reduction of their holdings of SDRs. For countries indebted to the Fund the position would also change little--in the sense that, as before, those in a weak payments and reserve position would have the option to make their "contribution" in the context of a quota increase by a modest acceleration in the repayment of their outstanding Fund credit.2/

A Fund extending conditional credit against the issuance of SDRs could, in addition to gold, hold other assets purchased against SDRs, such as reserve currency balances acquired under substitution arrangements, or claims on development financing institutions arising under "link" arrangements.

1/ In the 1958 and 1964 general quota reviews, this was made possible by allowing members to make a special drawing for an amount equal to the gold payment, the drawing to be repurchased in three (1958) or five (1964) equal annual installments; in the 1969 review, members with low reserves were entitled (under the provisions of Article III, Section 4(a)) to avail themselves of the opportunity to make a reduced gold payment, but were then required to repurchase the resulting additional currency subscription in five equal annual installments.

2/ Quantities are important in this connection. The 1964 and 1969 quota reviews resulted for many members in quota increases by 25 per cent. These would involve normal gold payments of 6.25 per cent of quota, or, if spread over 5 years, annual payments of 1.25 per cent of quota.

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Technical Transition to a General Account Based on SDRs

Adoption of the approach to credit operations of the Fund outlined above would involve a major amendment of the Articles of Agreement. Some of the present provisions dealing with the General Account would become redundant; there would have to be many consequential changes, e.g., in the provisions that indicate debtor or creditor positions by reference to the Fund's holdings of a member's currency compared to its quota; and the liquidation provisions might need to be completely revised.

Conceptually, the transition from a Fund in terms of currencies to one in terms of SDRs is not complicated. The transition would involve the Fund repaying members' subscriptions, thus changing the quota from a balance sheet entry into being exclusively a yardstick for members' rights and obligations, as it is already in the Special Drawing Account. The repayment of subscription would be made in the first instance in the member's currency. Where the Fund's holdings were insufficient for this purpose--i.e., where the member had a gold tranche position--the balance could be paid in SDRs created *ad hoc*, or, to the extent that this were desired, in gold. Where the Fund's holdings of a member's currency exceeded its quota, the excess could be converted into--or considered as--an SDR credit to that member. The Fund's reserves would of course remain unchanged. The effect on the balance sheet of the General Account as of April 30, 1972, would be as shown below, assuming that payments to countries with gold tranche positions of SDR 6.2 billion were made fully in SDRs, for which the General Account's holdings of SDRs (SDR 0.9 billion) were used first, and SDR 5.3 billion in new SDRs was created.[1] This happens to be the same amount as the Fund's gold holdings

[1] A Fund that finances its credit operations by the issuance of SDRs, would presumably not show SDR holdings on its balance sheet, just as a Central Bank does not show unissued bank notes on its balance sheet.

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on that date, when the use of Fund credit was no larger than the Fund's reserves. However, such use had been much higher in the past; it was in excess of SDR 4 billion at the end of 1959.

General Account Balance Sheet as of April 30, 1972

Billions of SDRs

Gold	5.3	Quota Subscriptions	28.8
SDRs	0.9	Reserves	0.8
Currencies1/	23.4		
Total Assets2/	29.6	Total Liabilities2/	29.6

Hypothetical General Account Balance Sheet as of April 30, 1972

Billions of SDRs

Gold	5.3	SDRs	5.3
Use of Fund Credit	0.8	Reserves	0.8
	6.1	Total Liabilities	6.1

Sources: IMF Annual Report for 1972, pp. 104-5; IFS, June 1972.
1/ Includes securities and balances of initial quotas, not due.
2/ Including minor items.

The recasting of the balance sheet of the General Account suggests a further point of reform, which would arise in particular from other more substantive reform proposals, viz., that there may no longer be a point in distinguishing separate Accounts in the Fund. One could readily imagine an integrated Fund balance sheet that carried as assets some or all of the following:

gold
currencies arising from substitution arrangements
conditional credit extended
SDR allocations
claims on development finance institutions

and as liabilities

SDRs
reserves.

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Effects on Certain Present Features of the Fund

The preceding summary description of how conditional credit transactions could be arranged on an SDR basis sketches a mechanism that would lack most of the esoteric characteristics of the present Fund and would thus be easier to understand. Thus there would be no need for concepts such as the "gold tranche," the "basic gold tranche," the "super gold tranche," the "currency budget," "overwhelming benefit of any doubt," "reserve positions in the Fund," "Fund positions" (net, gross, and creditor), "remuneration," and "scarce currencies." A reformed mechanism would also avoid some of the most difficult and divisive issues that have arisen in the Fund's history and many of which may arise again in the future under present provisions. Among these mention may be made of the automaticity of drawing in the gold tranche, "floating in the gold tranche" (applicable to compensatory financing but not to buffer stock financing), maintenance of the gold (or SDR) value of the Fund's assets (except in respect of currencies acquired under substitution arrangements and, perhaps, administrative cash balances), the General Arrangements to Borrow, bilateral borrowing, replenishment of currency holdings with gold, the usability of SDRs in payments to and by the General Account, and--if gold payments on quota increases were eliminated--mitigation of the direct and indirect reserve effects of such payments.

Beyond these general effects, there would be a number of special effects, some important, some less, some perhaps advantageous, others perhaps on balance less desirable. The present structure of the Fund is responsible for many features that would not necessarily be incorporated if one started from scratch, but that have, nevertheless, acquired a certain status. It would be difficult--and perhaps hardly worthwhile at this stage--to give a complete listing of these secondary effects; some that come readily to mind are briefly noted below.

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1. Absence of remuneration on the basic gold tranche. In the present Fund, members help to finance operation of the Fund and to make possible a relatively low average rate of charge on the use of Fund credit, to the extent that they hold a basic gold tranche position on which they do not receive remuneration, while interest or its equivalent is paid ~~both~~ on super-gold tranche positions, loan claims on the Fund, and holdings of SDRs. A corresponding arrangement in a restructured Fund would be for the Fund to pay interest on SDR holdings only on amounts in excess of 25 per cent of a member's quota. It would have no financial effect on members that hold a gold tranche position of 25 per cent of quota or more; but it would remove the anomaly in present arrangements that members can earn interest on SDR holdings while using part or all of their basic gold tranches interest free. The alternative arrangement suggested would, on a recent date (October 31, 1972), apply to some additional SDR 2.5 billion, which would mean an extra net income in the form of saving on SDR interest payments for the Fund as a whole, at 1½ per cent per annum, of about SDR 38 million. The arrangement would create an area of interest-free use of SDRs (up to holdings of 25 per cent of quota). If it were desired to eliminate this, it would be necessary to add to SDR charges rather than subtract from SDR interest payments, and stipulate that charges would be levied not only on the net cumulative allocation but also an amount equal to 25 per cent of the member's quota, with interest being paid, as at present, on all holdings of SDRs. This would add another SDR 0.6 billion at the same date on which the Fund would earn (at the rate of 1½ per cent) an additional SDR 9 million. The absence of super-gold tranche positions as separate reserve assets would eliminate the possibility in the present Articles to adjust the Fund's finances by allowing a slight difference between the rate of remuneration and the SDR interest rate.

2. Scarce currency provisions. Under these provisions of the Articles, the Fund is entitled to take action against a country in an extreme creditor position as reflected in the Fund's holdings of that member's currency; and such action then authorizes members to introduce discriminatory provisions with respect to the currency that has been declared scarce (Article VII, Section 3). While these provisions of the Articles were initially hailed as an important part of the adjustment process directed against persistent creditor positions, it has since become recognized that this provision "does not in its present form provide a practical means of applying pressure on surplus currencies,"[1] so that any other action with respect to extreme creditor countries will in any event have to be based on a different criterion.

3. Payment of charges in a member's own currency. This option, which members have in certain circumstances,[2] and which amounts to adding interest due to the outstanding balance, would lapse in an SDR-based Fund.

4. Effect of the provision for uniform change in par values on the value of positions in the Fund. The present Articles provide a possibility to scale down members' debtor and creditor positions in the Fund as a result of a uniform downward change in par values, accompanied by a decision not to apply the provisions on the maintenance of the gold value of the Fund's assets.[3]

5. Effect on non-participants. If all Fund transactions were conducted in SDRs, any of the few members that are not participants might have to be able to hold SDRs when obtaining conditional credit from the Fund and

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1/ Reform Report, p. 18.
2/ Article V, Section 8(f).
3/ Article IV, Sections 7 and 8(d). Both decisions require an 85 per cent majority of the total voting power of the Board of Governors.

when repaying such credit. The holding of SDRs for this purpose need only be transitional, in much the same manner as many countries now briefly hold currencies that they do not normally have in their reserves in connection with purchases and repurchases in these currencies. Less transitory holdings of SDRs would arise for these members if the Fund repaid their gold tranche positions in SDRs.

6. Special Rights for Creditors in the General Account. These rights, relating to voting in certain circumstances (Article XII, Section 5(b)) and the appointment of executive directors (Article XII, Section 3(c)), would lapse as there would no longer be a separate creditor position in the General Account. If desired, similar rights could be established as a function of members' positions in the Fund as a whole, expressed in terms of holdings of SDRs compared to net cumulative allocations.

7. Effect on administrative expenditure. The Fund would need a provision to acquire currencies against SDRs for its administrative expenditure. This expenditure is now financed by reserve creation in the form of reserve positions in the Fund; in a restructured Fund it would be financed by reserve creations in the form of SDRs.

SUBJECT COPY

MEMORANDUM

TO: Mr. Nicoletopoulos December 19, 1972

FROM: J. J. Polak

SUBJECT: Restructuring the General Account of the Fund--An Exploratory Paper

I want to return to one point of your memorandum of December 1st, namely the question you raise regarding the merger of acceptance obligations in the two Accounts. It seems to me that this is (or should be) a nonissue. Once the Fund extends conditional credit by creating SDRs, it can no longer make a distinction between the origins of the SDRs which members hold and which they may want to use through the designation mechanism. These SDRs may have come from allocations, from recent conditional drawings, from conditional drawings a long time ago, from transfers among participants with or without designation, from interest paid by the Fund, etc. To suggest the possibility of different acceptance obligations implies a need to trace each member's holdings of SDRs back to its origin--and how far back? It also implies that members themselves would have to consider some SDRs as potentially less usable than others.

I trust this is enough to convince you on this point.

cc: Mr. Gold

MEMORANDUM

TO: Mr. Sturc December 19, 1972

FROM: J. J. Polak

SUBJECT: Restructuring the General Account of the Fund--An Exploratory Paper

You will have noted that I have benefitted considerably from your memorandum of November 28th, partly by changes in substance, partly by clarification of points that were apparently not evident in the previous draft.

On one point I remain unconvinced, namely that it would be useful for members to pay in some gold or SDRs on the occasion of quota increases because one could then let the member have their own money back on an unconditional basis. I cannot believe that our tranche policies need this step to be effective and that we could not just as well start with the first credit tranche.

The restructuring suggested has no impact on the balance between conditional and unconditional liquidity creation and while this is, of course, an important subject I see no need to discuss it in the context of the present paper.

cc: Mr. Gold
Mr. Del Canto
Mr. Habermeier
Mr. Whittome

Office Memorandum

TO : Mr. Polak

DATE: November 28, 1972

FROM : Ernest Sturc

SUBJECT : Reform of the General Account

1. My colleagues and I have enjoyed reading the paper. It does, at first reading, seem to be a neat surgical operation, eliminating difficult concepts and procedures, without sacrificing much of substance.

2. While it may be logical to dispense with the members' contribution altogether, I believe there is a practical value in retaining a partial contribution in gold (or SDR). This is a tangible way each member contributes to a cooperative arrangement. Acceptance obligations also serve this purpose, but in a less obvious way. I also believe that it is useful to retain the counterpart of such contribution which is the unconditional access to the use of Fund resources. This makes tranche policies, with its main element of a progression of conditionality, more effective.

No

3. On page 6 you raise the possibility of making timing of repayment a function of the rate of interest. The original idea behind interest rates rising with the period of use was to discourage anything but a very short-term use of the Fund's resources. At that time it was believed that members should make routine use of the Fund, and drawings and repayments should occur at short intervals. This is not however the way the Fund has evolved, and there is little reason to expect that rising interest rates will preserve the revolving nature of the Fund.

4. In our view, it would be a serious mistake to abandon the 3-5 year rule. Apart from its contribution to the maintenance of Fund liquidity, it now forms the heart of the Fund's conditionality by providing a time horizon for the improvement of the member's balance of payments. Without such a time constraint, conditionality would become a vague concept and the Fund's role in helping to bring about balance of payments adjustment would greatly weaken.

5. We recognize that the 3-5 year rule may not be appropriate for all types of balance of payments problems. This is why in the past it has been found necessary in some instances to continue the stand-by relationship for successive years, thus, in effect, extending the period of repayment. In our view, a better expedient in these exceptional cases would be a special facility under which members may make longer-period and perhaps larger use of the Fund's resources.

6. A subject that needs further treatment is the nature of constraint on conditional liquidity creation, in particular whether in addition to limits on the access of individual members, one should also devise ways of setting a total limit on conditional credit outstanding. In this connection, it is important to stress the need for a balance between conditional and unconditional liquidity creation. Our view is that periodic quota reviews should continue and quota adjustments should determine the size of conditional liquidity.

7. The system of assessment levied on members' quotas, mentioned on page 14, to meet the Fund's administrative expenses appears undesirable. We would like to see interest rates on conditional resources to vary as at present, which would create a margin between interest rate earnings from users of SDR credit and payments to SDR holders.

8. Finally, it does not seem to us appropriate at this time to press for a large-scale amendment of the Articles. The changes suggested would give the Fund more of an appearance of an international central bank. Whether this is appropriate or not would depend very much on what role the Fund would be asked to play in the future. We need to know the results of the current negotiations on reform before we can form a clear idea of whether and how to simplify the procedures relating to the General Account.

cc: Mr. Gold
Mr. Del Canto
Mr. Habermeier
Mr. Whittome

MEMORANDUM

TO: Mr. Habermeier December 19, 1972

FROM: J. J. Polak

SUBJECT: Restructuring the General Account of the Fund--An Exploratory Paper

Thank you for the "basic comments" in your memorandum of December 5th. As indicated in my memorandum to the Acting Managing Director, the subject of a restructuring of the General Account is complex and has important implications. An intelligent discussion requires that these complexities be set out in some detail. Members can then decide whether they are prepared to buy the package or not.

No useful purpose would be served by an incomplete exposition of the implications, in hopes that this might look less radical, and thus more readily accepted. One cannot follow the advice of the Swedish wag who thought that a total switchover from driving on the left to driving on the right was too radical, and wanted to make the transition gradually by categories of vehicles, first buses, then taxis, etc.

I believe you overstate somewhat the difference between the ideas put forward by you on November 10 and those contained in the present paper. The present paper advocates no change in the balance between conditional and unconditional liquidity. Any suggestion that the General Account finance its transactions in part by the issuance of SDRs negates the principle of the separation of the two Accounts, which was explicitly based on the proposition that each Account would finance its operations from its own resources, the General Account from its holdings of assets and the Special Drawing Account by the creation of SDRs. Since the term "assessment" seems to raise an instinctive negative reaction (see Mr. Sturc's memorandum of November 28th) I have dropped that term in the present draft.

If there were a gradual way towards changing the structure of the General Account, I would favor that that would be put forward too. However, it seems clear that the suggestions contained in your memorandum of November 10th would raise just about as many problems of principle (the issuance of SDRs to finance conditional Fund transactions) and of amendment without producing a "clean" form for the General Account. In particular, by retaining

currency holdings and at the same time conducting transactions in newly created SDRs, it would raise complicated (and I think useless) questions of the measurement of members' positions in the Fund.

In my own view the important preparatory work has been done over the past 10 years by raising the quality of reserve positions in the Fund so as to make them as close to SDRs as the present approach permits. The gap that now still exists will have to be vaulted in one jump.

Various other things can usefully be done but it would be better not to confuse them with a possible new structure for the General Account. These include a wider use of SDRs for gold and currencies in the General Account, as envisaged before Stockholm. They also include a greater use of SDRs in drawings and repurchases; but as you yourself recently pointed out, there are severe limitations to this, arising from the fact that the General Account has its own principles of harmonization.

cc: Mr. Gold
Mr. Del Canto
Mr. Sturc
Mr. Whittome

Office Memorandum

TO : Mr. Polak

DATE: December 5, 1972

FROM : W. O. Habermeier

SUBJECT : Reform of the General Account

At this time I have just a few basic comments on the note prepared by the Research Department. If the discussion of it were to continue we would offer further general and also detailed comments.

1. The ideas contained in the above note are extremely far-reaching and one can have strong doubts about the advisability of bringing them forward at this time. Together with the ideas about gold sales of the Fund to the market and the conversion of Fund gold into SDRs these new concepts might truly be called "radical". Indeed, if the mark is overshot these new departures could easily prove to be lamentably unacceptable to governments even after the reform discussions have reached a more advanced stage.

2. This does not mean that no progress can be made nor that we are adverse to it. In fact, the recent note submitted by us for debate was meant to explore, in a more gradual way, such new frontiers. It was, however, kept deliberately low-key, advocating only a gradual substitution of SDRs for gold and currencies in a pragmatic, discretionary way. Above all, we had hoped to avoid a mandatory, inflexible, gold-SDR fund. The only exception to a basically evolutionary line was our idea to empower the General Account to create SDRs in place of super gold tranche positions, but even this we put forward with a good deal of diffidence.

