The Managing Director | November 3, 1977

L. A. Whittome

International Liquidity

Listening to this morning's discussion, it occurs to me that when the question is next discussed it would be useful to distinguish more clearly between three inter-related topics, namely:

(1) The undesirable growth of lending to countries whose position is such that adjustment is well overdue.

(2) The problem that, subject to unknown but probably wide limits, international borrowing can rise sharply, whether or not this is desirable in the context of the world demand situation of the moment.

(3) The difficulty of finding convincing arguments to support a new SDR allocation against the background of the problem summarized in (2).

In my opinion, the first question is distinct and it would be preferable for it to be left aside--as it muddies the waters--until discussion on the basic question, namely the second is more advanced. As regards this second question, it seems to me that we are never going to be able to quantify with any precision the degree of flexibility that may exist. The Crockett/White paper only states, and in this it is obviously correct, that ultimately the monetary policies of the main countries and in particular of the United States, impose a limit on the growth of total lending both domestic and international. The difficulty is that in present conditions, when targets for monetary aggregates are being set in relation to domestic growth targets which are not being reached, the room for "spill over" into international lending may be very large indeed. Certainly it is so large as to make it very difficult to obtain agreement on a new SDR allocation. Presumably if national monetary targets remained unchanged whilst domestic demand for credit in the main industrial countries grew, there would be less room for a substantial increase in international lending. But by how much is still very unclear and unfortunately is likely to remain unclear within wide limits.

None of this is at all helpful in the context of SDR allocation. One thought might be to shift the emphasis of the argument and maintain that in conditions of a short-fall in world demand SDR allocations can play a role in stimulating world demand and in a way that is more certain (because it leads to an increase in owned reserves) than an increase in international borrowing. But again I am far from certain that such an approach will convince the sceptics. A different argument would be one favoring a "token" allocation designed, say, to at least keep the outstanding value of SDRs at its 1972 level in real terms.

cc: The Deputy Managing Director
Mr. Polak
Mr. Ware

Called This is a useful summary. Thank you. IAW 18/4 J. O.

April 18, 1977

MEMORANDUM FOR FILES

Subject: Adequacy of International Liquidity (SM/77/62, 3/21/77) and the Fund's Future Role in the Financing of Payments Imbalances: The Provision of Supplementary Credit and Fund Borrowing (EBS/77/88, 3/30/77)

The two staff papers were taken up by the Board in conjunction and the discussions centered around three interrelated topics: the seventh general review of quotas to be completed by February 1978; SDR allocations for the third basic period for which the Managing Director had to make a proposal not later than June 30, 1977; and the provision of supplementary credit and Fund borrowing. The cooperation of the Fund with commercial banks was taken up as a subsidiary subject.

Seventh review of quotas

Mr. Cross was very critical of the two staff papers being discussed. He said they "resembled a sales brochure of the positions preferred by the drafters of the papers." Particularly, on the question of the quota review, he found the staff analysis most inadequate. He argued that relating quotas to trade overlooked other factors which had become important in recent years such as the development in capital markets, increased flexibility of exchange rates, etc. He agreed that an increase in quotas was probably warranted, but that more work needed to be done on this subject. He hoped that the widening of tranches to 145 per cent would be discontinued after the seventh quota review. On the subject of uniform versus selective quota increases, Mr. Cross was of the opinion that it would be simpler to have a uniform increase.

Mr. Pieske pointed out that the staff's proposals for the quota increase, SDR allocation, and the supplementary credit taken together added up to a possible liquidity creation of SDR 90-130 billion which exceeded total liquidity created in the last 30 years (i.e., about SDR 95-105 billion, including the oil facility). He was of the opinion that this surpassed by far the payments imbalances needed to be financed by the Fund's resources, although he recognized the need for shifting some of the burden of intermediation from private to official channels. Mr. Pieske did not think that the amount of Fund credit available at present was insufficient to induce countries to undertake balance of payments adjustments. It was the availability of low conditionality credit from other sources that was too large. On the quota review, Mr. Pieske argued along similar lines with Mr. Cross. He questioned the appropriateness of relating quotas to the developments in payments imbalances. Quoting statistics on the use of the credit tranches by member countries, he pointed out that facts did not support the claim that the resources of the Fund had fallen behind the need for these resources. He was not convinced that more countries would have turned to the Fund had quotas been larger and said that the last quota increase had not raised the use of the credit tranches. He was of the opinion that the surpluses of oil producing countries should finance the deficits of other countries, but he did not think a quota increase could achieve this considering the size of the oil producers' quotas in the Fund. Like Mr. Cross, Mr. Pieske was not convinced that a specific relationship

needed to be maintained between quotas and world trade. He also expressed doubt that an increase in Fund credit would limit private lending to deficit countries. Despite these reservations, Mr. Pieske said that his authorities would support a reasonable increase in quotas, but that the actual size of the increase would be influenced by the amount of supplementary credit that might become available. He also pointed out that the staff paper did not mention the distribution of quotas which was very important, and emphasized the need to maintain a certain balance between quotas of debtor and creditor countries. Mr. Pieske did not think that the recent widening of the credit tranches, which was a temporary measure, needed to be retained after the seventh quota review.

Mr. Kent agreed with the staff's view that the Fund must have adequate resources if it is to make a contribution to the adjustment process. He said that a quota increase was justified and that his authorities would support a considerably larger increase than had taken place under the sixth quota review. He thought that a doubling of quotas would be about right and that the sooner it took place the better. Mr. Wahl was also in favor of a sizable increase in quotas, but not in the magnitude suggested by the staff. He thought that a 50 per cent increase instead of 75 per cent would be reasonable, particularly in view of the fact that private banking credit had expanded in recent years and would continue to do so. He supported an across-the-board increase in quotas.

Mr. Ruding agreed with the view expressed in the two staff papers that existing Fund facilities are no longer in line with the size of balance of payments deficits faced by member countries, but thought that the staff had suggested extremely high aggregate amounts of increases in international liquidity. He argued that a better solution would be to encourage lending on a bilateral and longer-term basis by countries persistently in surplus to those persistently in deficit. Like Mr. Pieske, Mr. Ruding thought that the size of the quota increase would be influenced by the amount of supplementary credit made available to member countries. He considered an adequate quota increase the best solution to the Fund's liquidity problem. He said that the Dutch authorities saw no need for more than a reasonable increase in quotas, which might mean a somewhat less than 50 per cent increase. However, more frequent adjustments would be favored so that the eighth quota review might come soon after the seventh one. Because of the time constraint, Mr. Ruding was willing to support a uniform increase in quotas, although his preference would be for a selective increase, particularly in case of a large quota increase. Mr. Dini was full of praise for the two staff papers and in agreement also with the conclusions reached. He considered a substantial increase in quotas appropriate.

Mr. de Groote pointed out that a quota increase would benefit all members, while the benefits from a supplementary credit facility would be limited to some. On the other hand, countries might use the increased quotas in place of supplementary credit and postpone the adjustment process. Therefore, he favored a limited, across-the-board quota increase. Mr. Hollensen recognized the need for a substantial increase in Fund liquidity, regardless of the fact that Fund facilities are not always fully used (as pointed out by Mr. Pieske). He argued that Fund facilities are a safety net for the international monetary system and that, in determining the various magnitudes,

quota increases, SDR allocations, and special lines of credit should be considered together. Mr. Drabble said that the Canadian authorities were in favor of a moderate quota increase, since raising quotas by 75-100 per cent as suggested by the staff would increase excessively Fund resources with low conditionality. Mr. Whitelaw said that the position of the Australian authorities on the quota increase was one of extreme caution. In the end, they might support a quota increase of 25-50 per cent. He agreed with Mr. Cross that the staff had not taken into account changed world conditions (i.e., greater exchange rate flexibility, increased private lending, etc.) in making their calculations. He suggested, for example, that, had gold been valued at market prices, reserves might have increased rather than fallen in relation to imports during the 1971-75 period (Table 3, SM/77/62). He also agreed with Mr. Pieske on the lack of use of the upper credit tranches by member countries. Mr. Whitelaw said that the New Zealand and the Philippine authorities were willing to support a large increase in quotas.