3. You will, of course, be aware that there are at least a handful of other essential differences between the line taken by Research and that taken by us. For example, we did not seriously propose a conversion of "basic" gold tranches into SDRs at an early stage, nor a merger of the finances of the two Accounts; neither did we contemplate any change in the balance of conditional or unconditional liquidity believing this was a matter connected with the "link". Moreover, we did not want to do away altogether and at once with currencies, especially with reserve currencies, and we strongly prefer income over assessment as a means to finance the Fund's expenditures.

4. Reflecting on the sweeping character of the changes contemplated in the Research Department paper I am inclined to the view that it may have been even too early for us to argue for a special creation of SDRs by the General Account to substitute for super gold tranches. It would be possible to be much more modest as the existing Articles allow for a growing use of SDRs in Fund transactions side-by-side with currencies and gold; the more SDRs there would be in existence, for example, through a successful operation of a Substitution Account, the more SDRs might be channeled through the Fund, and perhaps this could even be encouraged. To do this a few, less incisive, amendments would of course be desirable for allowing greater flexibility, such as substituting SDRs for gold in subscriptions and for gold and currencies in certain repurchases, as well as perhaps to allow the General Account to become a vehicle for a certain type of "link" (financed either from the Fund's own resources or as supplemented by a transfer of some part of the regular SDR allocation).

5. As regards further procedures, we have doubts that a staff seminar would be useful on policy papers designed to lead up to amendment. Should, nevertheless, a staff seminar be convened it would, I believe, be proper for other participants to circulate their working documents also. In addition to the note which I submitted recently we can offer a fairly comprehensive study of the financial aspects of a reform of the General Account. This study, which was prepared last spring by Mr. Cutler, after some discussion in this department, was not circulated earlier because it also went in for some rather far-reaching changes. I would hope very much that any paper on this matter would be the subject of jointly prepared papers which we can all support.

cc: Mr. Gold
Mr. Del Canto
Mr. Sturc
Mr. Whittome

Limits to countries for which col (11) of II > 75%
Oct. 31, 1972

	.25 Q (1)	RPIF (2)	(1) − (2) (3)	H (4)	4 or (3) (5)			
U.S.	1675.00	418.0	1257	1803.1	1257.0			
U.K.	700.00	116.5	583.5	393.5	583.5			
Turkey	37.75	28.1	9.7	38.3	9.7			
Yugoslavia	51.75	—	51.8	7.1	7.1			
Argentina	110.00	—	110.0	18.4	18.4			
Barbados	3.25	2.0	1.3	2.8	1.3			
Bolivia	9.25	—	9.3	3.1	3.1			
Chile	39.50	0.1	39.4	—	—			
Colombia	39.25	—	39.3	17.6	17.6			
Costa Rica	8.00	0.3	7.7	4.0	4.0			
Dominican Rep.	10.75	—	10.8	7.0	7.0			
Ecuador	8.25	—	8.3	6.7	6.7			
El Salvador	8.75	—	8.8	3.8	3.8			
Guyana	5.00	0.4	4.6	4.2	4.2			
Haiti	4.75	2.5	2.3	3.1	2.3			
Honduras	6.25	—	6.3	5.5	5.5			
Jamaica	13.25	—	13.3	13.4	13.3			
Nicaragua	6.75	—	6.8	6.3	6.3			
Panama	9.00	8.0	1.0	2.7	1.0			
Peru	30.75	—	30.8	41.0	30.8			
Trinidad + Tobago	15.75	6.6	9.2	9.8	9.2			
Uruguay	17.25	—	17.3	8.0	8.0			
Bahrain *	2.50	2.5	—		—			
Egypt	47.00	—	47.0	21.2	21.2			
Iran	48.00	19.3	28.7	33.4	28.7			
Iraq	27.25	—	27.3	23.2	23.2			
Israel	32.50	—	32.5	29.4	29.4			
Oman *	1.75	1.8	—	0.7	—			
Qatar *	5.00	5.0	—		—			
Syrian Arab Rep.	12.50	—	12.5	4.1	4.1			
United Arab Emirates *	3.75	3.8	—		—			
Yemen Arab Rep.	2.50	1.5	1.0	2.1	1.0			
Yemen, People's D.R.	7.25	3.8	3.5	7.8	3.5			
Afghanistan	9.25	—	9.3	1.3	1.3			
Bangladesh *	31.25	2.0	29.3		29.3	?		
Burma	15.00	—	15.0	5.8	5.8			
Ceylon	24.50	—	24.5	13.3	13.3			
China	137.50	—	137.5	—	—			
Fiji *	3.25	2.3	1.0	1.4	1.0			
India	235.00	76.2	158.8	246.5	158.8			
Indonesia	65.00	—	65.0	35.8	35.8			
Khmer Rep.	6.25	—	6.3	4.3	4.3			
Korea	20.00	12.5	7.5	26.1	7.5			
Laos	3.25	2.8	0.5	1.3	0.5			
Malaysia	46.50	39.2	7.3	63.1	7.3			
Pakistan	58.75	—	58.8	30.7	30.7			

	.25 Q (1)	RPIF (2)	(1) - (2) (3)	H (4)	H or (3) (5)
Philippines	38.75	—	38.8	21.9	21.9
Thailand 1/	33.50	31.4	2.1	28.5	2.1
Viét Nam *	15.50	15.5	—	19.8	—
Western Samoa *	0.50	0.4	0.1	0.2	0.1
Algeria *	32.50	32.5	—	41.8	—
Botswana	1.25	0.6	0.7	1.6	0.7
Burundi	4.75	0.2	4.6	3.7	3.7
Cameroon *	8.75	6.9	1.9	10.5	1.9
Central Afr. Rep.	3.25	0.2	3.1	1.3	1.3
Chad	3.25	—	3.3	1.3	1.3
Congo, Peoples Rep. *	3.25	1.6	1.7	2.7	1.7
Dahomey *	3.25	2.1	1.2	4.4	1.2
Equatorial Guinea	2.00	—	2.0	1.9	1.9
Gabon	3.75	2.4	1.4	4.8	1.4
Gambia	1.75	0.4	1.4	2.3	1.4
Ghana	21.75	—	21.8	10.0	10.0
Guinea	6.00	—	6.0	2.9	2.9
Ivory Coast *	13.00	10.8	2.2	15.3	2.2
Lesotho	1.25	0.1	1.2	1.0	1.0
Liberia	7.25	—	7.3	1.6	1.6
Malagasy Rep. *	6.50	5.0	1.5	8.7	1.5
Malawi	3.75	1.7	2.1	4.8	2.1
Mali	5.50	—	5.5	2.5	2.5
Mauritania	3.25	0.6	2.7	2.3	2.3
Mauritius	5.50	2.5	3.0	7.3	3.0
Niger *	3.25	2.1	1.2	4.4	1.2
Nigeria 1/	33.75	12.9	20.9	45.5	20.9
Rwanda	4.75	—	4.8	0.4	0.4
Senegal *	8.50	3.6	4.9	6.0	4.9
Sierra Leone	6.25	4.9	1.4	5.7	1.4
Somalia	4.75	3.8	1.0	4.6	1.0
Sudan	18.00	—	18.0	1.5	1.5
Swaziland	2.00	0.2	1.8	0.8	0.8
Tanzania	10.50	6.9	3.6	6.7	3.6
Togo *	3.75	2.1	1.7	5.1	1.7
Tunisia	12.00	5.9	6.1	7.9	6.1
Uganda	10.00	—	10.0	13.7	10.0
Upper Volta	3.25	2.5	0.8	4.4	0.8
Zambia	19.00	—	19.0	0.3	0.3
Total			3112.6	3461.0	2532.8

1/ Except for Buffer Stock drawings that can be offset against the Gold Tranche.

Office Memorandum

TO : Mr. J. J. Polak

DATE: December 1, 1972

FROM : G. Nicoletopoulos

SUBJECT : Memorandum on Reform of the General Account--
Draft of November 20, 1972

We have the following comments on the November 20 draft of your memorandum:

Page 6, line 2: I would not stress the quantitative limitation of 25 per cent of quota per year. In practice it is waived routinely, and the tranche policy has taken its place.

Last paragraph: While we do not wish to pursue the question, we still have doubts regarding the merger of acceptance obligations in the two Accounts. The problem would not arise if, as suggested on p. 7, the absolute size of acceptance obligations were increased substantially, or the limit on them were removed. Without such a solution difficulties could arise for the separate and independent operation of the General Account, especially if the "peak needs" of the two Accounts were to coincide.

Page 7, lines 14-17: It may be helpful for the reader if the arithmetics of this sentence were clarified.

Page 8, paragraph (c): The first part of the second sentence may well be deleted; and the point of the remaining part of that sentence could be better expressed by reference to "decisions on borrowing by the Fund."

Moreover, would it not be appropriate to mention policies on repurchases, replenishment, and gold?

Page 10, and carry-over paragraph to p. 11: This discussion is difficult to square with the idea of an SDR-based General Account. The concepts of gold subscription and mitigation have no inherent rationale in that context. If gold were to be held for "a variety of reasons" as this is suggested on p. 9, it may be appropriate to derive criteria for gold transactions with members from these reasons explicitly rather than to recreate the present provisions in a new guise. These criteria would presumably also take into account whether there is any need for a requirement that members make gold payments to the Fund, whether on the occasions of joining the Fund, quota increases, or otherwise.

Footnote, line 4 from bottom: The correct reference is to Article III, Section 4(a).

General Account Balance Sheet: "subscriptions" should be substituted for "quotas".

Page 14, second full paragraph: It may be useful to discuss also how charges on the use of the Fund's resources may also finance the costs of the Fund's operation (rather than "operations"), and how higher charges in the upper credit tranches may also serve to make possible lower charges in the lower credit tranches.

If it is intended to maintain the existing system of differentiated charges on levels of holdings, a substitute mechanism, based on outstanding credit, would have to be devised. This may be mentioned.

Footnote: There is a presentational problem here, in that the footnote refers to assessment in a reformed Fund, while the idea of making assessments for subsidizing low charges is introduced only later on the page. Regarding the idea itself, SDR creation for this purpose may be mentioned as a conceivable alternative technique.

Page 15, scarce currency provision: We are still puzzled by the discussion of this provision here. In a simplified system there may be no scarce currency provision as such, but in all likelihood there would be other provisions intended to induce or force surplus countries to take adjustment measures.

Line 5 from bottom of page: Strictly speaking, the Articles provide a possibility, not a "theoretical" possibility. In any event, is it advisable to take a position in this respect in such definite terms?

Keep with Restructuring of Gen Acct

The rule that members pay 25 per cent of any quota increase in gold was for a long time considered an important disciplinary factor that would help to avoid undue pressure for quota increases. Although the Articles of Agreement provide for the possibility of a reduction in the gold payments by a member with small reserves (Article III, Section 4(a), it was decided in both the 1958 and the 1964 general quota increases not to apply this provision. The reason given on both occasions was that the "proposals for increases in quotas [were] based on the idea of a cooperative effort by the members of the Fund to provide larger resources against contingencies that might affect any member.", and that the general character of that effort should be preserved.[1]

The significance of the "effort" on the part of members that were not using the Fund in the credit tranches was however greatly reduced by the recognition--at first *de facto* and later *de jure*--of the reserve character of gold tranche positions. For countries in that position the payment of gold in connection with the quota contribution constituted no more than the replacement in their reserves of a gold guaranteed position in the Fund for actual gold. The economic meaning of the transaction would be even further reduced if countries were given the right (which they do not possess now) to substitute payment in SDRs for payment in gold. For countries that were using the Fund in the credit tranches on the other hand, the gold payment was the equivalent of an advance repayment of credit received from the Fund. These and other considerations led to a reversal of the position of the principle taken with respect to the

1/ "Enlargement of Fund Resources Through Increases in Quotas," Washington, 1958, p. 17; 1965 Annual Report, p. 126.

application of the provisions of Article III, Section 4(a): in the Fifth Quinquennial Review (1969), members with low reserves were entitled to avail themselves of the opportunity to make a reduced gold payment.

The substantive difference in treatment between the earlier and the later quota reviews was not as great as the change in the formal position might suggest; in fact it was minimal. On both of the earlier occasions, members encountering payments difficulties through the reduction of their reserves that the gold payment would involve could make a drawing for the corresponding amount, to be repurchased in three (1958) or five (1964) equal annual installments; and members that availed themselves of the possibility of reduced gold payments under the 1969 review were required to undertake to repurchase the resulting additional currency subscription in five equal annual installments.

If a member that receives a quota increase does not pay gold or pays gold and makes a drawing for the same amount, its position in the Fund is not changed. For a member that uses the Fund in the credit tranches, the arrangements under the various quota reviews therefore amount to some acceleration of repurchases of outstanding use of Fund credit and some commitment to build up a gold tranche position.

2. <u>Transactions with the Fund in gold</u>. The provisions with respect to the sale of gold by members to the Fund and the sale of gold by the Fund to members can be seen as providing an indirect mechanism assuring members of the usability of gold in their reserves to settle transactions with other members. The two provisions that, together, could provide this chain are Article V, Section 6(a) dealing with gold sales by members to the Fund and Article VII, Section 2(ii) under which the Fund can acquire

INTERNATIONAL MONETARY FUND

November 24, 1972

TO : Mr. Polak

FROM: E. W. Robichek

We feel your draft paper on reform of the General Account would provide a very good basis for a staff seminar, and we have no specific comments to make on the draft.

cc: Mr. Del Canto

Office Memorandum

TO : Mr. Polak

DATE: November 24, 1972

FROM : W.H. White WHW

SUBJECT : Requested Comments on your "Reform of the General Account", November 20 draft

1. The material on p.4 seems to be handling the subject from several conflicting viewpoints. Is there a possible source of confusion in your apparent belief that before the treatment of the gold tranche as reserves the Fund's loans did not create reserves? In reality, it would seem that insofar as members borrowed from the Fund to pay for deficits with the U.S. there was no change in reserves, but insofar as they borrowed (dollars) from the Fund to cover deficits with other countries--who presumably added the dollars to their reserves there was a creation of reserves by the Fund even under the old procedures. (Of course as you point out the U.S. started to gain reserves from drawings of dollars paid to the U.S. by the drawer once the associated rise in the U.S. gold tranche position became counted as reserves.)

Another possibly confusing element here is that, before the convention of counting gold tranche in reserves, initially to the extent that members' subscriptions were paid in other currencies and gold, total reserves went down. And from this point of view any outpayment of reserves by the Fund was not a net addition to reserves.

A final element, the position on which might be worth clarifying for the reader, is that contingent assets such as Fund credit tranches and contingent liabilities such as drawings of those tranches are not being counted as reserves or deductions from reserves.

If these interpretations are accepted then the material on this page would say that the Fund under the early procedures was not a creater of reserves to the extent its loans did not exceed gold and hard foreign currency payments toward member's quotas, although once the quotas were taken as given the Fund's credit operations did create and destroy credit the way SDR operations would (except to the extent that members drew dollars to pay for deficits with the U.S.). Hence the proposed use of SDRs in place of drawings on quotas would not constitute so radical a change in the credit-creating aspect of the Fund's operations.

2. Page 1: Insert in second line of second paragraph after "had": "in general"? That would provide for the exception to the stated result that exists in the case of gold tranche drawings.

The 6th line of the second paragraph calls the use of SDRs "unconditional". Is there not still a requirement that the member state a present or impending balance of payments need (with the implication that the Fund might change its treatment if event tended to prove the member wrong on its forecasts)? If so should any qualification be introduced for the benefit of the legal department's

blood pressure level? The distinction between "negotiated credits" on line 4 of page 3 and overdrafts may not be clear to some readers since overdrafts are themselves often contingent on existence of an (unused) negotiated line of credit.

3. Add to first paragraph, p.6? The equivalent of a gold tranche position would of course exist because an equal amount of reserves, usable completely at its own discretion, would be held under the SDR alternative to the General Account in place of the gold tranche position held if the general account existed.

4. P.6, lines12-13:Are "timing of repayment" and "rate of interest" interchanged?

5. The main reason given on p.7 for the SDR alternative to be more liquid than the present general account arrangement appears to be that the existing practice for SDRs of requiring willingness to accept additional SDRs beyond initial allocations equal to 200% of the latter could be extended to the conditional SDR loan arrangements: member's quotas for providing real resources (through accepting SDRs) would be set at twice their conditional quota for borrowings of SDRs. But is it clear that members would accept such an arrangement (or if they would that they would not accept it now, under the present arrangements) in which case the new arrangements cannot claim to have a net liquidity advantage? Accepting the obligation to lend twice the value of reserves (SDRs) received as a pure gift need not imply willingness to accept such an obligation merely in exchange for a conditional loan of the basic amount of reserves. If it should be true that the bait would then seem insufficient for the incurring of the contingent obligation, your implicit assumption for such an increase in contingent obligation--and for a zero quid pro quo--would have to be defended explicitly.

The last line of this page--unlimited acceptability of SDRs-should imply also unlimited (or at least greatly enlarged) acceptance of the obligation to provide currencies in excess of quota under the present system (provided that the super gold tranche position was equally as well rewarded with interest payments as excess holdings of SDRs would be).

6. P.10, line 4 says that the Fund would not need gold for liquidity reasons. That presumably holds only if the worries about members' willingness to enlarge greatly their obligation to give up resources argued above will prove unjustified. Any reason to qualify the stated freedom from need for gold for liquidity reasons?

7. The simplification of Fund terminology, concepts and regulations described in pp. 13-14 would also be diminished somewhat if the question of liquidity of the SDRs remained an issue for the reasons given earlier. If the members' willingness to accept extra SDRs were not increased by an amount sufficient to meet all future needs, then scarce currency would again be possible (although perhaps under a different name) and the general agreement to borrow, etc. might have to be revived. Similarly, as indicated earlier, if provision of adequate liquidity for SDRs was in fact in question, the retention of some sort of payment of part of quotas in gold would remain an alternative to GABs etc.