Mr. Kafka considered the adequacy of international liquidity a longer-term matter. He suggested that grant aid, additional subscriptions to IDA, or an arrangement in line with the International Resources Bank, once proposed by the United States, might offer alternative solutions to deficit countries. He emphasized that these countries needed to reduce the gap between their savings and investments and that otherwise it would not be possible for them to reduce their current account deficits.

Messrs. Al-Atrash, Mogae, Nana-Sinkam, Guarnieri, Ng, and Rasaputram were all in favor of a quota increase in the order of magnitude suggested by the staff. Mr. Matsunaga supported an adjustment of relative quotas as well as an overall increase of about 50 per cent.

SDR allocation

Mr. Cross was not convinced by the staff's arguments for an SDR allocation in the third basic period. He did not think that an SDR allocation would lead to a reduction in other forms of liquidity. He argued that reserves provided the basis for borrowing so that an increase in reserves through an SDR allocation could lead to increased rather than reduced borrowing. Mr. Pieske was also of the opinion that an allocation of SDRs is not justified at present. He pointed out that an SDR allocation for the purpose of altering the composition of reserves, as suggested by the staff, was not recognized by the Articles of Agreement as the role of the SDR. The staff had not denied the inflationary impact of an SDR allocation but had suggested that offsetting restrictive fiscal and monetary policies would need to be taken. Mr. Pieske thought that the degree of international coordination which such an approach assumed would be difficult to achieve. He found it ironical for the Fund to ask monetary authorities to take restrictive measures to counter inflationary tendencies which the Fund itself had created and pointed out that the consequences of this for the adjustment process had not been examined by the staff. He also warned that there might even be a need at a later stage to reverse the decision on allocation (i.e., to curb allocation midway) and that this would be like "turning the Articles of Agreement upside down."

Mr. Kent agreed with Mr. Cross that an allocation of SDRs would not necessarily lead to a reduction in borrowing, and might even raise borrowing since a larger level of reserves might be used as a cushion against further borrowing. He also shared Mr. Pieske's doubts that major industrial countries would take steps to offset the inflationary impact of an SDR allocation, and questioned the desirability of restrictive measures even if they were to be taken. He argued that an increase in interest rates and slower monetary growth in industrial countries could slow down the flow of private capital, and introduce a deflationary bias in countries which were expected to contribute to the growth of the world economy. Mr. Kent concluded his remarks by saying that the Fund should start with an increase in quotas and supplementary lines of credit and consider an allocation of SDRs only if it then proves to be necessary. He stressed that conditional versus partly conditional liquidity would also be a relevant part of the debate.

Mr. Wahl said that in taking decisions on the issues being discussed two major considerations had to be kept in mind: to provide the Fund with sufficient resources so that it could perform its functions effectively, and to preserve the character of the Fund as an institution providing conditional finance. Mr. Wahl did not support an allocation of SDRs since he was more sensitive to the problem of inflation than to the need for increasing unconditional liquidity. He stressed, however, that his authorities were in favor of making the SDR the principal reserve asset and of increasing its attractiveness with this purpose in mind. He argued that if a token amount of SDRs were to be allocated, this would not meet the needs of developing countries. These needs had to be met through other sources, perhaps by a better allocation of the existing liquidity rather than an increase in unconditional liquidity. Mr. Ruding was also against an SDR allocation and did not think that a change in the composition of reserves was sufficient in itself to make a clear case for an SDR allocation. He argued that it would be more desirable to replace commercial bank lending by conditional lending by the Fund rather than by unconditional SDRs. Mr. Whitelaw said that his constituency, Australia in particular, objected to an allocation of SDRs on the grounds that it would be inflationary and that the expansion of conditional rather than unconditional liquidity would be preferable. He pointed out that the SDR should be promoted not by a new allocation but by making it a more attractive reserve asset. Mr. De Groote was of the same opinion.

Mr. Hollensen supported the efforts to make the SDR the principal reserve asset of the international monetary system and shared the view that the SDR should be made a more attractive asset to hold. He said that, while the Danish authorities did not favor an SDR allocation at the present time, a majority of his constituency could support a new allocation for the third basic period. The size of the allocation would need to be viewed in light of the other measures taken to improve the liquidity of the Fund.

Mr. Dini, as the only Director from an EC country who supported an allocation of SDRs, pointed out that recent increases in international liquidity had resulted from borrowing and, therefore, had not increased net reserves. An SDR allocation would contribute to the stability of the financial system by reducing pressures on financial markets. It would not necessarily add to inflation, since countries would, in any case, continue to build up reserves to meet unexpected needs.

Mr. Matsunaga was not convinced of the shortage of unconditional liquidity and thought that an SDR allocation would be inflationary. He suggested, however, that a token amount of SDR allocation could be supported for the third basic period. Mr. Al-Atrash strongly favored an allocation of SDRs, even a token amount if a large allocation could not be supported by most members. He argued that an allocation would give credibility to the statement that the SDR should become the principal reserve asset. He was also of the opinion that the present level of international reserves was inadequate, and that a number of countries were not pursuing appropriate employment policies for fear of running into balance of payments problems. Mr. Amuzegar was glad that the staff had finally admitted that the inadequacy of international liquidity might lead to difficulties in balance of payments adjustments. He welcomed an SDR allocation on the grounds that it would not have the multiplier effects of increased short-term borrowing. He considered the size of the SDR allocation proposed by the staff to be in line with developments in world trade, but he did not think that an allocation by itself would ensure the wide use of SDRs. Mr. Simone welcomed an allocation of SDRs in the amount of SDR 5-8 billion, but doubted that this would restore the SDR to its relative standing in 1972. Messrs. Guarnieri, Ng, Mogae, Nana-Sinkam, and Rasaputram were in favor of an allocation of SDRs in the amounts suggested by the staff.

Supplementary credit[1/] and Fund borrowing

Mr. Cross considered the creation of supplementary lines of credit by the Fund to be a very important issue but did not agree with the argument in the staff paper that a larger role should be assumed by the Fund in order to increase the share of financing by the Fund relative to financing by other sources. He did not think that this was the correct way to look at the matter and was more in favor of the strengthening of the total system, so that the role of the Fund might increase as a result of this. He emphasized that substantial amounts of private credit would continue to be needed regardless of the role assumed by the Fund or other official institutions. On the question of how much the Fund should borrow, he did not dispute the figure of SDR 14 billion suggested by the staff but thought that a more convincing case needed to be made to determine the particular amount needed.

Mr. Pieske agreed that the credit arrangements proposed, including the "target" of SDR 14 billion, were broadly justified in light of the considerations on page 1 of EBS/77/88. He said Germany's contribution would depend on the amounts available from oil producers and that it would also consider Fund borrowing in financial markets. Mr. Pieske emphasized that the new facility should be limited to exceptional cases, and not be operated on "a fair share to all members" basis as had been the case with the oil facility. He wanted the use of all four credit tranches beforehand, and was against setting a rigid quota limit to access to the new facility. He favored at least second to fourth credit tranche conditionality and thought it would also be desirable to make sure that the fulfillment of the conditions was effectively controlled. He did not think it would be appropriate to go beyond a three-five-year maturity, and thought that a rate of interest on the new facility that would fluctuate with the average of market rates would be suitable.

1/ Referred to also as a special facility or emergency fund by a number of the Executive Directors.

Mr. Kent pointed out that there would be a "gap" until quotas are increased and, therefore, welcomed the supplementary line of credit proposed. He said that SDR 14 billion could be supported and that this arrangement could be complementary and not just supplementary to the quota increase, i.e., that it did not need to be simply a stop-gap measure, but might be continued after the quota increase. He favored upper credit tranche conditionality but with some flexibility in light of economic and political realities. He argued that a complete elimination of deficits should not be called for in all cases and that a deflationary bias should be avoided. Also a distinction needed to be made between short-term cyclical deficits and long-term structural ones. Mr. Kent preferred to avoid a rigid formula in relation to quota for determining access to the supplementary credit. He supported longer payment periods and some relation to market rates of interest, but reserved his final position on charges. Mr. Wahl did not support the proposed facility, particularly since he feared that the usual conditional pattern of Fund lending might be impaired. He argued that the Fund should obtain resources through a series of bilateral arrangements, and negotiate special terms with each creditor country. He proposed that these funds should be integrated into the existing financing scheme of the Fund, and suggested that any supplementary credit should be implemented in the framework of the "Jamaica clause," i.e., that under exceptional circumstances the Fund should waive the limit of 245 per cent of quota.

Mr. Ruding questioned whether SDR 14 billion could be raised for the supplementary credit lines proposed, and did not find the quantitative analysis of the staff on the actual need convincing. He favored a longer maturity, but pointed out that this might endanger the liquidity of the lenders' claims and would, therefore, limit willingness to lend to the Fund. He was in favor of considering early repayment by the Fund and incorporating a clause to this effect in any formulation. He supported strict conditionality, and limits in terms of quota on access with exceptions under special circumstances. Mr. Ruding emphasized that the new facility should not interfere with the GAB, and also expressed the wish of the Dutch authorities that the countries lending to the Fund for the special facility should be involved in all aspects of decision making related to the special facility.

Mr. Dini thought that Fund resources were insufficient to meet present payments imbalances, but that borrowing by the Fund in order to make supplementary credit available had to be considered as a temporary measure until quota increases became effective. Mr. de Groote favored the establishment of an emergency fund provided that it is (i) not established for a limited period of time; (ii) has a more flexible legal framework than the GAB; and (iii) participants can acquire a title negotiable with surplus countries. He also agreed with the implementation of upper credit tranche conditionality. Mr. Hollensen said that his constituency supported the establishment of a special facility to finance drawings beyond the credit tranches (i.e., the four credit tranches would need to be used first), and was in broad agreement with the main outlines proposed, while reserving their final position. He emphasized that the new facility should be a supplement and not an alternative to quota increases. The Fund should finance this facility with borrowed and not its own funds, and have the right to early repayment in cases when the debtors make repayments before due dates.

Mr. Whitelaw said that the Australian authorities supported the establishment of supplementary credits, and were in favor of upper credit tranche conditionality and market-related interest rates. Mr. Drabble said that the Canadian authorities questioned whether the new facility should be so directly related to the period of the seventh quota review. On the issue of size, he pointed out that it was misleading to regard the total of SDR 14 billion proposed since a large part of this would probably not be used. It would be more relevant to consider the amount that it would be prudent for the Fund to keep in unutilized credit lines. Mr. Drabble was in agreement with a market-related interest rate on the new facility and waiver of the quota limit in exceptional cases. He thought that more emphasis had to be placed on the member's ability to repay. On conditionality, he wondered whether there was really no distinction in conditionality between the credit tranches beyond the first credit tranche and wanted the staff to comment on this.

Mr. Al-Atrash was, in principle, in favor of the proposed supplementary credit, but was not convinced of a need in the amount envisaged. He said that there was no evidence that commercial bank credit would be curtailed in the near future, or that deficit countries would decide to turn to the Fund in place of commercial banks, particularly with higher charges and strict conditionality. He suggested an easing of conditionality by enlarging the credit tranches or by sliding existing conditionality one tranche upward. Mr. Amuzegar favored a larger role for the Fund in financing payments imbalances and considered SDR 14 billion roughly appropriate, but was not optimistic that a facility of this size could be created. He supported basing access on balance of payments needs, being flexible on maturity, and allowing a margin of income to the Fund over the rates paid on its borrowing. Mr. Kafka supported the new facility, but preferred to maintain some relationship between access to new resources and quotas. He emphasized that in all Fund transactions, political as well as economic realities had to be taken into account in determining conditionality. He agreed with the proposed charges and terms of the new facility. Mr. Matsunaga agreed with Mr. Cross that the main objective of the supplementary credit should be to strengthen the international monetary system and not to provide a substitute for private lending. Therefore, he questioned the proposed size of the facility, particularly since the Fund already had SDR 4 billion in usable currencies, the sixth quota increase would bring another SDR 6 billion, and more would be available with the sales of gold and the seventh quota increase. On conditionality, he argued that, if strict conditionality were not observed, the necessary adjustment would not be brought about. Messrs. Rasaputram, Ng, Mogae, Guarnieri, and Nana-Sinkam supported the proposed facility. Mr. Rasaputram favored a maturity of six-nine years, no further increase in charges, a stand-by period of three-four years, and flexibility on linking access to quotas.

Fund cooperation with commercial banks

Several Executive Directors commented on this subject. The general feeling was that the Fund should proceed with extreme caution in this area. Mr. Kafka was emphatically against the proposal to cooperate with commercial banks on the grounds that it would destroy the confidential relationship between the Fund and its members and would place dangerous responsibility on the Fund's shoulders. He argued that the Fund should proceed in its activities independently

of commercial banks and avoid co-financing arrangements. Messrs. Pieske and Kent agreed with Mr. Kafka, but suggested that there might be some informal exchange of information not of a confidential nature. Mr. Ruding suggested some "coordination" of work rather than "cooperation" with large commercial banks, and was of the opinion that this would be beneficial to the world monetary system as a whole. Mr. Whitelaw expressed some reservations on this. Mr. Hollensen thought that under certain circumstances it might be useful for the Fund to cooperate with commercial banks, but that the initiative for such action should come from the borrowing country in question. Mr. Simone agreed with the others that this was a delicate matter, and that, while some coordination might be warranted, it should not mean full centralization of credit. He advocated a case-by-case judgment. Mr. Ng favored minimum interference with private lending activities. Mr. Rasaputram was against providing confidential information to commercial banks.

The Managing Director concluded the meeting by saying that this had been a useful discussion and that the staff would reply to some of the questions raised on the various subjects in the next meeting of the Executive Board.

E. Gürgen

EG

cc: I.O.
Division Chiefs
Mr. Van Houtven
Mr. Ungerer

9.0.

April 18, 1977

MEMORANDUM FOR FILES

Subject: Adequacy of International Liquidity (SM/77/62, 3/21/77) and the Fund's Future Role in the Financing of Payments Imbalances: The Provision of Supplementary Credit and Fund Borrowing (EBS/77/88, 3/30/77)

The staff provided answers to some of the questions raised by Executive Directors during the initial discussion on SM/77/62 and EBS/77/88.

Mr. Polak made the following observations:

(1) A number of Directors had pointed out that the previous methods used to obtain the size of the quota increase needed had now become inappropriate. This view was shared by the staff and, therefore, an attempt had been made to include other criteria in the calculations. For example, figures on developments in total imbalances on current and capital accounts had been taken as a more reliable indicator than the ratio of imports to quotas. Allowance had been made for the recently increased availability of private sources of finance, and for increased exchange rate flexibility.

(2) On the subject of SDR allocation, Mr. Polak agreed with Messrs. Pieske and Ruding that the staff's analysis was unconventional, but did not think that it presented a case for an SDR allocation that was outside the framework of the Articles of Agreement (Mr. Gold elaborated on this point).

(3) Mr. Polak pointed out that it was necessary to take full account of the Fund's activities in the aggregate world monetary expansion. He said that Mr. Kent had expressed concern that monetary authorities might overdo the restrictive measures they would take to offset the impact of an SDR allocation which would result in a deflationary bias, while Mr. Pieske had found it unrealistic to assume that monetary authorities would necessarily take such measures. Mr. Polak disagreed with both observations and argued that monetary authorities did take into account the inflationary or deflationary impact of measures taken outside their economies when determining domestic policy measures needed, and that this did not require a great deal of coordination as Mr. Pieske had claimed. He agreed that the Fund should not make life unduly difficult for international monetary authorities, but that it was up to the bodies of the Fund to decide how far the Fund should go.