8. P.15 "scarce currency"provisions: that the Fund could take action against a country in an extreme credit position "as reflected in the Fund's holdings of the member's currency" has significance that the audience may miss, viz that (if I am not mistaken) members with strong BOP can avoid scarce currency sanctions by lending their currency to the Fund as needed. Would not a comparable loophole to that one, which--as you point out--makes the clause worthless, also exist in case of an SDR fund? Members who had absorbed their obligatory amount of SDRs could no longer be influenced in any way by the Fund (except of course to the extent that their SDR acceptance quota is by assumption larger than their currency quota in the Fund).

In any case, should not a new Fund have introduced other means to achieve the scarce currency clauses' purpose? From that point of view shifting to an SDR Fund would have no advantage with respect to the scarce currency clause; that clause would have been made unnecessary by the monetary reform's sanctions for BOP disequilibria.

9. Item 3, p.15. Should outstanding credit balance be outstanding debit balance (or, at least, outstanding credit)?

10. Item 5, p.16. Insofar as non-participants in SDRs have stayed out because they did not want the obligation to accept large amounts of SDRs in excess of those allocated to them, they might continue to insist on the same privilege with respect to the (former) "general account" SDRs--at least to be free of compulsory allocations. That might be thought to give them a privileged position. If so, is it worth discussion?

11. What about dealings with non Fund members who do not accept any SDRs. Would the Fund be permitted to sell gold to members who have deficits with such countries? Would an extra obligation to accept designation for sale of gold or acceptable currencies for payment to such non-members have to be added to the rules? If this involved, in particular, a loss of gold by the countries designated, it might cause difficulty.

Office Memorandum

TO : Mr. Polak

DATE: November 24, 1972

FROM : R.R. Rhomberg RRR

SUBJECT : Reform of the General Account

Page 6, second paragraph: Designation is akin to repurchase in the General Account only in certain instances, namely when the country designated has previously used SDRs. Perhaps this qualification would be helpful to the reader. The page reference in the footnote seems to be incorrect; perhaps it refers to the DM version of the same paper.

Page 7, middle: The description of the liquidity of the General Account makes it appear particularly illiquid. There do not seem to be enough resources (100 per cent of quota) to permit drawing of 125 per cent of quota. However, if half of the members, measured by quota, were to draw the currencies of the other half of the members, the Fund's holdings of these currencies, plus the gold subscriptions of both halves would be just sufficient to permit drawings by the deficit members of 125 per cent of their quotas.

Page 9, first full paragraph: In the context of the preceding comment and of this paragraph it may be relevant that credit in the form of SDRs could in principal be given to all members, or almost all members, simultaneously--although this would require a very unlikely world payments situation. By contrast, the General Account could at present not be used to extend full credit (100 per cent of quota) to, say, all members other than the United States; in the event of such a dollar-shortage situation credit to the membership would be limited by the amount of the U.S. currency subscription plus the gold subscription of all members.

Nov. 20, 1972

Reform of the General Account

Prepared by the Research Department

It was suggested in the Reform Report that an expansion of the role of the SDR might also be the occasion for a broader review of the provisions of the Articles relating to the General Account.[1/] As a background to such a review, this paper compares the method of operation of the General Account with that of the Special Drawing Account, and derives from this comparison certain inferences for a possible reform of the General Account.

Comparison between the two Accounts

On a sufficiently general level there is a strong similarity between the financial functions which the two Accounts perform for members: both enable a member in deficit to use financial resources that it had not earned from a previous balance of payments surplus. The two main differences between use of the two Accounts relate to conditionality--use of the General Account (except gold tranche use) being subject to conditions whereas the use of SDRs is unconditional--and to the need to restore the previous position after use. For members that provide the users with foreign exchange the effect of any use of the resources of either Account is also very similar; they acquire, in both cases, reserves in the form of "Fund related assets": a "reserve position in the Fund" (a gold tranche position or a loan claim on the Fund) when the drawing takes place in the General Account and SDRs when the drawing member uses its position in the Special Drawing Account.

1/ International Monetary Fund, Reform of the International Monetary System, A Report by the Executive Directors to the Board of Governors, (Washington, D.C. 1972), pp. 53-54. (All references in this paper are to the November 1972 printed version of the Reform Report.)

In spite of the fact that transactions in the two Accounts are so similar, both for the user and for the provider of resources, they are executed in entirely different ways. In the General Account, transactions are conducted on the basis of a pool of currencies contributed by all members, with further contributions in gold to enable the Fund to acquire additional amounts of any currency that it might need; there is also a provision to borrow additional amounts of currency. The drawing entitlements are expressed in terms of quotas, but the quotas themselves are not exchange reserves available to the member; such reserves have to be acquired by drawings made within the framework of the quotas. Drawings are technically made in the currencies of the countries that are selected by the Fund to acquire the reserve positions in the Fund; but these currencies are normally at once converted by the drawer, so that the drawee country experiences a substitution of a reserve position in the Fund for holdings of foreign exchange. In the Special Drawing Account, by contrast, given amounts of SDRs representing an equal percentage of quotas are allocated from time to time to participants. Use is made in the Special Drawing Account by the transfer of SDRs from one participant to another against convertible currency.

Why this difference between the two Accounts in technical arrangements, if it does not reflect any obvious difference in substance between the transactions in these two Accounts? Essentially, the explanation is that the SDR account is both the junior and simpler of the two Accounts; the more complicated form in the senior Account has clear historical reasons: the U.S. negotiators in the discussions that preceded Bretton Woods argued strongly that a Fund operating on the basis of "a mixed bag of currencies" was more

likely to win Congressional approval than one which introduced the unfamiliar concepts of a new international currency and of overdrafts.[1/] By now, the concept of an international currency is no longer unfamiliar. While "overdrafts" do not fit into normal U.S. banking practice, negotiated credits do. In the light of this, is there a continuing justification for the present form of the General Account?

Perhaps the best way to approach this question is as follows. Suppose that the founders of the Fund had felt it necessary to concentrate their attention on the need for unconditional rather than conditional liquidity and for this purpose had created a mechanism such as that contained in Articles XXI and following of the present Articles of Agreement, perhaps combined with regulatory provisions with respect to exchange rates, the avoidance of exchange restrictions, convertibility, etc. Such a Fund would have required quotas both as a basis for the allocation of unconditional liquidity and to determine voting power, but not the financial provisions of the original Articles of Agreement. Assume further that, despite the absence of a learning model which the pre-1969 Fund provided for the SDR mechanism, the provisions on SDRs were exactly those of Article XXI and following (with the exception of references to the General Account). If then, at some later time, when the SDR facility had been running smoothly for a considerable period, the Fund had reached the conclusion that it would be opportune to provide, side by side with the SDR facility, a conditional facility under which members would be entitled to obtain financial resources from the Fund for temporary use, how would it have gone about this?

1/ J. Keith Horsefield, The International Monetary Fund, 1945-1965, Vol. 1, pp. 28-30.

A General Account Patterened on the Special Drawing Account

It would seem unlikely that in order to provide this new facility the Fund would have found it necessary to ask each member to make a contribution in gold and in its own currency. Rather, it should have appeared natural that the Fund would have made provision for the creation of additional SDRs for the amount of credit it extended, these SDRs to be cancelled when Fund credit was repaid. This would be in line with the proposition that the extension of international credit by the Fund involves an expansion of reserves, and the repayment of such credit a contraction of reserves--a proposition which did not become valid until gold tranche positions began to be regarded as reserves in the early 1960's.[1] By that time the approach originally chosen--i.e., that the Fund would not be an international "bank", creating international money by extending "credit"--had been overcome by the economics of the situation. Once the Fund made the transition from the almost exclusive use of U.S. dollars to the use of a wide variety of currencies, it became necessary to monetize the resources that members made available to the Fund: members were willing (sometimes eager) to see a change in the composition of their reserves, but not a decline in them. Thus reserve creator as a byproduct to credit extension is a necessary element of a smoothly functioning Fund. At the same time, the attempt never took hold to view transactions through which the Fund made resources available to members in payments difficulties as a mere exchange of one currency for another. Fund transactions (beyond the gold tranche) are now generally regarded as the extension of balance of payments credit. This view is reflected, for example, in the adoption of the concept of "credit tranches" and in the widespread use of the term "repayment" as both more general and more meaningful than the legal "repurchase."

1/ For a brief discussion see, J. Marcus Fleming, "The Fund and International Liquidity," IMF Staff Papers, Vol. XI, No. 2 (July 1964) pp. 183-85. A more detailed description is given in Haman Ezekiel, "The Present System of Reserve Creation in the Fund," STaff Papers, Vol. XIII, No. 3 (November 1966), pp.398-420.

If operation of the conditional side of the Fund took place in the form of credit creation in SDRs, the country that obtained Fund credit would normally use the SDRs to acquire currencies, for which the designation mechanism could conveniently be used. Nothing new would be required for this purpose, but it would be necessary to create sufficient flexibility in the acceptance obligations so as to ensure that there would be takers for the additional SDRs put into circulation by the Fund's credit operations.

It is possible that a more important new feature might be required to enable countries to repay Fund credit in SDRs. Countries would have to be in a position to acquire such SDRs against the holdings of reserve currencies. If the Reform provided for an open-ended substitution facility, as suggested under the third approach for asset settlement described in the Reform Report,[1] this would take care of the problem. Under different settlement arrangements it might be necessary to introduce into the SDR mechanism a system of what might be called "reverse designation" to regulate which countries would have to make available SDRs against convertible currencies, and in what amounts (in contrast to the designation mechanism that regulates the countries that are to make available convertible currencies against SDRs).[2]

1/ Op. cit., p. 39.

2/ In the present SDR facility there are only the most rudimentary provisions for "reverse designation" because the need for it is unlikely to arise on any significant scale. In theory, a participant may, on "specification" by the Fund, be obliged to sell SDRs for "currency convertible in fact" for the purpose of enabling another participant to meet its obligations to pay charges and assessments (Article XXVI, Section 5 and Article XXX, Section 3) or its reconstitution obligation under Schedule G, paragraph 1(a); but the stock of SDRs held by the General Account makes it unlikely that these provisions will ever become operative. It should be noted that the sale of SDRs by the General Account against convertible currencies does not avoid the substantive problem, but transfers it to that Account. The question thus becomes the selection of countries that are to give up reserve positions in the Fund, rather than SDRs, against convertible currency.

The Fund's conditional drawing facilities could be subject to certain quantitative limitations such as a normal maximum of 25 per cent of quota per year and a normal upper limit of 100 per cent of quota, and within the latter limit to a tranche policy of increasing intensity of scrutiny depending on the extent of the use of Fund credit in terms of a member's quota. There would, of course, be no occasion for the introduction of automatic drawing rights in what is now called the gold tranche, because in the absence of gold payments and the sale of members' currencies, "gold tranche positions" would not arise.

Credit extended by the Fund in SDRs would naturally be repayable in SDRs. The Fund could set conditions for the duration of the credit (e.g., 3-5 years) or it could make timing of repayment a function of the rate of interest payable, along the lines of the provisions of Article V, Section 8(d). There could further be provisions for accelerated repayment in the light of the member's balance of payments and reserve position. This position is already used as a criterion in the operation of the designation system which affects the reversal of net use of SDRs in a manner somewhat akin to the repurchase provisions in the General Account,[1/] using, however, data on reserves based on a more flexible definition than that laid down in Article XIX to guide the repurchase provisions.

The Fund liquidity necessary to meet the needs for convertible currencies of the members that used the credit facility would be ensured by the size of the acceptance obligations, which, as mentioned, would have to be large enough to permit designation in relation to the total amount of SDRs that would at any time exist, whether arising from allocation or from conditional credit operations.

1/ J. J. Polak, "Some Reflections on the Nature of Special Drawing Rights," International Monetary Fund Pamphlet No. 16, p. 7.

Liquidity Aspects

The technical problem that arises in this connection is not different from that related e.g., to the issuance of SDRs in substitution for reserve currencies.[1/] But there would be a special effect on the liquidity of the General Account. Financing of that account by means of SDRs with a corresponding increase in acceptance obligations would by itself greatly reduce a liquidity constraint that now affects at least potentially, though by no means precisely, the operations of the General Account. The liquidity of the General Account is proportionally smaller than that of the Special Drawing Account. While the acceptance obligations in the Special Drawing Account (in excess of allocations) equal twice the outstanding holdings of SDRs, the General Account holds, in broad outline, 25 per cent of total quotas in gold and 75 per cent of quotas in currencies to meet potential drawings of 125 per cent of quotas (gold tranche plus four credit tranches). Assimilation of reserve positions in the Fund with SDRs and a corresponding increase in total acceptance obligations would introduce about double the room for acceptance that exists now with respect to General Account operations. Additional room would be created by the merger of the acceptance obligations of the two Accounts, inasmuch as their "peak needs" might not coincide. This tendency would be reinforced if, as part of the Reform, the absolute size of acceptance obligations were substantially increased to make room for SDRs issued in substitution for reserve currencies. And the possibility has also been mentioned that there might be no limit on the acceptance obligation for SDRs.[2/]

1/ Cf. Reform of the International Monetary System, A Report by the Executive Directors to the Board of Governors, (Washington, D.C. 1972), pp. 52-53.
2/ Ibid., p. 53.

Concern over its liquidity is not the only--or even the most important--factor limiting the operations of the General Account. Control over the extent of the operations, and hence on the magnitude of its contribution to reserve creation, is primarily exercised in a number of other ways.

(a) By decisions on quotas.

(i) The absolute size of quotas provides the scale that determines the amounts that can be drawn under given policies expressed in terms of percentages of quota.

(ii) The distribution of quotas among likely surplus and deficit countries affects the probable size of desired use of Fund resources and the availability of "usable currencies."

(b) By decisions on policies on the use of Fund resources, such as tranche policies, the compensatory financing and buffer stock financing policies, etc.

(c) By decisions on individual large transactions. Mention may be made here in particular of the special scrutiny in Working Party No. 3 of the OECD of drawings requested by participants in the General Arrangements to Borrow, and to the decisions on the lending of currencies under the GAB, that are taken by these participants with a special majority.

It should be noted that quota decisions and decisions on the use of resources are subject to various restraints of a legal or conventional character. Changes in quotas proposed as a result of a general review require an 85 per cent majority and other quota changes an 80 per cent majority.[1/]

1/ Article III, Section 2.

As a result of the adoption of Article V, Section 3(d), the Fund no longer has the power to create any new facility in the General Account for the unconditional use of its resources.1/ In the design or expansion of non-automatic facilities, the Fund pays careful attention to the liquidity implications.2/

A question for consideration would be whether the mechanism to control the size of the Fund's conditional financing activity would be sufficient in the absence of a constraint on the resources available to it, whether it would need to be strengthened, or whether some other total constraint, e.g., in terms of a maximum of conditional credit outstanding, would need to be introduced.

Gold and Quota Aspects

A Fund mechanism based on credit extension in terms of SDRs would not require Fund holdings of gold for liquidity reasons. The Fund could still hold gold for a variety of reasons. The Fund has large gold holdings at present, and it might well be felt that no good purpose would be served in returning these to members. As long as gold remained a reserve asset, members should presumably be able to discharge their obligations to the Fund in gold, as well as in SDRs. There could also be arrangements under which the Fund would acquire gold from members against newly issued SDRs.3/

1/ International Monetary Fund, Proposed Amendment of Articles of Agreement, (Washington, D.C. April 1968), p. 25.

2/ See, for example, the section on "Changes in the Compensatory Facility and Fund Liquidity" in Compensatory Financing of Export Fluctuations, A Second Report by the International Monetary Fund (Washington, D.C. 1966) p. 27-28; and a comparable section in the report containing the proposal for Fund financing of members' contributions to commodity stocks (International Monetary Fund, "The Problem of Stabilization of Prices of Primary Products," Scope for Action by the Fund, Washington, D.C. 1969, p. 19).

3/ Reform Report, p. 51.

There would be no technical problem in requiring members to transfer gold to the Fund--against SDRs or a reduction in their use of Fund credit--when they joined the Fund or when their quotas were increased. However, since the Fund would not need the gold for liquidity reasons, it would be able to judge on their merits the questions of (i) gold payments by new member and (ii) gold payments--or alternatively payments in SDRs--on the occasion of quota increases.

With respect to the second question, gold payments were thought to be useful also to restrain undue pressure for quota increases; the effectiveness of this restraint may have been affected by the fact that SDR allocations are tied to quotas. In any consideration of this question, two facts would in any event need to be allowed for:

(a) As part of the Reform, members would probably become entitled to use SDRs to pay the "gold component" of their contribution related to quota increases.

(b) Presumably, members in payments difficulties would in the future, as they were in the past, be able to stretch their gold payments to the Fund, or the equivalent of such payments, over a number of years while yet receiving the quota increase at once.[1]

In a Fund constructed on an SDR basis, (a) would make the requirement to make "gold payments" meaningless for countries that did not use Fund credit: they would--if they used the SDR option--buy SDRs from the Fund with SDRs. Even in the Fund as presently structured there would be very little meaning in

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1/ In the 1958 and 1964 general quota reviews, this was made possible by allowing members to make a special drawing for an amount equal to the gold payment, the drawing to be repurchased in three (1958) or five (1964) equal annual installments; in the 1969 review, members with low reserves were entitled (under the provisions of Article III, Section (f)(a)) to avail themselves of the opportunity to make a reduced gold payment, but were then required to repurchase the resulting additional currency subscription in five equal annual installments.

countries' increasing their creditor position in the Fund in exchange for a reduction of their holdings of SDRs. For countries indebted to the Fund the position would also change little--in the sense that, as before, those in a weak payments and reserve position would have the option to make their "contribution" in the context of a quota increase by a modest acceleration in the repayment of their outstanding Fund credit.[1/]

A Fund extending conditional credit against the issuance of SDRs could, in addition to gold, hold other assets purchased against SDRs, such as reserve currency balances acquired under substitution arrangements, or claims on development financing institutions arising under "link" arrangements.