(4) Mr. Polak commented on Messrs. Dini and Ruding's remarks on the provision of credit by the Fund versus commercial banks. Mr. Dini had asked how a coordination could be achieved in this area so that the amount of credit generated could be sustainable, while Mr. Ruding had suggested that the aggregate need for liquidity should be determined first and then a distribution should be made between the Fund and the commercial banks as lending institutions. Mr. Polak said that the Fund had to come to a judgment on the sustainable level of capital imports for the country in question, and make this known to that country. This could be done if there was a stand-by arrangement. In the absence of a stand-by the attitude of commercial banks, which would not necessarily coincide with that of the Fund, would gain importance.

(5) Mr. Polak replied to Mr. Drabble's observation that an increase of 100 per cent in quotas would raise unconditional credit provided by the Fund by 125 per cent. He said that this figure appeared to include additions to the first credit tranche (25 per cent), compensatory financing facility (75 per cent), and the reserve tranche (25 per cent). He argued that the compensatory financing facility was not automatically accessible and that the member had to meet certain technical conditions before it could be eligible for this facility. It was, furthermore, a mistake to include the reserve tranche in the calculations since, if quota increases were paid in domestic currency, there would be no increase in the reserve tranche. Finally, Mr. Polak commented on a "negative comment" by Mr. Pieske, namely, that the decision to allocate SDRs might need to be reversed or modified at a later stage during the third basic period and that this was "turning the Articles of Agreement upside down." Mr. Polak did not agree with this remark and saw no reason why it could not be announced at the time of allocation that should circumstances change the Managing Director would make a proposal for a modification of the allocation.

Mr. Habermeier confined his remarks to questions raised on the supplementary credit arrangement. He made the following points:

(1) A number of Executive Directors had considered SDR 14 billion to be a large sum and had expressed doubts whether the Fund could borrow as much. Mr. Habermeier pointed out that this figure was not a final figure, but a target to be aimed at. The amount had to be large in order to inspire confidence that the Fund could help finance the existing large deficits. SDR 14 billion would be spread over several years, so that the actual use in any one year would not necessarily be large. Therefore, the Fund would not encounter problems in raising the needed sums.

(2) On the purpose of the supplementary credit arrangement, Mr. Habermeier emphasized that the Fund did not aim at replacing commercial bank credit with its own credit, but that the new facility was suggested in order to supplement available credit in the system as a whole.

(3) On the character of the borrowing arrangement, Mr. Habermeier commented on a suggestion made by Mr. Kafka and supported by a number of Executive Directors that the access of creditors to the scheme should not be limited. He said that the technicality of such an arrangement would be one of bilateral credits open to anyone willing to lend. This would not interfere with the GAB which was referred to in the staff paper as a comparative standard.

(4) Mr. Habermeier commented on the discussions on the nature of the claims to be created by Fund borrowing, i.e., how liquid these claims would be if they could be mobilized (transferred to other official holders) or be marketable. Mr. Habermeier explained that the maturity of the claims would equal the maturity of the supplementary credit extended by the Fund, and some rollover might be allowed for in the case of shorter maturities. In reply to a point raised by Mr. Drabble, Mr. Habermeier said that the new lines of credit were not envisaged as a liquid reserve of the Fund. It might be thought that these lines of credit could be used for the substantial new purchases by members which the Fund might be faced with before the seventh quota increase became effective, but this would mean mixing low-cost finance with high-cost finance and would have implications for charges.

Mr. Gold commented on two issues:

(1) In reply to Mr. Drabble's question on distinction among the tranches in conditionality, Mr. Gold explained that since 1953 a distinction had been made between the first credit tranche and all the tranches beyond that. In practice, it was often thought that there would be an escalation of conditionality beyond the second credit tranche. This was a popular impression which did not conform to the traditional formulation of conditionality, and there was need for clarification of this matter in the formulation of the supplementary credit arrangement.

(2) On the subject of the consistency of the proposed reason for a new SDR allocation with the Articles of Agreement, Mr. Gold listed the following interrelated criteria for an SDR allocation: (i) long-term global need, (ii) need to supplement existing reserve assets, (iii) promotion of the purposes of the Fund, and (iv) avoidance of undesirable economic developments. He said that judgment had to be exercised as to which criteria applied in this particular instance. In his opinion, it was not necessarily true that a particular reserve asset would be held in smaller amounts because of an allocation of SDRs, so that there was no legal inconsistency with the Articles of Agreement. There was also a new purpose in the amended Articles of Agreement, namely, to make the SDR the principal reserve asset, which was also an important consideration in deciding on a new allocation of SDRs.

The meeting continued with a summing up by the Managing Director of the discussions which had taken place so far, and his suggestion to transmit to the Interim Committee the full paper on supplementary credit, the summary of the paper on adequacy of international liquidity, and his summing up of the discussions on these two papers. Mr. Cross disagreed with the Managing Director's summary and did not think that the papers on international liquidity had reached the stage where the matter could be presented to the Interim Committee in any form. He wanted more work to be done on the justification of SDR 14 billion proposed for the supplementary credit arrangement. Mr. Pieske said that the summing up was a fair statement, but that he would have preferred it if the Executive Board could have reported to the Interim Committee on the topics being discussed, rather than presenting the staff papers. He agreed with Mr. Cross that the paper on international liquidity should not be given to the Committee. Mr. Matsunaga was of the same opinion. Mr. Drabble wanted a second round of discussions and thought it premature to do a summing up at this stage. Mr. Kent shared Mr. Pieske's view that it would have been better to submit a report by the Board to the Committee. Mr. de Groote argued that there was a need to list the priorities to the Interim Committee. Mr. Amuzegar said that it was a matter of "urgencies" rather than "priorities," since all three topics were important and interrelated. He favored transmitting the full text of the paper on international liquidity, as did Mr. Guarnieri.

The Managing Director insisted that it was necessary to give a paper on international liquidity to the Interim Committee, but that he could make the objections of the various Directors more explicit in his summing up. He said that he would provide a text of his summary and it could be discussed further.

Mr. Temple-Seminario wanted to see more emphasis on the discussion of Fund cooperation with commercial banks and suggested that a separate paper be issued on this subject. The Managing Director said that this could be done after the meeting of the Interim Committee.

After two drafting sessions, the Executive Board agreed on the attached summing up by the Managing Director.

E. Gürgen
EG

cc: I.O.
Division Chiefs
Mr. Van Houtven
Mr. Ungerer

Attachment

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

EBS/77/108
Revision 1

CONFIDENTIAL

April 15, 1977

To: Members of the Executive Board

From: The Acting Secretary

Subject: Managing Director's Summing up of Discussion on International Liquidity and Provision of Supplementary Credit

The attached summing up by the Managing Director of the Executive Directors' discussion of the papers on International Liquidity and the Provision of Supplementary Credit has been prepared in the light of the Executive Board's discussion at EBM/77/57 (4/15/77).

The attached text is the same as that circulated to Members and Associates of the Interim Committee as ICMS/Doc/77/5.

Att: (1)

CONFIDENTIAL

Managing Director's Summing up of Discussion on International Liquidity and Provision of Supplementary Credit

April 15, 1977

The Executive Board has begun to discuss the two staff papers, SM/77/62,* The Adequacy of International Liquidity, and EBS/77/88,* The Provision of Supplementary Credit, and a wide range of views has been offered.

Executive Directors recognized that the issues raised in the two papers, i.e., the provision of supplementary credit, quotas and the allocation of SDRs, were closely interconnected. There was no reason to suppose on the basis of the discussions that any one of these three items was generally regarded as more important than the others. Nevertheless, certain issues were considered as more urgent and closer to resolution. In particular, with the support and guidance of the Committee, the supplementary credit arrangement could be put in place quite quickly.

I. Supplementary Credit and Fund Borrowing

There was general support for the proposal for temporary arrangements for supplementary credit mainly based on the reasons cited in the introduction to EBS/77/88. Such arrangements were considered by many Directors to be urgently needed. There was also a good deal of agreement on many of the main features of these arrangements.

1. Size -- Concerning the total size of the proposed lines of credit, it was recognized that there is continued uncertainty about the magnitude of members' problems in coming years and the resulting need for supplementary credit from the Fund. At the same time, it was felt that the credit lines to be established should be sufficiently large to maintain confidence in the financial system. In the light of these considerations, most Directors were disposed to accept a target of the order of SDR 14 billion. These credit lines will in any event be used only to the extent of members' needs to utilize supplementary credit.

2. "Open-ended" nature -- Several Directors stressed the desirability of the proposed arrangements for supplementary credit being "open-ended," i.e., leaving open the possibility for additional countries to become creditors in the event that their balance of payments and reserve position warranted it. I am sure this would have general support.

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*ICMS/Doc/77/3 and ICMS/Doc/77/4.

3. Conditionality -- There was widespread support for access to supplementary credit being equal in conditionality to access to the upper credit tranches. I also noticed support for the idea that, in order to allow appropriate time for adjustment, access to supplementary credit should normally be on the basis of a stand-by arrangement covering a period longer than one year. Some Directors felt that access to supplementary credit should be subject, on balance, to easier conditionality than that of the higher credit tranches.

4. Repayment period -- The staff proposed in EBS/77/88 that the period for repayment of purchases might be the 3-7 year period used in the oil facility. Directors expressed a range of views on this subject, from a preference for the normal 3-5 year period to a willingness to see repurchases phased over perhaps 6-9 years.

5. Magnitude of access -- There was considerable discussion of the question of whether access should be determined by the magnitude of the problem a member was facing, while ensuring that the amounts would be guided by uniform principles, or whether access should be related to members' quotas, with the possibility of further assistance in special circumstances. The Directors who addressed themselves to this question seemed broadly satisfied with one or other of these positions, and I would assume that a common view could be reached.

6. Charges -- It was accepted that the lenders would be paid market-related interest rates. It was generally felt that the Fund should derive a margin of income from the provision of supplementary credit to members, but that such a margin should be relatively low so as to keep charges at a reasonable level. Some Directors felt that the possibility of an interest subsidy for low-income countries should be explored.

7. Liquidity of claims -- A number of Directors stressed the need to provide adequate liquidity for the claims of lenders. The ways in which this could be achieved are being studied further.

II. Quota Review

1. Size -- There was a consensus among the Executive Directors that the overall size of the Fund should be increased as a result of the Seventh Quota Review.

A number of Directors found that the statistical evidence presented in the staff paper, SM/77/62, justified an increase in the range 75 per cent to 100 per cent. Such an increase would be needed to restore broadly the ratio between access to Fund credit and payments imbalances that prevailed a decade ago. These Directors considered that the small size of existing quotas was an important factor in the unwillingness of some countries to undertake the substantial reorientation of their policies required under Fund programs.

A number of other Directors favored a rather smaller increase. In this connection they pointed to the increased access now possible as a proportion of quotas; the increased flexibility in the exchange rate mechanism and the availability of other sources of balance of payments finance in larger amounts; and the lack of use of the upper credit tranches under existing quotas.

There was also a view that at this stage consideration had not proceeded far enough to make even an approximate judgment on the size of a possible quota increase.

2. Distribution -- Apart from the overall size of any quota increase a number of Directors touched on the question of whether such an increase should be equiproportional, or should involve readjustment of relative quota sizes. Some of the Directors who addressed this issue favored a readjustment of quota shares in such a way as to reflect changes in the relative economic position of members and to improve the liquidity of the Fund. Others, however, pointed to the difficult and time-consuming nature of discussions on relative quota sizes and noted that a readjustment of quota shares would have been effected shortly before, by the implementation of the Sixth Quota Review. They, therefore, favored the simplicity of an equiproportional increase. These two points of view will have to be reconciled.

III. SDR Allocation

1. It is argued in the staff paper that the case for an SDR allocation today, while in the staff's view consistent with the Articles, is somewhat different from that put forward at the time of the first allocation. Then an SDR allocation was seen as providing a needed increase in the supply of reserves in order to avoid the adverse consequences of a reserve shortage: now the case for an allocation of SDRs is based on the expectation that it would primarily affect the composition of reserve increases.

2. A wide range of views was expressed by Directors on this matter. The analysis of the staff paper was supported by a number of Directors who considered that annual allocations in the range of SDR 5-8 billion, as discussed in the Annex to the staff paper, were reasonable. There was also a view that an allocation could be justified by a present need for reserves. Some Directors favored an allocation as a means of enhancing the role of the SDR. Several suggested a short period for allocations, smaller allocations, or both. A number of Directors held the view that no need existed at present to supplement existing reserve assets in accordance with Article XXIV, Section 1(a).

3. There was support from a number of Directors for action to improve the attractiveness of the SDR, and some saw this as an appropriate requisite for any new allocation. Others advocated caution in modifying

the characteristics of the SDR, and felt that further careful study was required of the implications of any such changes.

4. Both the important differences of view and the number of analytic and policy issues that appear to require exploration suggest that this subject will require considerable further study and discussion.

2

The Executive Board has begun to discuss the two staff papers, SM/77/62,[1] The Adequacy of International Liquidity, and EBS/77/88,[1] The Provision of Supplementary Credit, and a wide range of views has been offered.

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There was general support for the proposal for temporary arrangements for supplementary credit mainly based on the reasons cited in the introduction to EBS/77/88. Such arrangements were considered by many Directors to be urgently needed. There was also a good deal of agreement on many of the main features of these arrangements.

1. Size -- Concerning the total size of the proposed lines of credit, it was recognized that there is continued uncertainty about the magnitude of members' problems in coming years and the resulting need for supplementary credit from the Fund. At the same time, it was felt that the credit lines to be established should be sufficiently large to maintain confidence in the financial system. In the light of these considerations, most Directors were disposed to accept a target of the order of SDR 14 billion. These credit lines will in any event be used only to the extent of members' needs to utilize supplementary credit.

2. "Open-ended" Nature -- Several Directors stressed the desirability of the proposed arrangements for supplementary credit being "open-ended", i.e. leaving open the possibility for additional countries to become creditors in the event that their balance of payments and reserve position warranted it. I am sure this would have general support.

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that prevailed a decade ago. These Directors considered that the small size of existing quotas was an important factor in the unwillingness of some countries to undertake the substantial reorientation of their policies required under Fund programs.

A number of other Directors favored a rather smaller increase. In this connection they pointed to the increased access now possible as a proportion of quotas; the increased flexibility in the exchange rate mechanism and the availability of other sources of balance of payments finance in large amounts; and the lack of use of the upper credit tranches under existing quotas.

There was also a view that at this stage consideration had not proceeded far enough to make even an approximate judgment on the size of a possible quota increase.

2. Distribution -- Apart from the overall size of any quota increase a number of Directors touched on the question of whether such an increase should be equiproportional, or should involve readjustment of relative quota sizes. Some of the Directors who addressed this issue favored a readjustment of quota shares in such a way as to reflect changes in the relative economic position of members and to improve the liquidity of the Fund. Others, however, pointed to the difficult and time-consuming nature of discussions on relative quota sizes and noted that a readjustment of quota shares would have been effected shortly before, by the implementation of the Sixth Quota Review. They, therefore, favored the simplicity of an equiproportional increase. These two points of view will have to be reconciled.