Technical Transition to a General Account Based on SDRs

Adoption of the approach to credit operations of the Fund outlined above would involve a major amendment of the Articles of Agreement. Some of the present provisions dealing with the General Account would become redundant; there would have to be many consequential changes, e.g., in the provisions that indicate debtor or creditor positions by reference to the Fund's holdings of a member's currency compared to its quota; and the liquidation provisions might need to be completely revised.

Conceptually, the transition from a Fund in terms of currencies to one in terms of SDRs is not complicated. The transition would involve the Fund repaying members' subscriptions, thus changing the quota from a balance sheet entry into being exclusively a yardstick for members rights and obligations, as it is already in the Special Drawing Account. The repayment of subscription

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1/ Quantities are important in this connection. The 1964 and 1969 quota reviews resulted for many members in quota increases by 25 per cent. These would involve normal gold payments of 6.25 per cent of quota, or, if spread over 5 years, annual payments of 1.25 per cent of quota.

would be made in the first instance in the member's currency. Where the Fund's holdings were insufficient for this purpose--i.e., where the member had a gold tranche position--the balance could be paid in SDRs created *ad hoc*, or, to the extent that this were desired, with the Fund's gold. Where the Fund's holdings of a member's currency exceeded its quota, the excess could be converted into--or considered as--an SDR credit to that member. The Fund's reserves would of course remain unchanged. The effect on the balance sheet of the General Account as of April 30, 1972, would be as shown below, assuming that payments to countries with gold tranche positions of SDR 6.2 billion were made fully in SDRs, for which the General Account's holdings of SDRs (SDR 0.9 billion) were used first, and SDR 5.3 billion in new SDRs was created.[1] (This happens to be the same amount as the Fund's gold holdings on that rate.)

General Account Balance Sheet as of April 30, 1972

Billions of SDRs

Gold	5.3	Quotas	28.8
SDRs	0.9	Reserves	0.8
Currencies[1]	23.4		
Total Assets[2]	29.6	Total Liabilities[2]	29.6

Hypothetical General Account Balance Sheet as of April 30, 1972

Billions of SDRs

Gold	5.3	SDRs	5.3
Use of Fund Credit	0.8	Reserves	0.8
Total Assets	6.1	Total Liabilities	6.1

Sources: IMF Annual Report for 1972; IFS, June 1972.
1/ Includes securities and balances of initial quotas, not due.
2/ Including minor items

1/ A Fund that finances its credit operations by the issuance of SDRs, would presumably not show SDR holdings on its balance sheet, just as a Central Bank does not show unissued bank notes on its balance sheet.

The recasting of the balance sheet of the General Account suggests a further point of reform, which would arise in particular from other more substantive reform proposals, viz. that there may no longer be a point in distinguishing separate Accounts in the Fund. One could readily imagine an integrated Fund balance sheet that carried as assets some or all of the following:

gold
currencies arising from substitution arrangements
conditional credit extended
SDR allocations
claims on development finance institutions

and as liabilities

SDRs
reserve.

Effects on Certain Present Features of the Fund

The preceding summary description of how conditional credit transactions could be arranged on an SDR basis sketches a mechanism that would lack most of the esoteric characteristics of the present Fund and would thus be easier to understand. Thus there would be no need for concepts such as the "gold tranche," the "basic gold tranche," the "super gold tranche," the "currency budget," "overwhelming benefit of any doubt," "reserve positions in the Fund," "Fund positions" (net gross, and creditor), "remuneration," and "scarce currencies." A reformed mechanism would also avoid some of the most difficult and divisive issues that have arisen in the Fund's history and many of which may arise again in the future under present provisions. Among these mention may be made of the automaticity of drawing in the gold tranche, "floating in the gold tranche" (applicable to compensatory financing but not to buffer stock financing), maintenance of the gold (or SDR) value of the Fund's assets (except in respect of currencies acquired under substitution arrangements and,

perhaps, administrative cash balances), the General Arrangements to Borrow, bilateral borrowing, replenishment of currency holdings with gold, the usability of SDRs in payments to and by the General Account, and--if gold payments on quota increases were eliminated--mitigation of the direct and indirect reserve effects of such payments.

Beyond these general effects, there would be a number of special effects, some important, some less, some perhaps advantageous, others perhaps on balance less desirable. The present structure of the Fund is responsible for many features that would not necessarily be incorporated if one started from scratch, but that have, nevertheless acquired a certain status. It would be difficult--and perhaps hardly worthwhile at this stage--to give a complete listing of these secondary effects; some that come readily to mind are briefly noted below.

1. Interest payments on SDRs equivalent to the basic gold tranche. In the present Fund, members help to finance the Fund's operations and make possible a relatively low rate of charge on the use of Fund credit to the extent that they hold a basic gold tranche position on which they do not receive remuneration.[1] The equity of a contribution on this basis is open to question. Members of whose currency the Fund holds 100 per cent of quota or more do not share in it, and members in the 75 to 100 per cent bracket share in it only partially. Members that hold a corresponding amount of their reserves in the form of SDRs rather than as a basic gold tranche position do not forego income on these assets. In a reformed Fund, this arrangement would more naturally be replaced by an assessment levied on all members' quotas, e.g., at the rate of one-fourth of the SDR interest rate; this would follow the approach adopted

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1/ The possibility that now exists for a difference between the SDR interest rate and the rate of remuneration would have been replaced by the possibility to change the rate of assessment.

to finance the cost of the Special Drawing Account by an assessment on net cumulative allocations. All SDR holdings, including those arising from gold tranche positions in the General Account, would carry the same rate of interest.

2. Scarce currency provisions. Under these provisions of the Articles, the Fund is entitled to take action against a country in an extreme creditor position as reflected in the Fund's holdings of that member's currency; and such action then authorizes members to introduce discriminatory provisions with respect to the currency that has been declared scarce (Article VII, Section 3). While these provisions of the Articles were initially hailed as an important part of the adjustment process directed against persistent creditor positions, it has since become recognized that this provision "does not in its present form provide a practical means of applying pressure on surplus currencies."[1]

3. Payment of charges in a member's own currency. This option, which members have in certain circumstances,[2] and which amounts to adding interest due to the outstanding credit balance, would lapse in an SDR-based Fund.

4. Effect of the provision for uniform change in par values on the value of positions in the Fund. The present Articles provide a theoretical possibility to scale down members' debtor and creditor positions in the Fund as a result of a uniform devaluation in par values accompanied by a decision not to apply the provisions on the maintenance of the gold value of the Fund's assets.[3] The practical significance of this possibility may be doubted.

1/ Reform Report, p. 18.
2/ Article V, Section 8(f).
3/ Article IV, Sections 7 and 8(d).

5. <u>Effect on non-participants</u>. If all Fund transactions were conducted in SDRs, any of the few members that are not participants might have to be able to hold SDRs when using the Fund's conditional credit and when repaying such credits. The holding of SDRs need only be transitional, in somewhat the same manner as many countries now make purchases and repurchases in currencies that they do not normally hold in their reserves.

6. <u>Effect on administrative expenditure</u>. The Fund would need a provision to acquire currencies against SDRs for its administrative expenditure.

MEMORANDUM

TO: Mr. Gold

November 24, 1972

FROM: J. J. Polak

SUBJECT: Recasting the General Account

As we have agreed, recasting the General Account would involve quite substantial amendment of the Articles. For my own amusement I have gone through the Articles to note the places where changes would be needed, and their approximate character (leaving out of acco-nt the withdrawal and liquidation provisions).

You find my list attached. You will find that it consists to a very large extent of deletions and reasonably simple conforming changes. Only one issue of important substance arises, namely that of "specification" (the reverse of designation). There may, in addition, be important questions of terminology to be decided, e.g., whether one sticks to "use of the Fund's resources" and to "exchange transactions." And I do not underestimate the large amount of technical work to be done on the withdrawal and liquidation provisions, although these will almost certainly have to be revised in any event.

SUBJECT COPY

Recasting the General Account

Introductory Article (ii), (iii)	Conforming changes.
Article III.3, 4	Delete, possibly provide for gold payment to be made by new members.
5	Probably keep, rephrasing last sentence.
Article IV.8	Maintain, but only relevant to substitution account currencies and administrative balances.
Article V.2	Revise broadly.
Article V.3(a)	Recast in credit terms. Delete (ii) and reference to gold tranche.
(d)	Delete reference to gold tranche.
6	Replace by provision regulating acquisition of SDRs against gold.
7(a)	Replace by right to redeem SDR credit with gold. Perhaps redundant, depending on V.6.
7(b), (c), (d)	Replace by provision that Fund will set rules on repayment of SDR credits.
8(a), (c), (d)	Recast in terms of charges on use of credit.
(f)	Replace gold by SDRs. Delete 2nd sentence.
~~(h)~~ 9.	Delete.
Article VI.2	Delete
Article VII	Delete
Article VIII.4	Introduce option of payment in SDRs. Delete (b)(iv) and conform (b)(v).
Article XII.2	Conforming changes.
Article XIII.3(c)	Delete.
Article XII.3(i)	Delete penultimate sentence.
5(b)	Delete.
6	Reduce to substance of second sentence.

SUBJECT COPY

Article XVX(a)-(h)	Probably delete, since there would be no application of these definitions.
(j)	Delete.
Article XVII	Conforming changes (probably mostly deletion of (1) and (2)).
Article XXV.7	Replace by provision that a member can discharge any obligation to the Fund in SDRs. * Introduce new provision to the effect that a member that needs to acquire SDRs to make any payment due to the Fund shall be entitled to obtain them from a (member) (participant) which the Fund shall specify.
Article XXVI.4	Probably delete as a conforming change.
5	Delete (except last sentence?).
Article XXXII(c)	Delete.
Schedule B	Delete.

* Assume [illegible] Acct will sell SDRs for req. currency as needed for currency

SUBJECT COPY

MEMORANDUM

TO: Mr. Gold November 21, 1972

FROM: J. J. Polak

SUBJECT: Reform of the General Account

Most of the points in your memorandum of November 14th are, of course, well taken and are reflected in the rather substantial redraft. Below are listed those points which I could not take, and the reasons.

I.2. It should be clear from the new text that I do not envisage a transitional phase. The old Articles will apply until a certain date on which the Fund repays the quota contributions. Thereafter the new regime applies.

I.4. We have accommodated reserve creation to the fact that the General Account produces short-term fluctuations in reserve creation. The trend of reserve creation by the General Account is allowed for in the amount of SDRs to be created; the ups and downs are ignored. I do not believe that the General Account could operate effectively otherwise than by reserve creation. In any event, the issuance of SDRs held in the General Account or borrowing of the type now practiced by the General Account, would equally involve reserve creation.

I.5. Most of the changes in the Special Drawing Account arise in any event under the reform options. Insofar as they did not need discussion in the Reform Report, I do not think they need it here.

I.6. The only effect on the Fund's income is discussed. In general one would not expect such effects from a change in form.

With respect to the specific comments, I have omitted suggestions for additions that make the story more complete but also less easy to follow. For example, I see no need to insert in the comparison between the two Accounts a discussion of reconstitution or of the use of SDRs in the General Account; nor do I think one need to single out the unusual case of Fund sale of a currency held in excess of quota. I do not think that the idea of separate acceptance obligations for identical SDRs has any future. When we consider the Fund as a banking institution, I think it is logical to speak of members making resources available to it rather than through it.

I have cut down somewhat on the claims for simplification. Note, however, that these extend beyond the elimination of certain sections of the Articles. The transposition of the General Account to a more reasonable basis (i.e., measuring credit extended in one direction and resources made available in another direction) would in itself be a major simplification to all but the initiated. I am aware of the fact that the amendments would be massive but the most difficult ones (those related to liquidation and withdrawal) would arise in any event if the Fund came to hold currencies and claims on development institutions against which it had issued SDRs. It would not notably complicate the liquidation provisions if one had at the same time to find a solution for holdings of credit claims financed in the same way.

MEMORANDUM

TO: Mr. Gold - due Mon
Mr. Del Canto --
Mr. Habermeier
Mr. Sturc
Mr. Whittome

November 21, 1972

FROM: J. J. Polak

SUBJECT: Reform of the General Account

The attached has been prepared for delivery in an informal way, e.g., as a staff seminar paper. I would be very grateful for comments, preferably by the end of this week.

MEMORANDUM

TO: Mr. Hicks – Wed
Mr. Rhomberg ✓
Mr. Blackwell – No Comments
Mr. Wm. White ✓

November 21, 1972

FROM: J. J. Polak

SUBJECT: Reform of the General Account

The attached has been prepared for delivery in an informal way, e.g., as a staff seminar paper. I would be very grateful for comments, preferably by the end of this week.

Nov. 20, 1972

Reform of the General Account

Prepared by the Research Department

It was suggested in the Reform Report that an expansion of the role of the SDR might also be the occasion for a broader review of the provisions of the Articles relating to the General Account.[1/] As a background to such a review, this paper compares the method of operation of the General Account with that of the Special Drawing Account, and derives from this comparison certain inferences for a possible reform of the General Account.

Comparison between the two Accounts

On a sufficiently general level there is a strong similarity between the financial functions which the two Accounts perform for members: both enable a member in deficit to use financial resources that it had not earned from a previous balance of payments surplus. The two main differences between use of the two Accounts relate to conditionality--use of the General Account (except gold tranche use) being subject to conditions whereas the use of SDRs is unconditional--and to the need to restore the previous position after use. For members that provide the users with foreign exchange the effect of any use of the resources of either Account is also very similar; they acquire, in both cases, reserves in the form of "Fund related assets": a "reserve position in the Fund" (a gold tranche position or a loan claim on the Fund) when the drawing takes place in the General Account and SDRs when the drawing member uses its position in the Special Drawing Account.

1/ International Monetary Fund, Reform of the International Monetary System, A Report by the Executive Directors to the Board of Governors, (Washington, D.C. 1972), pp. 53-54. (All references in this paper are to the November 1972 printed version of the Reform Report.)

SUBJECT COPY

In spite of the fact that transactions in the two Accounts are so similar, both for the user and for the provider of resources, they are executed in entirely different ways. In the General Account, transactions are conducted on the basis of a pool of currencies contributed by all members, with further contributions in gold to enable the Fund to acquire additional amounts of any currency that it might need; there is also a provision to borrow additional amounts of currency. The drawing entitlements are expressed in terms of quotas, but the quotas themselves are not exchange reserves available to the member; such reserves have to be acquired by drawings made within the framework of the quotas. Drawings are technically made in the currencies of the countries that are selected by the Fund to acquire the reserve positions in the Fund; but these currencies are normally at once converted by the drawer, so that the drawee country experiences a substitution of a reserve position in the Fund for holdings of foreign exchange. In the Special Drawing Account, by contrast, given amounts of SDRs representing an equal percentage of quotas are allocated from time to time to participants. Use is made in the Special Drawing Account by the transfer of SDRs from one participant to another against convertible currency.

Why this difference between the two Accounts in technical arrangements, if it does not reflect any obvious difference in substance between the transactions in these two Accounts? Essentially, the explanation is that the SDR account is both the junior and simpler of the two Accounts; the more complicated form in the senior Account has clear historical reasons: the U.S. negotiators in the discussions that preceded Bretton Woods argued strongly that a Fund operating on the basis of "a mixed bag of currencies" was more

likely to win Congressional approval than one which introduced the unfamiliar concepts of a new international currency and of overdrafts.[1/] By now, the concept of an international currency is no longer unfamiliar. While "overdrafts" do not fit into normal U.S. banking practice, negotiated credits do. In the light of this, is there a continuing justification for the present form of the General Account?

Perhaps the best way to approach this question is as follows. Suppose that the founders of the Fund had felt it necessary to concentrate their attention on the need for unconditional rather than conditional liquidity and for this purpose had created a mechanism such as that contained in Articles XXI and following of the present Articles of Agreement, perhaps combined with regulatory provisions with respect to exchange rates, the avoidance of exchange restrictions, convertibility, etc. Such a Fund would have required quotas both as a basis for the allocation of unconditional liquidity and to determine voting power, but not the financial provisions of the original Articles of Agreement. Assume further that, despite the absence of a learning model which the pre-1969 Fund provided for the SDR mechanism, the provisions on SDRs were exactly those of Article XXI and following (with the exception of references to the General Account). If then, at some later time, when the SDR facility had been running smoothly for a considerable period, the Fund had reached the conclusion that it would be opportune to provide, side by side with the SDR facility, a conditional facility under which members would be entitled to obtain financial resources from the Fund for temporary use, how would it have gone about this?

1/ J. Keith Horsefield, The International Monetary Fund, 1945-1965, Vol. 1, pp. 28-30.

A General Account Patterened on the Special Drawing Account

It would seem unlikely that in order to provide this new facility the Fund would have found it necessary to ask each member to make a contribution in gold and in its own currency. Rather, it should have appeared natural that the Fund would have made provision for the creation of additional SDRs for the amount of credit it extended, these SDRs to be cancelled when Fund credit was repaid. This would be in line with the proposition that the extension of international credit by the Fund involves an expansion of reserves, and the repayment of such credit a contraction of reserves--a proposition which did not become valid until gold tranche positions began to be regarded as reserves in the early 1960's.[1] By that time the approach originally chosen--i.e., that the Fund would not be an international "bank", creating international money by extending "credit"--had been overcome by the economics of the situation. Once the Fund made the transition from the almost exclusive use of U.S. dollars to the use of a wide variety of currencies, it became necessary to monetize the resources that members made available to the Fund: members were willing (sometimes eager) to see a change in the composition of their reserves, but not a decline in them. Thus reserve creator as a (byproduct to credit extension is a necessary element of a) smoothly functioning Fund. At the same time, the attempt never took hold to view transactions through which the Fund made resources available to members in payments difficulties as a mere exchange of one currency for another. Fund transactions (beyond the gold tranche) are now generally regarded as the extension of balance of payments credit. This view is reflected, for example, in the adoption of the concept of "credit tranches" and in the widespread use of the term "repayment" as both more general and more meaningful than the legal "repurchase."

1/ For a brief discussion see, J. Marcus Fleming, "The Fund and International Liquidity," IMF Staff Papers, Vol. XI, No. 2 (July 1964) pp. 183-85. A more detailed description is given in Hamn/Ezekiel, "The Present System of Reserve Creation in the Fund," STaff Papers, Vol. XIII, No. 3 (November 1966), pp.398-420.

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If operation of the conditional side of the Fund took place in the form of credit creation in SDRs, the country that obtained Fund credit would normally use the SDRs to acquire currencies, for which the designation mechanism could conveniently be used. Nothing new would be required for this purpose, but it would be necessary to create sufficient flexibility in the acceptance obligations so as to ensure that there would be takers for the additional SDRs put into circulation by the Fund's credit operations.

It is possible that a more important new feature might be required to enable countries to repay Fund credit in SDRs. Countries would have to be in a position to acquire such SDRs against the holdings of reserve currencies. If the Reform provided for an open-ended substitution facility, as suggested under the third approach for asset settlement described in the Reform Report,[1] this would take care of the problem. Under different settlement arrangements it might be necessary to introduce into the SDR mechanism a system of what might be called "reverse designation" to regulate which countries would have to make available SDRs against convertible currencies, and in what amounts (in contrast to the designation mechanism that regulates the countries that are to make available convertible currencies against SDRs).[2]

1/ Op. cit., p. 39.

2/ In the present SDR facility there are only the most rudimentary provisions for "reverse designation" because the need for it is unlikely to arise on any significant scale. In theory, a participant may, on "specification" by the Fund, be obliged to sell SDRs for "currency convertible in fact" for the purpose of enabling another participant to meet its obligations to pay charges and assessments (Article XXVI, Section 5 and Article XXX, Section 3) or its reconstitution obligation under Schedule G, paragraph 1(a); but the stock of SDRs held by the General Account makes it unlikely that these provisions will ever become operative. It should be noted that the sale of SDRs by the General Account against convertible currencies does not avoid the substantive problem, but transfers it to that Account. The question thus becomes the selection of countries that are to give up reserve positions in the Fund, rather than SDRs, against convertible currency.

The Fund's conditional drawing facilities could be subject to certain quantitative limitations such as a normal maximum of 25 per cent of quota per year and a normal upper limit of 100 per cent of quota, and within the latter limit to a tranche policy of increasing intensity of scrutiny depending on the extent of the use of Fund credit in terms of a member's quota. There would, of course, be no occasion for the introduction of automatic drawing rights in what is now called the gold tranche, because in the absence of gold payments and the sale of members' currencies, "gold tranche positions" would not arise.

Credit extended by the Fund in SDRs would naturally be repayable in SDRs. The Fund could set conditions for the duration of the credit (e.g., 3-5 years) or it could make timing of repayment a function of the rate of interest payable, along the lines of the provisions of Article V, Section 8(d). There could further be provisions for accelerated repayment in the light of the member's balance of payments and reserve position. This position is already used as a criterion in the operation of the designation system which affects the reversal of net use of SDRs in a manner somewhat akin to the repurchase provisions in the General Account,[1/] using, however, data on reserves based on a more flexible definition than that laid down in Article XIX to guide the repurchase provisions.

The Fund liquidity necessary to meet the needs for convertible currencies of the members that used the credit facility would be ensured by the size of the acceptance obligations, which, as mentioned, would have to be large enough to permit designation in relation to the total amount of SDRs that would at any time exist, whether arising from allocation or from conditional credit operations.

1/ J. J. Polak, "Some Reflections on the Nature of Special Drawing Rights," International Monetary Fund Pamphlet No. 16, p. 7.

Liquidity Aspects

The technical problem that arises in this connection is not different from that related e.g., to the issuance of SDRs in substitution for reserve currencies.[1/] But there would be a special effect on the liquidity of the General Account. Financing of that account by means of SDRs with a corresponding increase in acceptance obligations would by itself greatly reduce a liquidity constraint that now affects at least potentially, though by no means precisely, the operations of the General Account. The liquidity of the General Account is proportionally smaller than that of the Special Drawing Account. While the acceptance obligations in the Special Drawing Account (in excess of allocations) equal twice the outstanding holdings of SDRs, the General Account holds, in broad outline, 25 per cent of total quotas in gold and 75 per cent of quotas in currencies to meet potential drawings of 125 per cent of quotas (gold tranche plus four credit tranches). Assimilation of reserve positions in the Fund with SDRs and a corresponding increase in total acceptance obligations would introduce about double the room for acceptance that exists now with respect to General Account operations. Additional room would be created by the merger of the acceptance obligations of the two Accounts, inasmuch as their "peak needs" might not coincide. This tendency would be reinforced if, as part of the Reform, the absolute size of acceptance obligations were substantially increased to make room for SDRs issued in substitution for reserve currencies. And the possibility has also been mentioned that there might be no limit on the acceptance obligation for SDRs.[2/]

1/ Cf. Reform of the International Monetary System, A Report by the Executive Directors to the Board of Governors, (Washington, D.C. 1972), pp. 52-53.
2/ Ibid., p. 53.

Concern over its liquidity is not the only--or even the most important--factor limiting the operations of the General Account. Control over the extent of the operations, and hence on the magnitude of its contribution to reserve creation, is primarily exercised in a number of other ways.

(a) By decisions on quotas.

(i) The absolute size of quotas provides the scale that determines the amounts that can be drawn under given policies expressed in terms of percentages of quota.

(ii) The distribution of quotas among likely surplus and deficit countries affects the probable size of desired use of Fund resources and the availability of "usable currencies."

(b) By decisions on policies on the use of Fund resources, such as tranche policies, the compensatory financing and buffer stock financing policies, etc.

(c) By decisions on individual large transactions. Mention may be made here in particular of the special scrutiny in Working Party No. 3 of the OECD of drawings requested by participants in the General Arrangements to Borrow, and to the decisions on the lending of currencies under the GAB, that are taken by these participants with a special majority.

It should be noted that quota decisions and decisions on the use of resources are subject to various restraints of a legal or conventional character. Changes in quotas proposed as a result of a general review require an 85 per cent majority and other quota changes an 80 per cent majority.[1/]

1/ Article III, Section 2.

As a result of the adoption of Article V, Section 3(d), the Fund no longer has the power to create any new facility in the General Account for the unconditional use of its resources.[1/] In the design or expansion of non-automatic facilities, the Fund pays careful attention to the liquidity trans implications.[2/]

A question for consideration would be whether the mechanism to control the size of the Fund's conditional financing activity would be sufficient in the absence of a constraint on the resources available to it, whether it would need to be strengthened, or whether some other total constraint, e.g., in terms of a maximum of conditional credit outstanding, would need to be introduced.

Gold and Quota Aspects

A Fund mechanism based on credit extension in terms of SDRs would not require Fund holdings of gold for liquidity reasons. The Fund could still hold gold for a variety of reasons. The Fund has large gold holdings at present, and it might well be felt that no good purpose would be served in returning these to members. As long as gold remained a reserve asset, members should presumably be able to discharge their obligations to the Fund in gold, as well as in SDRs. There could also be arrangements under which the Fund would acquire gold from members against newly issued SDRs.[3/]

1/ International Monetary Fund, Proposed Amendment of Articles of Agreement, (Washington, D.C. April 1968), p. 25.

2/ See, for example, the section on "Changes in the Compensatory Facility and Fund Liquidity" in Compensatory Financing of Export Fluctuations, A Second Report by the International Monetary Fund (Washington, D.C. 1966) p. 27-28; and a comparable section in the report containing the proposal for Fund financing of members' contributions to commodity stocks (International Monetary Fund, "The Problem of Stabilization of Prices of Primary Products," Scope for Action by the Fund, Washington, D.C. 1969, p. 19).

3/ Reform Report, p. 51.

There would be no technical problem in requiring members to transfer gold to the Fund--against SDRs or a reduction in their use of Fund credit--when they joined the Fund or when their quotas were increased. However, since the Fund would not need the gold for liquidity reasons, it would be able to judge on their merits the questions of (i) gold payments by new member and (ii) gold payments--or alternatively payments in SDRs--on the occasion of quota increases.

With respect to the second question, gold payments were thought to be useful also to restrain undue pressure for quota increases; the effectiveness of this restraint may have been effected by the fact that SDR allocations are tied to quotas. In any consideration of this question, two facts would in any event need to be allowed for:

(a) As part of the Reform, members would probably become entitled to use SDRs to pay the "gold component" of their contribution related to quota increases.

(b) Presumably, members in payments difficulties would in the future, as they were in the past, be able to stretch their gold payments to the Fund, or the equivalent of such payments, over a number of years while yet receiving the quota increase at once.[1]

In a Fund constructed on an SDR basis, (a) would make the requirement to make "gold payments" meaningless for countries that did not use Fund credit: they would--if they used the SDR option--buy SDRs from the Fund with SDRs. Even in the Fund as presently structured there would be very little meaning in

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1/ In the 1958 and 1964 general quota reviews, this was made possible by allowing members to make a special drawing for an amount equal to the gold payment, the drawing to be repurchased in three (1958) or five (1964) equal annual installments; in the 1969 review, members with low reserves were entitled (under the provisions of Article III, Section (f)(a)) to avail themselves of the opportunity to make a reduced gold payment, but were then required to repurchase the resulting additional currency subscription in five equal annual installments.

countries' increasing their creditor position in the Fund in exchange for a reduction of their holdings of SDRs. For countries indebted to the Fund the position would also change little--in the sense that, as before, those in a weak payments and reserve position would have the option to make their "contribution" in the context of a quota increase by a modest acceleration in the repayment of their outstanding Fund credit.1/

A Fund extending conditional credit against the issuance of SDRs could, in addition to gold, hold other assets purchased against SDRs, such as reserve currency balances acquired under substitution arrangements, or claims on development financing institutions arising under "link" arrangements.

Technical Transition to a General Account Based on SDRs

Adoption of the approach to credit operations of the Fund outlined above would involve a major amendment of the Articles of Agreement. Some of the present provisions dealing with the General Account would become redundant; there would have to be many consequential changes, e.g., in the provisions that indicate debtor or creditor positions by reference to the Fund's holdings of a member's currency compared to its quota; and the liquidation provisions might need to be completely revised.

Conceptually, the transition from a Fund in terms of currencies to one in terms of SDRs is not complicated. The transition would involve the Fund repaying members' subscriptions, thus changing the quota from a balance sheet entry into being exclusively a yardstick for members rights and obligations, as it is already in the Special Drawing Account. The repayment of subscription

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1/ Quantities are important in this connection. The 1964 and 1969 quota reviews resulted for many members in quota increases by 25 per cent. These would involve normal gold payments of 6.25 per cent of quota, or, if spread over 5 years, annual payments of 1.25 per cent of quota.

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would be made in the first instance in the member's currency. Where the Fund's holdings were insufficient for this purpose--i.e., where the member had a gold tranche position--the balance could be paid in SDRs created *ad hoc*, or, to the extent that this were desired, with the Fund's gold. Where the Fund's holdings of a member's currency exceeded its quota, the excess could be converted into--or considered as--an SDR credit to that member. The Fund's reserves would of course remain unchanged. The effect on the balance sheet of the General Account as of April 30, 1972, would be as shown below, assuming that payments to countries with gold tranche positions of SDR 6.2 billion were made fully in SDRs, for which the General Account's holdings of SDRs (SDR 0.9 billion) were used first, and SDR 5.3 billion in new SDRs was created.[1] (This happens to be the same amount as the Fund's gold holdings on that rate.)

General Account Balance Sheet as of April 30, 1972

Billions of SDRs

Assets		Liabilities	
Gold	5.3	Quotas	28.8
SDRs	0.9	Reserves	0.8
Currencies[1]	23.4		
Total Assets[2]	29.6	Total Liabilities[2]	29.6

Hypothetical General Account Balance Sheet as of April 30, 1972

Billions of SDRs

Assets		Liabilities	
Gold	5.3	SDRs	5.3
Use of Fund Credit	0.8	Reserves	0.8
Total Assets	6.1	Total Liabilities	6.1

Sources: IMF Annual Report for 1972; IFS, June 1972.
1/ Includes securities and balances of initial quotas, not due.
2/ Including minor items

1/ A Fund that finances its credit operations by the issuance of SDRs, would presumably not show SDR holdings on its balance sheet, just as a Central Bank does not show unissued bank notes on its balance sheet.

The recasting of the balance sheet of the General Account suggests a further point of reform, which would arise in particular from other more substantive reform proposals, viz. that there may no longer be a point in distinguishing separate Accounts in the Fund. One could readily imagine an integrated Fund balance sheet that carried as assets some or all of the following:

gold
currencies arising from substitution arrangements
conditional credit extended
SDR allocations
claims on development finance institutions

and as liabilities

SDRs
reserve.

Effects on Certain Present Features of the Fund

The preceding summary description of how conditional credit transactions could be arranged on an SDR basis sketches a mechanism that would lack most of the esoteric characteristics of the present Fund and would thus be easier to understand. Thus there would be no need for concepts such as the "gold tranche," the "basic gold tranche," the "super gold tranche," the "currency budget," "overwhelming benefit of any doubt," "reserve positions in the Fund," "Fund positions" (net gross, and creditor), "remuneration," and "scarce currencies." A reformed mechanism would also avoid some of the most difficult and divisive issues that have arisen in the Fund's history and many of which may arise again in the future under present provisions. Among these mention may be made of the automaticity of drawing in the gold tranche, "floating in the gold tranche" (applicable to compensatory financing but not to buffer stock financing), maintenance of the gold (or SDR) value of the Fund's assets (except in respect of currencies acquired under substitution arrangements and,

perhaps, administrative cash balances), the General Arrangements to Borrow, bilateral borrowing, replenishment of currency holdings with gold, the usability of SDRs in payments to and by the General Account, and--if gold payments on quota increases were eliminated--mitigation of the direct and indirect reserve effects of such payments.

Beyond these general effects, there would be a number of special effects, some important, some less, some perhaps advantageous, others perhaps on balance less desirable. The present structure of the Fund is responsible for many features that would not necessarily be incorporated if one started from scratch, but that have, nevertheless acquired a certain status. It would be difficult--and perhaps hardly worthwhile at this stage--to give a complete listing of these secondary effects; some that come readily to mind are briefly noted below.

1. Interest payments on SDRs equivalent to the basic gold tranche. In the present Fund, members help to finance the Fund's operations and make possible a relatively low rate of charge on the use of Fund credit to the extent that they hold a basic gold tranche position on which they do not receive remuneration.1/ The equity of a contribution on this basis is open to question. Members of whose currency the Fund holds 100 per cent of quota or more do not share in it, and members in the 75 to 100 per cent bracket share in it only partially. Members that hold a corresponding amount of their reserves in the form of SDRs rather than as a basic gold tranche position do not forego income on these assets. In a reformed Fund, this arrangement would more naturally be replaced by an assessment levied on all members' quotas, e.g., at the rate of one-fourth of the SDR interest rate; this would follow the approach adopted

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1/ The possibility that now exists for a difference between the SDR interest rate and the rate of remuneration would have been replaced by the possibility to change the rate of assessment.

to finance the cost of the Special Drawing Account by an assessment on net cumulative allocations. All SDR holdings, including those arising from gold tranche positions in the General Account, would carry the same rate of interest.

2. Scarce currency provisions. Under these provisions of the Articles, the Fund is entitled to take action against a country in an extreme creditor position as reflected in the Fund's holdings of that member's currency; and such action then authorizes members to introduce discriminatory provisions with respect to the currency that has been declared scarce (Article VII, Section 3). While these provisions of the Articles were initially hailed as an important part of the adjustment process directed against persistent creditor positions, it has since become recognized that this provision "does not in its present form provide a practical means of applying pressure on surplus currencies."[1]

3. Payment of charges in a member's own currency. This option, which members have in certain circumstances,[2] and which amounts to adding interest due to the outstanding credit balance, would lapse in an SDR-based Fund.

4. Effect of the provision for uniform change in par values on the value of positions in the Fund. The present Articles provide a theoretical possibility to scale down members' debtor and creditor positions in the Fund as a result of a uniform devaluation in par vales accompanied by a decision not to apply the provisions on the maintenance of the gold value of the Fund's assets.[3] The practical significance of this possibility may be doubted.

1/ Reform Report, p. 18.
2/ Article V, Section 8(f).
3/ Article IV, Sections 7 and 8(d).

5. Effect on non-participants. If all Fund transactions were conducted in SDRs, any of the few members that are not participants might have to be able to hold SDRs when using the Fund's conditional credit and when repaying such credits. The holding of SDRs need only be transitional, in somewhat the same manner as many countries now make purchases and repurchases in currencies that they do not normally hold in their reserves.