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2. A wide range of views was expressed by Directors on this matter. The analysis of the staff paper was supported by a number of Directors who considered that annual allocations in the range of SDR 5-8 billion, as discussed in the annex to the staff paper, were reasonable. There was also a view that an allocation could be justified by a present need for reserves. Some Directors favored an

allocation as a means of enhancing the role of the SDR. Several suggested a short period for allocations, smaller allocations, or both. A number of Directors held the view that no need existed at present to supplement existing reserve assets in accordance with Article XXIV, Section 1(a).

3. There was support from a number of Directors for action to improve the attractiveness of the SDR, and some saw this as an appropriate requisite for any new allocation. Others advocated caution in modifying the characteristics of the SDR, and felt that further careful study was required of the implications of any such changes.

4. Both the important differences of view and the number of analytic and policy issues that appear to require exploration suggest that this subject will require considerable further study and discussion.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

Mr. L.A.Whittome

Room 9-120

#11

April 18, 1977

To: Senior Staff

From: The Secretary's Department

Subject: Executive Board Meeting 77/57, April 15, 1977 a.m.*

Adequacy of International Liquidity, and Provision of Supplementary Credit and Fund Borrowing

Staff representatives: Young, Habermeier, Nicoletopoulos
Discussion: 2 hours, 25 minutes

Executive Directors considered a version of the Managing Director's summing up of the discussion on international liquidity and the provision of supplementary credit for communication to the members of the Interim Committee (EBS/77/108, 4/15/77). They also commented on a letter of transmittal.

Discussion centered on the language of Section III--SDR Allocation--where it was found desirable to spell out the views of various groups of Executive Directors rather fully, and to indicate explicitly that, while the staff believed that there was a case for SDR allocation, consistent with the Articles, a number of Directors held the view that no need existed at present to supplement existing reserve assets.

Summing up and letter of transmittal approved for communication to members of the Interim Committee.

* * * * * * * * * * *

Decisions taken since previous Board meeting to be recorded in minutes of Meeting 77/57

Governors' Allowances - Amendment to Section 14(a) of the By-Laws (EBAP/77/94)
Rwanda - Technical Assistance (EBD/77/88)
Executive Board Travel (EBAP/77/105)

* Précis for limited distribution; not basis for official action.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

Mr. L.A.Whittome

Room 9-120

#11

April 15, 1977

To: Senior Staff

From: The Secretary's Department

Subject: Executive Board Meeting 77/54, April 13, 1977, p.m.*

Adequacy of International Liquidity, and Fund's Future Role in Financing of Payments Imbalances: Provision of Supplementary Credit and Fund Borrowing

Staff representatives: Gold, Habermeier, Polak
Discussion: 2 hours, 20 minutes

Staff commented on points raised by EDs during discussion of papers on adequacy of international liquidity (SM/77/62) and on provision of supplementary credit and Fund borrowing (EBS/77/88) at EBM/77/51 and EBM/77/52 (4/11/77). MD gave summing up of discussion at those meetings.

EDs considered submission to the Interim Committee of EBS/77/88 with the title shortened and paragraph 13 omitted, and of SM/77/62, along with MD's summing up; text of latter would be discussed further on Thursday, April 14. Submission of staff papers, with indication of this nature as such, seen to be necessary owing to time constraints, but speakers stressed that the usual practice of submitting a report from the EDs should be followed where possible.

*Précis for limited distribution; not basis for official action.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

Mr. L.A. Whittome

Room 9-120

#11

April 13, 1977

To: Senior Staff

From: The Secretary's Department

Subject: Executive Board Meetings 77/51 and 77/52, April 11, 1977 a.m. and p.m.*

China

Staff representatives: Tun Thin, Gold

EDs, in restricted session, accepted MD's proposal.

Adequacy of International Liquidity and Fund's Future Role in Financing of Payments Imbalances: Provision of Supplementary Credit and Fund Borrowing

Staff representatives: Polak, Habermeier, Gold
Discussion: 4 hours, 40 minutes

EDs discussed papers on adequacy of international liquidity (SM/77/62) and on provision of supplementary credit and Fund borrowing (EBS/77/88).

Speakers commented that issues of quota increase under Seventh General Review, new allocation of SDRs for third basic period, and provision of supplementary credit and Fund borrowing were closely related. They agreed that Fund ought to have adequate resources to contribute effectively to adjustment process, but views differed on priority that should be attached to each of the three ways of increasing size of Fund's resources and members' access to them, as well as on relationship between conditional and unconditional liquidity.

A number of EDs considered that new allocation of SDRs in range of SDR 5-8 billion for three years would be appropriate as means not only of helping members to reduce borrowing in order to maintain level of their reserves, but also of lending credibility to assertion that SDR should become principal reserve asset in international monetary system. Rather than issue more SDRs, rate of interest needed to be increased and general attractiveness of SDR enhanced, several EDs argued. Other speakers contended that there was no case for an allocation since global liquidity was sufficient. One noted that Article XXIV, which dealt with allocations of SDRs, did not recognize goal of redistribution of liquidity as legitimate reason for SDR creation. Various views expressed on possible inflationary effect of any allocation.

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* Précis for limited distribution; not basis for official action.

While a number of EDs believed that staff proposal for a 75-100 per cent increase of quotas under Seventh General Review would be appropriate, others considered that a smaller rise would be sufficient, particularly in light of possible availability of supplementary credit. Some speakers commented that large increase of quotas would not significantly help Fund's liquidity and that, in any event, most members had made little or no use of resources beyond first two credit tranches. In general, problems of this sort required specific solutions rather than large increase in Fund quotas. Several EDs spoke in favor of moderate increase in quotas. Difference of view whether selective quota increases feasible.

Most EDs agreed on need for Fund to make supplementary credit available to members without distinction between various groups; number of lenders should not be limited. Some speakers considered that access to resources should be fairly closely related to quotas, but with possibility of further assistance if member's need was very large in relation to quota. Others, however, believed that access should be proportional to total bop need. Speakers generally agreed that resources should be made available subject to upper credit tranche conditionality, and that charges should be such that the Fund would have a margin of income in relation to the market-related interest it would pay on borrowing to finance use of supplementary credit. Most EDs considered that period of repurchase should be longer than normal 3-5 years, say, 4-7 years or even 6-9 years, but some maintained that customary period would be more appropriate. Credit lines of the order of SDR 14 billion appeared to be reasonable target at which to aim, the majority seemed to consider, although there was some doubt whether the figure would be reached.

Staff proposal for closer coordination between Fund and commercial banks in connection with provision of credit was criticized by a number of speakers. They contended that it could impair confidential relationship that existed between Fund and its members, although some sharing of data with banks not excluded.

Agreed that staff and management should sum up on Wednesday, April 13.

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Decisions taken since previous Board meeting to be recorded in minutes of <u>Meeting 75/51</u>

Financial Position of the Fund and Increases in Fund's Charges (EBS/77/93, Sup. 4)
Gold Sales by the Fund in Replenishment in Connection with the Eighth Gold Auction by the Trust Fund on April 6, 1977 (EBS/77/97)
Executive Director - Technical Assistant (EBAP/77/95)
Executive Board Travel (EBAP/77/97)

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

Mr. L. A. Whittome

Room 9-120
#1

SM/77/79

April 13, 1977

To: Members of the Executive Board

From: The Acting Secretary

Subject: The Adequacy of International Liquidity - Summary

There is attached the Summary of SM/77/62, prepared for the benefit of the Interim Committee. This paper will be on the Executive Board agenda in connection with items 3 and 4 of Executive Board Meeting 77/53, scheduled for this morning.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

The Adequacy of International Liquidity

Summary*

April 12, 1977

At its meeting on October 2, 1976 in Manila, the Interim Committee requested the Executive Directors to keep all aspects of international liquidity under review and to report to it at a later meeting. This paper reviews recent tendencies in international liquidity and assesses the adequacy of the credit facilities and reserve assets provided by the Fund. The Seventh General Review of Quotas must be completed by February 1978 and the provisions of the present Article XXIV, Section 4(c) require action by the Managing Director with respect to SDR allocations for the third basic period not later than June 30, 1977.

I. Reserve Assets and Credit Facilities

This analysis distinguishes two main components of international liquidity: reserve assets and credit facilities available for temporary balance of payments financing. The ownership of reserves and access to balance of payments credit are by no means perfect substitutes, and it is therefore understandable that countries pursue some reasonable balance between them. If desirable adjustment policies are to be fostered, this balance should be reflected internationally in the provision of conditional and unconditional liquidity, the former to encourage adjustment, the latter to discourage members from adopting adjustment policies that are internationally as well as nationally undesirable.

II. Credit Facilities Provided by the Fund

After the Sixth General Review of Quotas becomes effective, aggregate quotas will be 88 per cent larger than at end-1966. During the same period, however, world trade (as measured by imports denominated in SDRs) has quadrupled. Comparing the ratios of quotas to imports immediately after quota increases, the ratio was 13 per cent in 1959, 11 per cent in 1966, and 10 per cent in 1970; in 1977 after the implementation of the Sixth

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* For full text, see SM/77/62.

General Review of Quotas it is estimated to be only 4.3 per cent. The ratio of quotas to payments imbalances (overall deficits and surpluses summed without regard to sign) has also declined.

Fund credit available to members has, however, gradually increased relative to quotas by the introduction of the compensatory financing facility (1963), the buffer stock facility (1969) and the Extended Fund Facility (1973). Later temporary measures, including the oil facility (1974) and the widening of credit tranches by 45 per cent (1976), were introduced.

In order to restore members' access to Fund credit to the importance it once held, substantial quota increases would have to be agreed under the Seventh General Review. Making the notional allowance suggested above for the expansion in Fund credit relative to quotas since the mid-1960s, quotas in 1977 would have to be higher than those agreed in the Sixth General Review by SDR 25-35 billion to restore the 1966 ratio between access to Fund credit and imports. Since any quota increases agreed in the Seventh General Review probably could not become effective before late 1978, a doubling of quotas as the outcome of the Seventh General Review would restore Fund credit to the relative importance it had in 1966. Even a restoration to the position after the general quota increase in 1970 would require a quota increase of SDR 25-35 billion in 1978.

In the assessment of this level considerable weight will have to be attached to a direct judgment of the adequacy of quotas. The Fund has, in effect, made such a judgment several times in the past few years when it introduced the special facilities or arrangements referred to above in order to give members larger access than their quotas would have permitted. Since all extensions of access on the basis of unchanged quotas cut deeply into the Fund's liquidity, steps must be taken to supplement the resources available to the Fund even on the basis of present rules for access by members.

The most suitable way to meet members' needs for additional credit and the Fund's need for resources is by an increase in quotas. Experience shows that this involves considerable time. Over the near term, therefore, (i.e., up to the implementation of the Seventh Review of Quotas), further action is necessary. In particular, active consideration is being given to a temporary arrangement for obtaining additional resources by the negotiation of lines of credit from surplus countries. The resources so obtained would be available on a conditional basis to members encountering major financial difficulties.

Borrowing is not, however, a substitute for a quota increase. Indeed, in some respects the two are complementary, i.e., an expansion in borrowing requires in due course an increase in quotas to enhance the liquidity of the claims on the Fund.

III. The Provision of Reserves by the Fund

If the objective of the new Article XXII "of making the special drawing right the principal reserve asset in the international monetary system" is to be effectively pursued, regard must be paid to the long-term viability of the asset. It is difficult to see how this can be done without an early resumption of SDR allocations. Serious consideration should therefore be given to an allocation of SDRs if it can be made without exacerbating the problem of inflation, and without an unwarranted permanent transfer of resources among member countries.

Because of major changes in the system, the impact of any decision on SDR allocation may differ from the impact that was envisaged at the first allocation. Then the SDR allocation was seen as providing a needed increase in the supply of reserves in order to avoid the untoward consequences feared from a reserve shortage. Now a decision to allocate or not to allocate SDRs is likely to affect primarily the composition of reserves, as they substitute allocated SDRs for increases in foreign exchange holdings that they would otherwise have acquired. This shift would avoid the assumption of a corresponding increase in these countries' indebtedness, with the attendant weakening of their debt profile.

The essential precondition for the control of inflation in the world lies with the national monetary and fiscal authorities. Since SDR creation is a monetary measure, the proper offsetting action should occur in the monetary field. Concretely, this would mean that national monetary authorities, in particular in the main countries, should make allowance for the amount of SDR creation in determining the noninflationary expansion in monetary aggregates they would permit.

A balanced increase in countries' reserves need not diminish significantly incentives for appropriate adjustment. The desire for secular reserve accumulation is broadly held among countries. Hence, the Fund's function of supplying all of its participating members with needed reserves through SDR allocations should not be expected to interfere seriously with its at least equally important function of promoting timely adjustment for some of its members. A further safeguard in this respect would be that, on any reasonable assumptions, annual SDR allocations would be only a small percentage of members' quotas, which would hardly be significant in the context of the very large amounts likely to be involved in any Fund stabilization action. It is suggested that allocations of SDRs should not amount to more than a conservative estimate of the growth in reserve needs resulting from the expansion of the volume of world trade.

Because of the considerable uncertainties that prevail at this stage with respect to some features of the system--such as the future role of gold in reserves--it would seem advisable to put more weight than has been done in the past on the Fund's annual review of the international liquidity situation, and to envisage from the outset the possibility of a change in

annual allocations during the basic period in the event of "unexpected major developments" (Article XXIV, Section 3). It is worth recalling that reductions in the rate of allocation during a basic period can be brought about by a simple majority of total voting power (Article XXIV, Section 4(d)). But, the Fund's policy on the supply of reserves cannot aim at "fine tuning" and it should not try to do so.

It would seem likely that a substantial increase in the stock of SDRs would require some increase in the rate of interest to avoid putting undue reliance on the provisions concerning the holding, acceptance, use and reconstitution of SDRs. It would, further, be desirable in any event to give some reconsideration to the existing reconstitution provisions.

Question 13

Please assess the adequacy of the present level and composition of official reserves.

The approximate composition of official reserves at the end of December 1975 was:

	NZ $ million
Sterling	264.2
US dollars	154.4
Other currencies	120.6
SDRs	4.6
Gold	.7
	544.5

From a record level of $1,094 million in June 1973, official reserves declined to around $600 million in June 1974. Since then, they have remained at around the $600 million level, supported by official overseas borrowing. The rundown in reserves understates the deterioration in the real purchasing power of the current level of reserves. The value of reserves was written down by $161 million during the year ended March 1974, as a result of the revaluation of the NZ dollar but reserves have since been revalued by $34 million in October 1974 and by $65 million in August 1975 following devaluations by New Zealand.

Present policy is to maintain a minimum level of reserves of about $550 million, sufficient to cover New Zealand's import bill for two to three months, and to borrow to sustain this amount. In addition, it is felt that devaluation rumours and associated exchange problems would arise if reserves fell significantly beneath this level. A reserves figure of

$550 million is assumed in all official OET estimates (forecasts).

The currency composition of New Zealand's reserves is kept under review with a view to diversification of holdings in certain currencies to more acceptable levels. We deem it desirable to diversify our overseas investments as far as possible and the recent improvement in the United Kingdom gilt market has given us the opportunity to move out of long term sterling investments.

Office Memorandum

TO : The Acting Managing Director DATE: March 25, 1977

FROM : W. O. Habermeier

SUBJECT : The Fund's Future Role in Financing Deficits

1. Attached is a revised version of the draft dated March 18, 1977. You will recall that the March 18 draft mainly reflected the changes decided at the meeting on March 17, 1977, when it was agreed that extra credit would be made available by an expansion of the credit tranches rather than by a separate facility.