6. Effect on administrative expenditure. The Fund would need a provision to acquire currencies against SDRs for its administrative expenditure.

Office Memorandum

TO : Mr. J. J. Polak

DATE: November 14, 1972

FROM : Joseph Gold JG

SUBJECT : The General Account as Seen from the Special Drawing Account

The following are comments on your draft of October 27, 1972. Let us have a word together about procedure.

I. General Comments

I feel that a number of basic problems are ignored or touched on too lightly even in a first essay at a new General Account. A number of the following comments derive from this feeling:

1. It may be useful to make a clear distinction between a General Account operating solely on the basis of special drawing rights and a General Account that would hold and operate in gold as well. As long as gold remains a reserve asset, it is difficult to envisage a General Account that would not permit members to use gold in operations and transactions with it. What modifications in your scheme would be necessary on this assumption?

2. It seems desirable even in a first memorandum to dwell on the differences between a scheme in full operation and the transitional phase. The problems that relate solely to the transitional phase will be of considerable interest to members.

3. Is it likely that members will accept an amendment of the provisions relating to the General Account that reduces the safeguard they have at present? The hypothesis of the paper that the General Account is being established for the first time after the establishment of the Special Drawing Account, with its now familiar acceptance obligation, ignores the real development of the Fund. If members insist on a maximum acceptance obligation with respect to the General Account, the obvious comparable safeguard would be the quota. Is this feasible, and if it is, what are the consequences?

4. Why should it be assumed that if a conditional facility were established in the Fund after the Special Drawing Account had been functioning for some time, temporary balance of payments assistance by the Fund through the General Account would be made in the form of transfers of additional special drawing rights specially created for this purpose? The extension of credit in that way would involve an unplanned and unsystematic expansion of reserves which, although short- to medium-term, could be relatively large and difficult to reconcile with the assumption underlying the establishment of the Special Drawing Account. Special drawing rights held in the General Account or borrowed from participants could be used for temporary assistance.

The argument on page 4 that it is now understood that the extension of credit expands reserves does not involve the further proposition that this is necessary or desirable.

5. The change in the General Account would have consequences for the Special Drawing Account that should be considered more fully. For example, the use of the criterion of net cumulative allocation might have to be reconsidered if special drawing rights were issued in order to meet the demand for conditional credit from the General Account.

6. It would be useful to deal more fully with the Fund's income, expenses, and reserves in the revised General Account. I assume that the existing reserves would be carried forward into the new regime.

7. I believe that a massive amendment of the Articles would be necessary, and this should be said.

8. The effect of the proposal on the distinction between participants and members that do not participate in the Special Drawing Account is dismissed too lightly.

II. Specific Comments

Page 1, line 2:
With the advent of special drawing rights, the operation of the General Account is no longer based exclusively on gold and currencies.

line 8:
Insert "in the General Account" after "currencies".

third paragraph, first sentence:
The proposition does not take the gold tranche into account.

Page 2, lines 2-3:
In comparing the two Accounts, mention of reconstitution in the Special Drawing Account would be appropriate.

lines 3-8: In the General Account members providing foreign exchange achieve a reduction of their repurchase obligations when they do not have a reserve position.

first full paragraph:
The description should refer also to the various uses of special drawing rights in the operation of the General Account; and lending to the Fund may be added to the description.

Page 3:
In referring to the establishment of "a mixed bag of currencies" as the operational technique of the General Account, you make the point

that such a Fund "was more likely to win Congressional approval than one based on an international currency which could be created at will". The reference to creation "at will" may be misunderstood to mean the lack of any controls. Your argument might be stronger if you cite the History for the proposition that the U.S. negotiators resisted "the unfamiliar concepts of a new international currency and of overdrafts" (p. 30). With the successful establishment of special drawing rights as an international monetary asset, the argument of unfamiliarity falls away.

misleading

The claim that a technically more sophisticated General Account would not have contained the financial provisions of the original Articles of Agreement may go too far. Analogous provisions to deal with the same issues might have been adopted. For example, "repayment" provisions might have resembled the repurchase provisions.

Page 4, last two sentences:

✓ The point here is somewhat overstated, as it does not apply to use of the gold tranche. In recent years a large portion of the Fund's transactions involved the gold tranche.

fifth line from bottom:

no "available through" for "available to".

Page 5, line 2:

no Would separate acceptance obligations be desirable in connection with the two Accounts?

middle of page:

✓ The term used in the Articles for "reverse designation" is specification, i.e., the Fund must "specify" a participant from which special drawing rights are to be obtained under the provisions cited in the last two lines on this page. A reference to Article XXX, Section 3 should be added.

last line:

✓ It would be better to make it clear that the "reconstitution obligation" referred to is the obligation under Schedule G, paragraph 1(a)(iii).

Page 7, lines 3-7:

✓ In connection with the comparison made between the two systems, it goes too far to allege that Article XIX does not contain an economic definition. Your objection may be that it is too specific, but then one should not ignore the "without limitation" clause in Article XIX (d).

four lines from bottom:

"of any doubt" for "of the doubt".

second full paragraph, and p. 8, first full paragraph:
"difficult and divisive issues that have arisen in the Fund's history" are now resolved, so that they make no case for reform. Moreover, if your hypothesis were accepted, several of the issues would probably have arisen in connection with comparable concepts, e.g., "designation plan" (instead of "currency budget") and "interest" (instead of "remuneration").

Even in a reformed General Account currencies may be received, held, and expended for administrative purposes, and the maintenance of their value would continue to be appropriate. Suppose too that, for whatever reason, we were to hold securities again. We applied Article IV, Section 8(a) to our investment.

It is not obvious that "a substantial portion of the present Articles relative to the General Account would become redundant". This is probably true of some provisions, but others may continue to survive in modified form and some of the problems of amendment would be complicated (e.g., the liquidation and withdrawal provisions). I get the feeling that you are implying that a simplification is simple. The reform of the General Account on balance may be desirable, but I would not support it with the argument of simplified legal provisions.

Regarding comparisons, reference may be appropriate to SM/71/62, A Comparison of Certain Characteristics of Fund-Related Reserve Assets with Special Reference to Yield, March 9, 1971.

Page 8, second full paragraph, last line:
"exhaustible" should be "exhaustive".

last paragraph:
In the last line, "monetary reserves" should be substituted for "gold".

Page 11, second line:
This should be revised, as follows: "... legal duty of the Fund to buy gold has been questioned in ...".

first full paragraph, last sentence:
These ideas are difficult to understand.

second full paragraph:
Is the implication of this discussion that there is a need for revising this provision by substituting, for example, "exhaustion of acceptance obligation" for scarcity of the member's currency, or that such an approach would be as impractical as the existing provision?

Page 12, last paragraph:
In the fourth line "change" should be "devaluation". This paragraph raises, as do so many others, the questions of the transition.

cc: Mr. Fleming, Mr. Schwartz, Mr. Williamson

Mr Polak

Office Memorandum

TO : Mr. Habermeier DATE: November 14, 1972

FROM : P. Høst-Madsen H-M

SUBJECT : Enlarged Use of SDRs in the General Account

Many thanks for sending us the interesting draft paper on the subject referred to above. In reading this draft, it occurred to me that underlying the proposed enlargement of the use of SDRs in the General Account must be the assumption that individual member countries will have no preference for holding currencies over SDRs. While I do not exclude the possibility that this may be so in the future, there is not, I think, sufficient evidence at this time to expect that countries will in the future give up any preference they may now have for currencies over SDRs. To the extent that countries have this preference, it is rooted in traditional views taken on a desirable composition of their reserves, or on a desire to maximize the yield on total reserves. And as long as these considerations prevail, and the yield on SDRs is, moreover, not made more competitive with the yield on reserve assets held in the form of currencies, it would seem difficult if not impossible for the Fund to persuade countries to shift toward SDRs.

Therefore, while I do not want to dissent from the attractiveness of the changes which you suggested for the future of SDRs, I have my doubts whether now is the best time to launch these ideas with the Executive Board. But they may well deserve consideration, after some further staff study, in the context of the reform plans for the international monetary system. Among the important variables are the yield of SDRs, the removal of obstacles to their transferability, and the rules governing the value of SDRs in relation to currencies. I am impressed with the wealth of imaginative ideas contained in your draft, and I am sure that the European Department would take an interest in participating in the thorough review of your draft that appears to be required.

cc: Mr. Gold
Mr. Polak ✓
Mr. Del Canto
Mr. Sturc
Mr. Whittome

November 13, 1972

The Managing Director

Joseph Gold

Subject: Enlarged Use of Special Drawing Rights in the General Account

I hope it is clear from Mr. Habermeier's memorandum of November 10, 1972 that the paper attached to it, which goes into some radical proposals for amendment of the Articles, has not been seen by my Department.

cc: The Deputy Managing Director
Mr. Polak
Mr. Del Canto
Mr. Habermeier
Mr. Sturc
Mr. Whittome

MEMORANDUM

TO: Managing Director November 14, 1972

FROM: J. J. Polak

SUBJECT: Restructuring the General Account

I agree with the point in Mr. Habermeier's memorandum of November 10th (Enlarged Use of Special Drawing Rights in the General Account) that it would be useful to initiate a discussion on the subject of a new structure of the General Account that would reflect the experience gained with the Special Drawing Account.

I would not think it advisable to raise this issue in the context of certain noncontroversial aspects of the Special Drawing Account that need to be reviewed before the end of the year. I also think that a discussion of these questions would need a broader base than is provided by the text attached to Mr. Habermeier's memorandum.

I have had a paper on this subject in preparation for some time, on which I have, as a first stage, sought comments from colleagues in the Research and Legal Departments. I intend shortly to submit a further draft for comment to the Treasurer's and other interested Departments and, after having had the benefit of their view, to the Deputy Managing Director and yourself.

While it would be helpful to get a discussion of this subject started, I think one should want to avoid any impression that the staff is coming forward with a proposal. I had, therefore, thought that ideas on this subject should be put forward in a very low key. My preference would be for a staff seminar (which Executive Directors could of course attend). A text could then be circulated afterwards and, if there was interest, a Directors' Seminar could be organized.

cc: Deputy Managing Director
Mr. Gold
Mr. Del Canto
Mr. Habermeier
Mr. Sturc
Mr. Whittome

MR POLAK

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: November 10, 1972

FROM : W. O. Habermeier

SUBJECT : Enlarged Use of SDRs in the General Account

Under an existing Executive Board decision we are required, before the end of this year, to review the use of SDRs in repurchases and charges. We are in the process of finalizing a departmental draft paper on this question. Its main conclusion will be that no change should be made in the option which members have to repurchase with special drawing rights. However, we feel that the paper might go somewhat beyond a mere review of the past and look forward in the direction of the reform. A modest expansion of the review in this way would be helpful in two respects: it would start discussion on an issue which was not dealt with in the Report on the Reform and it would allow Executive Directors to feel a somewhat greater sense of involvement than they recently have had in connection with the review of reconstitution and the designation.

Attached for your consideration is a draft of a chapter on the enlarged use of SDRs in the General Account. If, after discussion, the basic concept is acceptable, the draft would be revised to improve it from the point of view of exposition and further clarification.

cc: Mr. Gold
Mr. Polak
Mr. Del Canto
Mr. Sturc
Mr. Whittome

DRAFT--November 10, 1972

Enlarged Use of SDRs in the General Account

The willingness of the Fund to accept SDRs in repurchases, except those made under Article V, Section 7(b), without any limitations and restrictions, as well as its readiness to channel SDRs back to members through drawings, has led to a considerable expansion of the use of SDRs in the transactions conducted through the General Account. In this way SDRs have served as a direct means of settlement between the member and the Fund, and also among members, as illustrated by the recent gold tranche drawing of the United Kingdom, thus enhancing the quality of SDRs as a means of payment as distinct from its quality as a reserve asset.

This process of conducting the transactions of the General Account in SDRs rather than in currencies could be extended in one of two ways: either gradually, under the present Articles, by actively encouraging members to receive SDRs in drawings and use SDRs in repurchases, or more decisively, through an amendment of the Articles, by authorizing the Fund, at its discretion, to sell SDRs to purchasing members and to ask repurchasing members to pay in SDRs. Few, if any, incentives may be needed for members to use SDRs in repurchases so long as interest on other reserve assets is more attractive, and so long as the value of these other assets in terms of gold is not expected to decline. It is also unlikely that special incentives would be needed to encourage members to draw SDRs from the General Account in substitution for currencies; however, the Fund could declare that it would welcome an increased use of SDRs in transactions with the General Account.

This approach has two evident limitations. Firstly, SDRs cannot be used in substitution for currencies (or for gold) in repurchases that accrue under Article V, Section 7(b); indeed, in this respect SDRs have not been granted equal status to gold or currencies and an amendment of the Articles seems called for to remedy this. Secondly, drawings in SDRs could exceed repurchases in SDRs and the Fund's holdings of SDRs might become insufficient to satisfy the demand. It may thus be necessary to regulate the outflow of SDRs from the General Account in an agreed manner. For example, last year an understanding had been reached among Executive Directors to make provisions in the quarterly currency budget for the amount of SDRs to be sold, and this understanding could be revived.

Under amended Articles, and in the context of the reform of the international monetary system, these limitations could be mitigated, if not removed, by a number of steps which would serve to enhance the role of SDRs not only as a reserve asset but also as a means of payment. At the same time, such a reform would serve to streamline the financial operations of the General Account and also simplify the structure of international reserve assets by reducing or eliminating super gold tranche positions. It would also eliminate the need, which is increasingly recognized, for some form of coordination among the various Fund-related reserve assets.

A mechanism can be envisaged as follows: when the Fund sells a member's currency it usually creates a super gold tranche position for the country whose currency is sold, unless the holdings of the currency sold were to remain above 75 per cent of quota.[1/] If a repurchase is made with currency,

1/ For example, as a result of previous drawings of that member, or because of a reduced gold subscription.

this will reduce the super gold tranche positions which have been created by drawings. (Super gold tranche positions could, of course, also be reduced by replenishment of currencies through gold sales or by borrowing, but this is not essential for describing the process.) In this way the operations of the Fund create or destroy international reserves in the form of super gold tranche positions.

Since the attributes of SDRs and of super gold tranches are very similar[1], it would be possible to authorize the Fund to create and destroy SDRs instead of super gold tranche positions in analogy to the mechanism described above. As a complement, the Fund would also be enabled to request members that repurchases be made in SDRs instead of in currencies.

The creation of SDRs by the General Account would take the form of special allocations of SDRs as and when drawings were made under the regular policies of the Fund on the use of its resources. These special allocations could be either equal to the amount of drawings or some lesser amount, leaving the remainder of drawings to be financed from currency holdings. Contrary to the present system in which repurchases of SDRs add to the SDR holdings of the General Account, SDRs used in repurchases would be canceled, as super gold tranches are canceled through repurchases. This cancellation would continue as long as the inflow of SDRs in repurchases would not exceed the amount of SDRs created previously through special allocations of SDRs to drawing members. If the repurchases in SDRs exceeded the amount of SDRs created through General Account transactions, then these SDRs obviously would derive from allocations in the Special Drawing Account and would be added to the SDR holdings of the General Account as at present.

1/ Both may be used without challenge in response to a balance of payments need; both carry the same rate of return, and their value in terms of currencies can be regarded as identical in practice.

A participant making a drawing on the General Account would be entitled to use SDRs received in such a drawing either to obtain foreign exchange or its own currency in accordance with the rules of the Special Drawing Account.

A repurchasing member whose holdings of SDRs are insufficient would need to be provided with some assured means of obtaining the necessary amounts of SDRs. For example, as repurchases are usually preceded by an improvement in the balance of payments position of the country concerned, one possibility would be for the repurchasing member to acquire SDRs through designation in a period preceding a repurchase. It would also be possible to extend to repurchases a similar entitlement as presently exists to obtain SDRs in order to promote reconstitution; and it is conceivable that SDRs may be obtained by depositing reserve currencies in a so-called substitution account, as discussed in the Report on Reform.

In addition, care would need to be taken both to assure the liquidity of the SDRs issued by the General Account and to circumscribe the extent to which such issues may take place. At present these matters are determined by the gold and currency subscriptions that members pay, and by the ability of the Fund to borrow currencies. The liquidity arrangements of a reformed General Account could be made either through the Special Drawing Account by augmenting the existing acceptance obligations, or by setting up special acceptance limits related to the quotas of the General Account. Any ceiling on the total amount of SDRs that the General Account might issue would most likely be set as a proportion of total quotas, to be reviewed from time to time as quotas are reviewed. The Fund's power to replenish with gold would be extended to include SDRs; the authority to borrow would be simply replaced by an authority to issue additional SDRs as may be agreed.

The plan outlined above could easily be varied in a number of ways. In particular, instead of giving the Fund discretionary authority to substitute SDRs for currencies, the use of currencies could be abandoned altogether. On amendment of the Articles, all outstanding super gold tranche positions would be converted into SDRs for the credit of the members concerned.[1/] This kind of approach may be attractive because of its clarity and simplicity; on the other hand, discretionary authority to substitute SDRs for currency may have some advantage since the same results could be achieved with it but in a more evolutionary and flexible way. For example, the Fund could as a general policy, gradually reduce and finally eliminate super gold tranche positions by directing repurchases into currencies while at the same time selling SDRs to drawing members. The continuing ability to sell currencies or absorb them may be useful, at least for a transitional period, for a number of reasons. For example, not all members are participants in the Special Drawing Account and they might not wish to become other holders, or the Fund may want to re-establish the basic gold tranche position of certain members through the sale of their currencies. Under both plans, however, consideration would be given to the eventual liquidation of all currency holdings of the General Account except those needed for administrative purposes.

The conversion of super gold tranche positions into SDRs might also be extended to that part of gold tranche positions which results from gold subscriptions. In this case the General Account would be transformed into a credit institution where the size of quota would be the basic measurement of the amount of credit that may be extended and the financing would take place through the issue of SDRs within prescribed limits. However, gold tranche

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1/ It would be possible to apply first the existing SDR holdings of the Fund to the reduction of the net creditor positions before issuing SDRs for the conversion of the remainder.

positions may be regarded as a derivative of gold, in testimony of which they carry no return. Their conversion into SDRs might raise issues that are more closely analogous to the conversion of gold into SDRs (a subject which was discussed in the Report on Reform), than to the conversion of super gold tranche positions into SDRs. The role of gold in the reformed General Account need not necessarily be redefined as part of the plan outlined above; gold could continue to serve as a backstop to the liquidity of the General Account as and when the authority to issue SDRs would be exhausted; members could continue to be permitted to pay their obligations to the General Account in gold, or sell gold to the Fund, in which case they might be provided with SDRs instead of currencies. The General Account would—either immediately upon amendment, or in the longer run--hold only gold; its holdings of currencies would have been replaced by a right to issue SDRs.

Office Memorandum

TO : Mr. Polak DATE: November 10, 1972

FROM : J. Marcus Fleming

SUBJECT : The General Account as Seen from the Special Drawing Account
Your Draft of October 27

While I would, on balance, favor the transformation of the General Account, at some point, along the lines suggested here (mainly in order to make it easier to find resources for G.A. operations, and possibly easier to increase quotas as required), I do not think that governments, still less parliaments, should be burdened with the complexities of changing the Fund's language from "Cherokee" to "good Christian English" (as Keynes would have put it) while they are still struggling with the more substantive issues of the reform of the international monetary system. Thus, while it might be useful to have Executive Directors discuss this issue, I doubt whether they should be asked to work on it. This suggests to me that it might be better to issue the paper as a DM than as an SM.

The paper itself strikes me as an elegant presentation of the case for having the General Account operate exclusively in SDRs, but one in which the difficulties and costs of the transformation are either treated in summary fashion or else passed over in silence. In the first category I would include the question of the "flexibility" of acceptance obligations and the thorny issue of "reverse designation"; in the second category, the problem of securing agreement to open-ended financing of General Account operations and, above all, the problems of transition--of "changing clothes in mid-stream" as it were.

The questions of open-ended financing of the Fund and open-ended acceptance obligations go together. I find it difficult to believe that governments are going to give the Fund unlimited resources and the right to create SDRs in indefinite amounts, and are going to assume acceptance obligations varying from week to week with the extent to which Fund credit is used with no other restriction than that provided by the magnitude of quotas. Over the last decade the link between quotas and the amount of credit available to countries has been lessening with the introduction of compensatory financing and buffer stock financing; even apart from these the 100 per cent limit has become less sacrosanct. At the very least the introduction of such a system of providing Fund resources as is envisaged in your paper would put a stop to this rather desirable tendency and make the quota more of a straight jacket on the amount of assistance that individual countries could obtain: more probably countries would insist on setting maxima, from time to time, to the amount of SDRs that could be created as a by-product of Fund lending, and would prefer to increase their acceptance obligations by definite discrete amounts related to these maxima.

The likelihood that the problem of acceptance obligations will be a tricky one is enhanced if these obligations are in any case going to be increased to accommodate reserve substitution arrangements and if the relationship between such obligations and allocations is going to be increased for industrial countries by the Link. Of course, if the principle of indefinite acceptance of SDRs is adopted as part of the reform, this part of the problem would disappear. Otherwise there is a danger that a premature raising of the problem in connection with a face-lifting for the General Account could intensify the difficulty of securing adoption of the Reserve Substitution Account, which would be a tragedy.

If it proved necessary, in order to enable borrowers to repay the General Account in SDRs, to institute a reverse designation system, this could be very troublesome indeed. Had reverse designation been operative during the period following 15 August of this year the SDR system might have run into the same difficulties as the General Account owing to the reluctance of creditors to give up a gold-related asset. And even a threat of such a breakdown would have been fatal to confidence in the SDR and its hopes of becoming the major reserve asset of the future. Moreover, what form would a reverse designation obligation take? Would a country be obligated to accept any currency convertible in fact in exchange for SDRs or only its own currency? If the former, we lean heavily on that rather weak spot in the SDR system, the concept of "interconvertibility." If the latter, there may be difficulties of reconciliation with more general concepts of asset settlement.

As regards the problem of transactions between the Fund in its present or in its future form, this would clearly raise all the difficulties of implementing Article XXI and Schedule I--and then some.

My comments on other points can be made page by page.

Page 1: The title is distinctly odd.

Page 2, third last sentence: The second half of this sentence is true only of drawings other than dollars.

Page 4: I am rather surprised at your statement that the Fund did not become generally aware of the manner in which its credit operations affected reserves "until some twenty years after the beginning of these operations," and the implications of your footnote that it was enlightened on this matter by Mr. Ezekiel. In fact, a description of the process quite as accurate as, if somewhat briefer than, that of Mr. Ezekiel was contained in a Staff Paper of my own appearing in July 1964,[1] and to my recollection the matter was quite well understood in the staff for several years before that.

Last sentence: The distinction drawn between an extension of credit and an exchange of value for value appears to me somewhat metaphysical; all extensions of credit involve such an exchange.

Pages 4 and 5: The line of argument here is not too clear. The first sentence in the paragraph beginning on page 5 really follows from the second sentence of the paragraph beginning on page 4, but this is not as clear as might be, partly because you are making a transition from describing a hypothetical development to putting forward a proposal.

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Page 7, first complete paragraph: I wonder if this point is worth making.

1/ "The Fund and International Liquidity," pages 183-85.

Pages 7 and 8, straddling paragraph: I find the argument here somewhat overdone. Naturally some of the terms and concepts of the old Fund would disappear but there would be new terms and concepts under any new system, and many of the problems that have affected us in the past would reappear in a different guise. There would be no currency budget but the problems of designation might be intensified and reverse designation might be required. While there might not be any scarce currencies there might be more countries that would be pushed to their acceptance limits. While there would be no problem of maintaining the gold value of the Fund's assets, the problems arising out of the gold valuation of SDRs might be intensified, especially if there were reverse designation. If the General Account no longer had to worry about what to do about SDRs, on the other hand, the SDR system itself might suffer from the absence of a General Account, permitting some substitution of SDRs and currencies. Moreover, it is not so clear to me that the General Account under the new system would never have occasion to borrow, and it may be advantageous that it should be able to borrow in relatively illiquid forms, so as to be able to extend credit without increasing reserves.

cc: Mr. Gold
Mr. Nicoletopoulos
Mr. Schwartz
Mr. Williamson

Mr. Polak November 10, 1972

J. Marcus Fleming

The General Account as Seen from the Special Drawing Account
Your Draft of October 27

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The likelihood that the problem of acceptance obligations will be a tricky one is enhanced if these obligations are in any case going to be increased to accommodate reserve substitution arrangements and if the relationship between such obligations and allocations is going to be increased for industrial countries by the Link. Of course, if the principle of indefinite acceptance of SDRs is adopted as part of the reform, this part of the problem would disappear. Otherwise there is a danger that a premature raising of the problem in connection with a face-lifting for the General Account could intensify the difficulty of securing adoption of the Reserve Substitution Account, which would be a tragedy.

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cc: Mr. Gold
Mr. Nicoletopoulos
Mr. Schwartz
Mr. Williamson

MEMORANDUM

TO: Mr. Gold
Mr. Nicoletopoulos
Mr. Fleming
Mr. Schwartz
Mr. Williamson

October 27, 1972

FROM: J. J. Polak

SUBJECT: The General Account as Seen From The Special Drawing Account

I would be grateful for comments on the attached. This would be intended as an SM with two purposes in mind:

(a) It would alert Directors to the important possibilities of simplification that now exist.

(b) It would provide a subject of work for Directors which would usefully link into some aspects of the Reform, in particular the nature of the substitution account.

J.J.P.:
10/26/72

The General Account as seen from
The Special Drawing Account

Prepared by the Research Department

Summary

This paper considers the method of operation of the General Account, which is based on gold and currencies, against the background of operation of the Special Drawing Account conducted in SDRs. It shows that, given the existence of SDRs, operation of the General Account in SDRs alone would be simpler than the present method and would avoid many of the most difficult and divisive issues that have arisen in the past. This is followed by a discussion of certain features of the Fund that derive from the fact that it holds gold and currencies and engages in transactions in these assets; these features, whose importance to the functioning of the Fund differs from one to the other, would be lost (or would have to be recast on an SDR basis).

These issues, which suggest themselves by the two separate methods of operation adopted for the two Accounts, may assume additional interest in the context of the reform of the system, which is likely to have important effects on the operation of the Special Drawing Account, and perhaps on that of the General Account as well.

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On a sufficiently general level there is a strong similarity between the financial functions which the two Accounts in the Fund, the General Account and the Special Drawing Account, perform for members: both enable a member in deficit to use financial resources that it had not earned from a previous balance of payments surplus. The two main differences between use of the two Accounts relate to conditionality--use of the General Account

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(except gold tranche use) being subject to conditions whereas the use of SDRs is unconditional--and to the need to restore the previous position after use. For members that provide the users with foreign exchange the effect of any use of the resources of either Account is also very similar; they acquire, in both cases, reserves in the form of "Fund related assets": a "reserve position in the Fund" (a gold tranche position or a loan claim on the Fund) when the drawing takes place in the General Account and SDRs when the drawing member uses its position in the Special Drawing Account.

In spite of the fact that transactions in the two Accounts are so similar, both for the user and for the provider of resources, they are executed in entirely different ways. In the General Account, transactions are conducted on the basis of a pool of currencies contributed by all members, with further contributions in gold to enable the Fund to acquire additional amounts of any currency that it might need. The drawing entitlements are expressed in terms of quotas, but the quotas themselves are not exchange reserves available to the member; such reserves have to be acquired by drawings made within the framework of the quotas. Drawings are technically made in the currencies of the countries that are selected by the Fund to acquire the reserve positions in the Fund; but these currencies are normally at once converted by the drawer, so that the drawee country experiences a substitution of a reserve position in the Fund for holdings of foreign exchange. In the Special Drawing Account by contrast, given amounts of SDRs representing an equal percentage of quotas are allocated from time to time to participants. Use is made in the Special Drawing Account by the transfer of SDRs from one participant to another against convertible currency.

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Why this difference between the two Accounts in technical arrangements, if it does not reflect any obvious difference in substance between the transactions in these two Accounts? It may be noted that the SDR account is both the junior and simpler of the two Accounts, and the more complicated form in the senior Account has clear historical reasons: the U.S. negotiators in the discussions that preceded Bretton Woods argued strongly that a Fund operating on the basis of "a mixed bag of currencies" was more likely to win Congressional approval than one based on an international currency which could be created at will.[1/] But is there a continuing justification for this latter form? Perhaps the best way to approach this question is as follows. Suppose that the founders of the Fund had felt it necessary to concentrate their attention on the need for unconditional rather than conditional liquidity and for this purpose had created a mechanism such as that contained in Articles XXI and following of the present Articles of Agreement, perhaps combined with regulatory provisions with respect to exchange rates, the avoidance of exchange restrictions, convertibility, etc. Such a Fund would have required quotas both as a basis for the allocation of unconditional liquidity and to determine voting power. But it would not have contained the financial provisions of the original Articles of Agreement. Assume further that, despite the absence of a learning model which the pre-1969 Fund provided for the SDR mechanism, the provisions on SDRs were exactly those of Article XXI and following (with the exception of references to the General Account). If then, at some later time, when the SDR facility had been running

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1/ J. Keith Horsefield, The International Monetary Fund, 1945-1965, Vol. I, pp. 28-30.

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smoothly for a considerable period, the Fund had reached the conclusion that it would be opportune to provide, side by side with the SDR facility, a conditional facility under which members would be entitled to obtain financial resources from the Fund for temporary use, how would it have gone about this?

It would seem unlikely that in order to provide this new facility the Fund would have found it necessary to ask each member to make a contribution in gold and in its own currency. Rather, it should have appeared natural that the Fund would have made provision for the creation of additional SDRs for the amount of credit it extended, these SDRs to be cancelled when Fund credit was repaid. This would be in line with the proposition that the extension of international credit by the Fund involved an expansion of reserves, and the repayment of such credit a contraction of reserves--a proposition of which the Fund did not become generally aware with respect to its own operations until some twenty years after the beginning of these operations.[1/] By that time the approach originally chosen--i.e., that the Fund would not be an international "bank", creating international money by extending "credit"--had been overcome by the economics of the situation. Member countries making resources available to the Fund wanted these resources to be monetized. At the same time, the attempt never took hold to view transactions through which the Fund made resources available to members in payments difficulties as an exchange of value for value (currency for currency). Fund transactions are now generally regarded as the extension of balance of payments credit.

1/ Hannan Ezekiel, "The Present System of Reserve Creation in the Fund," Staff Papers, Vol. XIII, No. 3 (November 1966), p. 398-420.

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This view is reflected, for example, in the adoption of the concept of "credit tranches" and in the widespread use of the term "repayment" as both more general and more meaningful than the legal "repurchase."

The country that obtained Fund credit in SDRs would normally use these SDRs to acquire currencies, for which the designation mechanism could conveniently be used. Nothing new would be required for this purpose, but it would be necessary to create sufficient flexibility in the acceptance obligations so as to ensure that there would be takers for the additional SDRs put into circulation by the Fund's credit operations. A more important new feature would be required to enable countries to repay Fund credit in SDRs. Countries would have to be in a position to acquire such SDRs against the holdings of reserve currencies. If the Reform provided for an open-ended substitution facility, this would take care of the problem. Otherwise, it would be necessary to introduce into the SDR mechanism a system of what might be called "reverse designation" to regulate which countries would have to make available SDRs against convertible currencies, and in what amounts (in contrast to the designation mechanism that regulates the countries that are to make available convertible currencies against SDRs). In the present SDR facility there are only the most rudimentary provisions for "reverse designation" because the need for it is unlikely to arise on any significant scale. In theory, a participant may be obliged to sell SDRs for other reserve assets for the purpose of enabling another participant to meet its obligations to pay charges and assessments (Article XXVI, Section 5) or its reconstitution obligation (Schedule G, 1(a)(iv)); but

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the stock of SDRs held by the General Account makes it unlikely that these provisions will ever become operative.[1]

The Fund's conditional drawing facilities could be subject to certain quantitative limitations such as a normal maximum of 25 per cent of quota per year and a normal upper limit of 100 per cent of quota, and within the latter limit to a tranche policy of increasing intensity of scrutiny depending on the extent of the use of Fund credit in terms of a member's quota. There would, of course, be no occasion for the introduction of automatic drawing rights in what is now called the gold tranche, because in the absence of gold payments and the sale of members' currencies, "gold tranche positions" would not arise.

The Fund liquidity necessary to meet the needs for convertible currencies of the members that used the credit facility would be ensured by the size of the acceptance obligations, which, as mentioned, would have to be large enough to permit designation in relation to the total amount of SDRs that would at any time exist, whether arising from allocation or from conditional credit operations.

Credit extended by the Fund in SDRs would naturally be repayable in SDRs. The Fund could set conditions for the duration of the credit (e.g., 3-5 years) or it could make timing of repayment a function of the rate of interest payable, along the lines of the provisions of Article V, Section 8(d). There cold further be provisions for accelerated repayment in the light of the member's balance of payments and reserve position. Information on this subject is already used in the operation

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1/ The sale of SDRs by the General Account against convertible currencies transfers the economic problem to that Account, where it is assimilated with that of the currency budget for repurchases. The question thus becomes the selection of countries to give up reserve positions in the Fund rather than SDRs.

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of the designation system which regulates inter alia the reversal of net use of SDRs in a manner somewhat akin to the repurchase provisions in the General Account.[1/] It may be noted that this system employs data on reserves based on an economic definition rather than the definition laid down in Article XIX to guide the repurchase provisions of Artile V, Section 7(b).

It might be presumed that a Fund that did not hld balances in the currencies of its members would not give members the option in certain circumstances to add the interest charges to the outstanding credit--which is the effect of the provision in the present Articles allowing payment of interest in the member's own currency--rather than pay them in SDRs.

The preceding summary description of how the SDR Account of the Fund could be extended to cover conditional credit transactions sketches a mechanism that would not only lack most of the esoteric characteristics of the present Fund and would thus be much easier to understand; it would also avoid many of the most difficult and divisive issues that have arisen in the Fund's history. Among the concepts for which there would be no need one may mention the "gold tranche," the "basic gold tranche," the "super gold tranche," the "currency budget," "overwhelming benefit of the doubt," "reserve positions in the Fund," "Fund positions" (net, gross, and creditor), "remuneration," and "scarce currencies." Among the major issues that would not have arisen, mention may be made of the automaticity of drawing in the gold tranche, "floating in the gold tranche"

1/ J.J. Polak, "Some Reflections on the Nature of Special Drawing Rights," International Monetary Fund Pamphlet Series No. 16, p. 17.

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(applicable to compensatory financing but not to buffer stock financing), maintenance of the gold (or SDR) value of the Fund's assets, mitigation of the direct and indirect reserve effects of gold subscriptions, the General Arrangements to Borrow, bilateral borrowing, replenishment of currency holdings with gold, and the usability of SDRs in payments to and by the General Account.

A substantial portion of the present Articles relative to the General Account would become redundant if the approach to the credit operations of the Fund outlined above were adopted. There would also have to be many consequential changes, e.g., in the provisions that indicate debtor or creditor positions by reference to the Fund's holdings of a member's currency compared to its quota.

If the conditional facility in the Fund were constituted along the lines indicated, it would be very much simpler than the present General Account. The absence of holdings of gold and currencies derived from subscriptions and exchange transactions,[1/] would, however, imply that the Fund would lack certain features related to these assets. Five of these features deserve some consideration in this context, although tis is not an exhaustible list.[2/]

1. Gold payments. Members make gold payments to the Fund when they join, and when their quotas are increased, With respect to initial gold payments the Fund has been flexible, accepting payment of less (sometimes much less) than the standard 25 per cent of quota in the light of the member's holdings of gold.

1/ It might still hold gold and currencies arising from (or construed to have arisen from) other sources, e.g., if it could acquire gold and currencies against SDRs through a substitution facility.

2/ One might mention, in addition, that in a Fund whose transactions were all conducted in SDRs the distinction between participants and other members might be difficult to maintain; such a Fund might also need a provision to acquire currencies for its administrative expenditures.

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The rule that members pay 25 per cent of any quota increase in gold was for a long time considered an important disciplinary factor that would help to avoid undue pressure for quota increases. Although the Articles of Agreement provide for the possibility of a reduction in the gold payments by a member with small reserves (Article III, Section 4(a), it was decided in both the 1958 and the 1964 general quota increases not to apply this provision. The reason given on both occasions was that the "proposals for increases in quotas [were] based on the idea of a cooperative effort by the members of the Fund to provide larger resources against contingencies that might affect any member.", and that the general character of that effort should be preserved.[1/]

The significance of the "effort" on the part of members that were not using the Fund in the credit tranches was however greatly reduced by the recognition--at first *de facto* and later *de jure*--of the reserve character of gold tranche positions. For countries in that position the payment of gold in connection with the quota contribution constituted no more than the replacement in their reserves of a gold guaranteed position in the Fund for actual gold. The economic meaning of the transaction would be even further reduced if countries were given the right (which they do not possess now) to substitute payment in SDRs for payment in gold. For countries that were using the Fund in the credit tranches on the other hand, the gold payments was the equivalent of an advance repayment of credit received from the Fund. These and other considerations led to a reversal of the position of the principle taken with respect to the

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1/ "Enlargement of Fund Resources Through Increases in Quotas," Washington, 1958, p. 17; 1965 Annual Report, p. 126.

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application of the provisions of Article III, Section 4(a): in the Fifth Quinquennial Review (1969), members with low reserves were entitled to avail themselves of the opportunity to make a reduced gold payment.

The substantive difference in treatment between the earlier and the later quota reviews was not as great as the change in the formal position might suggest; in fact it was minimal. On both of the earlier occasions, members encountering payments difficulties through the reduction of their reserves that the gold payment would involve could make a drawing for the corresponding amount, to be repurchased in three (1958) or five (1964) equal annual installments; and members that availed themselves of the possibility of reduced gold payments under the 1969 review were required to undertake to repurchase the resulting additional currency subscription in five equal annual installments.

If a member that receives a quota increase does not pay gold or pays gold and makes a drawing for the same amount, its position in the Fund is not changed. For a member that uses the Fund in the credit tranches, the arrangements under the various quota reviews therefore amount to some acceleration of repurchases of outstanding use of Fund credit and some commitment to build up a gold tranche position.

2. Transactions with the Fund in gold. The provisions with respect to the sale of gold by members to the Fund and the sale of gold by the Fund to members can be seen as providing an indirect mechanism assuring members of the usability of gold in their reserves to settle transactions with other members. The two provisions that, together, could provide this chain are Article V, Section 6(a) dealing with gold sales by members to the Fund and Article VII, Section 2(ii) under which the Fund can acquire

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a member's currency for gold for replenishment purposes. However, the legal right of a member to sell gold to the Fund has been questioned in recent years.

A number of questions with respect to gold will in any event have to be dealt with in connection with the Reform. For example, it has been suggested that the Fund might be enabled to acquire gold frommembers against newly issued SDRs.[1/] Any arrangements to that effect that might be introduced could give members an assured possibility to use their gold holdings; the existence of such an arrangement would also make it possible, if that were desired, to eliminate the role of gold in the General Account without the need for the Fund to dispose of the gold it had at the moment of transition.

3. Scarce currency provisions. Under these provisions of the Articles, the Fund is entitled to take action against a country in an extreme creditor position as reflected in the Fund's holdings of that member's currency; and such action then authorizes members to introduce discriminatory provisions with respect to the currency that has been declared scarce (Article VII, Section 3). While these provisions of the Articles were initially hailed as an important part of the adjustment process directed against persistent creditor positions, it has since become recognized that this provision "does not in its present form provide a practical means of applying pressure on surplus currencies." (Reform Report, p. 18)

4. Absence of remuneration on the basic gold tranche. Simplification of the Fund as described above might also make it more difficult to maintain the implicit contribution that members now make to the Fund's budget to

1/ Reform Report, p. 36.

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the extent that they hold a basic gold tranche position on which they do not receive remuneration.[1/] The amount involved has been of the order of SDR 60 to 75 million in recent years (1 1/2 per cent on basic gold tranche positions of SDR 4 to 5 billion). The equity of a contribution on this basis is open to question. Members of whose currency the Fund holds 100 per cent of quota or more do not share in it, and members in the 75 to 100 per cent bracket share in it only partially. Members that hold a corresponding amount of their reserves in the form of SDRs rather than as a basic gold tranche position do not forego income on these assets. If creditor interest were paid at the SDR rate on all creditor positions, the effect on the Fund's budget could be compensated by an assessment levied on all members' quotas, e.g., at the rate of one-fourth of the SDR interest rate; this would follow the approach adopted to finance the cost of the Special Drawing Account by an assessment on net cumulative allocations.

5. Effect of the provision for uniform change in par values on the value of positions in the Fund. The present Articles provide a theoretical possibility to scale down members' debtor and creditor positions in the Fund as a result of a uniform change in par values accompanied by a decision not to apply the provisions on the maintenance of the gold value of the Fund's assets.[2/] The practical significance of this possibility may be doubted.

1/ Admittedly, this question can be looked at from different angles. For many years the absence of interest or its equivalent on gold tranche positions was not questioned, and there was indeed considerable reservation to the idea that any part of such positions should form the basis for any form of "creditor interest." However, as gold tranche positions (basic as well as super) have come to be considered as reserves and as remuneration is now paid on super gold tranche positions, at a rate equal to that on SDRs, the unremunerated basic gold tranche must increasingly be regarded as the "odd reserve out."

2/ Article IV, Sections 7 and 8(d).

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Mr. Polak

Mr. Gold

June 29, 1971

W.O. Habermeier

General Account--Requirement of Need

I would suggest that a communication to the Board at this stage might be premature. It is my strong impression from looking at some preliminary investigation of drawings in 1968 to 1970, which we started earlier this year, that the concept of the requirement of need in the General Account differed in fact from that which we use generally on SDRs. If this is so, then the use of the SDR concept might restrict the access to the General Account in comparison with the accepted practices, and also with previous decisions by the Executive Board approving specific drawings. Such a move could raise serious issues of consistency of treatment.

Before alerting the Board is is my view therefore that we should explore more systematically the criteria used by area departments in recommending drawings. Perhaps the area departments could be asked to initiate a memorandum (along the lines of those presently used to reach a judgment on the use of SDRs) each time a member makes a drawing on the Fund, or as soon as their reserve data are available. In the light of the legal view that all Fund-related assets may be used to meet balance of payments needs, I would suggest that we start by applying the same quantitative criteria that have been used internally to determine whether the use of SDRs has met the requirement of need. These memoranda should be circulated, as at present, and all interested departments would come to a view on them jointly. At the end of some period a paper could be written for the Board using the accumulated experience as background. I should perhaps add, in order to avoid misunderstandings, that I do not insist that we be guided solely by "experience," but that any criteria which we wish to apply should be tested for a while in practice before we undertake to affirm them to the Executive Board.

cc: Mr. Polak ✓

Mr. Smith August 13, 1971

J. J. Polak

Subj.: <u>Requirement of Need in the General Account</u>

Perhaps not much can be done on this for the time being, but you might at least begin to give some attention to the questions that concern us most in this connection. In that connection, I attach some charts that have been prepared by the Treasurer's Department.

~~I couldn't find charts~~--

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MEMORANDUM

TO: Mr. Gold
Mr. Habermeier
Mr. Sturc

August 13, 1971

FROM: J. J. Polak

SUBJECT: Requirement of Need in the General Account

I am sure all of us would prefer to deal with this matter at some leisure, but since at least some Directors expect us to come forward with proposals with remedial action on Malaysia shortly after the recess, I think we have to give this matter some rather urgent attention.

There are many aspects that deserve consideration. To get the process moving I have put down in the attached some of the major points that might form the basis for an SM. If you could let Mr. Fleming have your reactions within the next two weeks, it might be possible to meet thereafter and to decide how to proceed from there.

cc: Mr. J. Smith

J. J. Polak
August 13, 1971

Requirement of Need in the General Account

Outline of Points for Staff Paper

1. Background

The situation has been so far that, with respect to need, there have been roughly two categories of transactions--those where the need was evident and where it was tested, and those where the need was not evident and often not present, but which were not tested. In the first category there were straight drawings in the credit tranches or the first installment under a stand-by arrangement, as well as drawings under the compensatory financing facility. Members did not request such drawings unless they had a clear need, which they also knew would be tested. In the second category were gold tranche drawings and subsequent drawings under stand-by arrangements. These transactions were handled extremely expeditiously; moreover, the myth was allowed to grow that drawings under stand-by arrangements do not "really" require to meet the needs test.

The net result of this constellation was that the Fund never challenged a drawing on the ground of absence of need, nor made a formal subsequent judgment afterwards that there had been no need. Thus, the remedy--inclusion in the currency budget--also remained untested.

2. Remedies

If in the future the Fund is to take the requirement of need seriously we should be aware of two facts: (a) that in many cases it will not be possible for the staff to give a clear ruling at the time of a drawing that the need is met or is not met without introducing considerable delay; (b) that the corrective mechanism via the currency budget is exceedingly difficult to handle.

The reason for (a) is that it takes time to judge need and that need is at least to some extent a prospective concept. The reason for (b) is that a member can in practice make use of its currency in transactions difficult if it does not want to increase its position in the Fund.

These considerations lead to the suggestion of the following two-pronged approach, which is of course greatly influenced by experience in the Special Drawing Account.

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1. In transactions subject to challenge the staff would not need to propose challenge by the Fund even where it was not convinced that the requirement of need had been met. In practice this would mean that all, or almost all, transactions would continue to remain unchallenged, either because the staff was satisfied that the requirement of need had been met or because it did not feel sufficiently certain to the contrary to challenge the transaction. This half of the policy would obviously require as a counterpart an effective corrective mechanism.

2. Such a mechanism should operate through repurchase, not through the currency budget. To introduce this it would be necessary to introduce the rule that members, when requesting a drawing including a gold tranche drawing, would undertake to repurchase promptly in the event the Fund had found that the requirement of need had not been met. Perhaps it could be argued that members are already giving a general undertaking in this direction when they subscribe to the principles of the 1952 Decision, which includes the provision that "exchange purchased from the Fund should not remain outstanding beyond the period reasonably related to the payments problem for which it was purchased from the Fund." In cases where there is no need, there is obviously no payments problem related to the purchase and a prompt undoing of the transaction is, therefore, indicated. However, no specifics have been suggested for this in the past and some appropriate Fund decision would obviously be necessary. Any decision to the effect that a member should repurchase when the Fund found that the requirement of need had not been met would require stipulation with respect to timing and other particulars. (Reversal through repurchase would not be applicable to drawings in the super gold tranche; however, the fact that a country has acquired a super gold tranche position must mean that at least in the past some solution had been found to sales of its currency; moreover, the normal currency policy will have some corrective effect.)

3. Criteria of Need

Even though, as suggested, need would normally be assessed after the event, there would be great advantage if members could, as a minimum, be assured that drawings in specified circumstances would pass the test. The two tests applied in the Special Drawing Account might do for this: reserve movement over recent months, and a minimum level of working balances (see SM/71/85). The second of these would be agreed specifically in the case of individual stand-by arrangements.

Attention would have to be given to the question how far forward to look in determining need. Where the drawing can be made any time in the future, as in the Special Drawing Account or the gold tranche, there would appear to be no reason for anything beyond a very short forward look. This has been the practice in the Special Drawing Account, (SM/71/85, page 3). Should the position be different where the member may lose the opportunity to draw (under stand-by arrangements, compensatory financing, buffer stock financing)? To what extent should the problem be resolved by allowing greater leeway to a member to draw under the buffer stock facility after making its payment to the buffer stock if it has a need later which it did not have at the time of the payment?

Office Memorandum

TO : Mr. Polak

DATE: July 30, 1971

FROM : J. Marcus Fleming

SUBJECT : Requirement of Need in the General Account

new file on this.

I agree with the general lines of your draft of July 29. However, I think that it requires rounding out in various ways.

(1) It should be emphasized that "presently needed for making ..... payments" has a forward as well as a backward reference. Unless one is going to confine the need to draw to the restoration of reserves lost over a recent period, one must allow that it includes also an acquisition of reserves to meet a prospective decline over a nearby future period. The "present" is of course a period of time and not a point in time. It is only if prospective as well as past deficits are relevant that we can establish the point that judgments of need are always subject to some uncertainty and may be subject to considerable uncertainty, and also the point that need or its absence can sometimes be more clearly established at a point of time subsequent to the drawing.

(2) You should probably admit that one of the reasons why in certain cases members draw only when they have a need is that they are aware that their need may be challenged.

(3) It should probably be mentioned that in some cases, notably the super-gold tranche cases, some reversal of unneeded transactions will take place, albeit slowly, as a result of the normal operation of the currencies to be drawn policy, quite apart from the addition to that policy of a specific provision about reversals.

Confidential

JJP:July 29, 1971

to Fleming only

Requirement of Need in the General Account

The ease with which the staff has handled (or rather avoided) the problems in this area in recent years should not hide from us the real difficulties that we would be faced with if we began to take this problem seriously.

The situation has been that there have been roughly two categories of transactions--those where the need was evident and where it was tested, and those where the need was not evident and often not present, but which were not tested. In the first category there were straight drawings in the credit tranches for the first installment under a stand-by arrangement as well as drawings under the compensatory financing facility. Members did not request such drawings unless they had a clear need. In the second category were gold tranche drawings and subsequent drawings under stand-by arrangements. These transactions were handled extremely expeditiously; moreover, the myth was allowed to grow that drawings under stand-by arrangements do not "really" require to meet the needs test.

The net result of this constellation was that the Fund never challenged a drawing on the ground of absence of need, nor made a formal subsequent judgment afterwards that there had been no need. Thus, the remedy--inclusion in the currency budget--also remained untested.

If now we want to take the requirement of need more seriously we should be aware of two facts: (a) that in many cases it will not be possible for the staff to give a clear ruling at the time of a drawing that the need is met or is not met without introducing considerable delay; (b) that the corrective mechanism via the currency budget is exceedingly difficult to handle.

This would lead me to the following two-pronged suggestion, which is of course greatly influenced by our experience in the Special Drawing Account.

1. In transactions subject to challenge the staff would not need to propose challenge by the Fund even where it was not convinced that the requirement of need had been met. In practice this would mean that all, or almost all, transactions would continue to remain unchallenged, either because the staff was satisfied that the requirement of need had been met or because it did not feel sufficiently certain to the contrary to interpose the transaction. This half of the policy would obviously require as a counterpart an effective corrective mechanism.

2. Such a mechanism should operate through repurchase, not through the currency budget. To introduce this it would be necessary to introduce the rule that members, when requesting a drawing, would undertake to repurchase promptly in the event the Fund had found the absence of need. There

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would be no reason not to subject gold tranche purchases to this requirement as well. Perhaps it could be argued that members are already giving a general undertaking in this direction when they subscribe to the principles of the 1952 Decision, which includes the provision that "exchange purchased from the Fund should not remain outstanding beyond the period reasonably related to the payments problem for which it was purchased from the Fund." In cases where there is no need there is obviously no payments problem related to the purchase and a prompt undoing of the transaction is, therefore, indicated. However, no specifics have been suggested for this in the past and some appropriate Fund decision would obviously be necessary. Reversal through repurchase would not be applicable to drawings in the super gold tranche; however, the fact that a country has acquired a super gold tranche position must mean that at least in the past some solution has been found to sales of its currency.

MEMORANDUM

TO: Mr. Gold June 25, 1971

FROM: J. J. Polak

SUBJECT: Requirement of Need--General Account

I gather that the decision at yesterday's Staff Meeting was that the staff should undertake a study of the question of misuse of automatic drawing rights in the gold tranche as referred to in paragraph 32 of the 1968 Report of the Executive Directors, and any related questions for drawings in other tranches, and that moreover a way should be found in advance to inform the Board that this study would be undertaken.

It might be best to start with the communication to the Board. Would you be willing to take the initiative on this?

cc: Mr. Habermeier

DRAFT
6/24/71

Gold Tranche Purchases - Need

I hope that we will pursue the subject raised by Mr. Gold at the Staff Meeting on June 24th. It was agreed, I believe, that you would inform the Board that the staff was studying the subject on the basis of, although not necessarily confined to, Section 32 of the Executive Directors' Report on the Proposed Amendment of the Articles. I suggest that Mr. Gold take the initiative to prepare a draft in collaboration with Mr. Habermeier and myself for your consideration.