2. The principal revisions in the attached draft are as follows:

(i) In paragraphs 5, 6 and 7 the references to a separate facility are dropped; there is a clearer formulation of the proposal as an extension of the credit tranches; and a suggestion is made as to what is to be done about the existing 45 per cent expansion of the tranches. The suggestion yesterday that the first four credit tranches might be condensed to two of 50 per cent has been included in square brackets; I would omit it. As agreed, paragraph 7 states more directly the possible problem on charges that may result from the Fund's present liquidity.

(ii) Paragraph 8(a) puts in square brackets the idea of access of several times quota and adds in square brackets the possibility of limits.

(iii) Paragraph 8(b) on conditionality has been supplied by the Exchange and Trade Relations Department. We have made only the most minor editorial changes. However, I would propose eliminating the first and the second half of the final sentence in the middle section. I would also suggest adding something on limitations on borrowing from commercial sources, as mentioned by Executive Directors in the WEO discussion and included in earlier drafts.

(iv) Paragraph 8(e) has been put in square brackets reflecting the doubts raised by Executive Directors on possible cooperation between the Fund and commercial banks.

(v) Paragraphs 8(f) and (g) have been added in square brackets at the suggestion of the Exchange and Trade Relations Department. I would be inclined not to include them in a final draft.

(vi) Paragraph 11, on the quantification problem has been supplied by the Research Department. I feel it gives somewhat too great an impression of precision and I have some problems with the final subparagraph. Would it not be simpler to say that the share of the Fund might perhaps double?

(vii) The paragraph suggesting that we should borrow under the credit lines for a short period with the possibility of repayment after the quota increase has been omitted.

Attachment

cc: The Managing Director (on return)
Mr. Gold
Mr. Polak
Mr. Sturc

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/77/62

March 21, 1977

To: Members of the Executive Board

From: The Secretary

Subject: The Adequacy of International Liquidity

The attached paper on the adequacy of international liquidity will be brought to the agenda for discussion on a date to be agreed.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

The Adequacy of International Liquidity

Prepared by the Research Department

(In consultation with other departments)

Approved by J. J. Polak

March 17, 1977

At its meeting on October 2, 1976 in Manila, the Interim Committee requested the Executive Directors to keep all aspects of international liquidity under review and to report to it at a later meeting. This paper presents a review of recent tendencies in international liquidity and assesses the adequacy of the credit facilities and reserve assets provided by the Fund. Some important aspects of the broader issue of control over international liquidity are discussed in this paper, but this is a topic which remains under continuing study.[1/]

Even under the par value system it was difficult to make an accurate assessment of the adequacy of international liquidity. As the Executive Directors emphasized in the *Annual Report* of 1976, this difficulty has increased in recent years. The new position of gold and the volatility of its price is a complication. The change in exchange arrangements is another, as is the growth in the size and scope of the activities of private credit and capital markets. The Seventh General Review of Quotas must, however, be completed by February 1978, and the provisions of the present Article XXIV, Section 4(c) require action by the Managing Director with respect to SDR allocations for the third basic period not later than June 30, 1977.[2/] Thus, decisions on the credit facilities and reserve assets provided by the Fund will have to be taken in the fairly near future.

1/ DM/77/18, "Control over International Liquidity," summarizes the views expressed on this subject by participants at the Fleming Memorial Conference in October of last year.

2/ No decision was taken before the end of the first basic period 1970-72 on an allocation or cancellation for the second basic period. That period began, therefore, as an "empty period" on January 1, 1973 and will end five years later, at the end of this calendar year. The Managing Director is required to make a proposal for the next basic period at least six months before this date, or if he ascertains that there is no proposal which he considers to be consistent with the principles governing allocation that has broad support among participants, to report to the Board of Governors and to the Executive Directors.

I. Reserve Assets and Credit Facilities

In carrying out the analysis a distinction will be drawn between the two main components of international liquidity: reserve assets, sometimes called "owned reserves," and credit facilities available for temporary balance of payments financing. The demarcation line between these two sources or forms of international liquidity is not absolutely watertight, but the distinction is, nevertheless, clear in principle as well as in practice. Reserve assets (or "reserves") are at the disposal of the country owning them without any need for negotiation, without any conditionality as to the countries' policies, and without any significant limitation as to the circumstances in which they can be used. Credit facilities are always subject to the first of these restrictions and may be subject to the other restrictions mentioned. The availability of such facilities, therefore, provides less assurance to a country than the ownership of an equal amount of reserves that it will be able to meet possible balance of payments deficits.

At the same time, the holding of reserves is normally more costly than reliance on credit facilities. Although reserves can be invested in money markets, their interest yield is usually below that which the country could obtain if it had a corresponding amount of real capital, while reserve credits are typically costless, or virtually costless, if they are not used. It follows from considerations such as these that the ownership of reserves and access to balance of payments credit are by no means full substitutes, and it is therefore understandable that countries pursue some reasonable balance.

Given this preference on the part of countries, it is necessary to pursue a similar balance internationally in the provision of conditional and unconditional liquidity if desirable adjustment policies are to be fostered. Since the international community has its most direct influence on the adjustment policies of deficit countries through the conditionality on which Fund credit is made available, it is clearly necessary that a disproportionate amount of owned reserves should not be provided relative to conditional liquidity. But there is also an international interest in members' reserves not being unduly small. Inadequate reserves may lead members to adopt adjustment policies that are internationally as well as nationally undesirable, and an ample supply of conditional credit is not likely by itself to be effective in deflecting members from such a course of action. These questions were extensively discussed prior to the first allocation of special drawing rights, and in the *Annual Report* for 1969 the following conclusion was reached:

> The two types of international liquidity, conditional and unconditional, are, of course, interrelated, in particular in the sense that the one can to some extent serve the same purpose as the other so that the need for the one is not entirely independent of the availability of the other. At the same time, the composition of international liquidity is not a matter of indifference from an international standpoint. Any attempt to

meet a growing shortage of international liquidity solely by expanding conditional liquidity might leave countries without the readily usable assets they require to meet the payments disequilibria that inevitably arise from time to time, irrespective of the policies pursued. It would also be a mistake to assume that the creation of additional reserves would serve in any substantial way to meet the growing need for conditional liquidity.

The Fund as originally established was charged only with the provision of credit facilities. At that time, attention was not focused on the possible inadequacy of the supply of reserves (although such concerns had often been voiced in the past) and no provision was made for this contingency except through the power of the Fund to change the official price of gold. Twenty years later it had become clear that there was at least a potential risk of an insufficiency of reserves, and (by means of the first amendment) the Fund's responsibilities were enlarged to meet that need "as and when it arises."

II. Credit Facilities Provided by the Fund

The most common approach used in the past to measure the relative importance of Fund credit was to compare over time aggregate quotas with world trade. Figures on this basis are presented in Table 1. This comparison was based on two implicit assumptions:

(a) that the size of the payments problems that members were likely to encounter would increase proportionally with the increase in world trade, and

(b) that quotas were a good indicator of the amount of credit that members could normally expect to receive from the Fund.

It was always realized that assumption (a) was at best a reasonable approximation to reality, which made no allowance for the growth of invisibles and, what is more important, for the increase in capital movements since the controls that were applied against such movements in the early years of the Fund have been greatly reduced. These considerations suggest that the growth of trade over time may have provided too small a measure of the growing need of members for balance of payments credit. Indeed, as is shown in Table 1, payments imbalances (overall deficits and surpluses summed without regard to sign) were larger relative to trade in the 1970s than in the three previous quinquennial subperiods, even though they were to some extent kept down by an increasing willingness of members to meet balance of payments disturbances by movements in their exchange rates through floating or changes in the peg.

With respect to assumption (b) it should be recognized that Fund credit available to a member has not been proportional to quotas, but has increased in relation to quotas by a number of successive steps. Until 1961, the use

Table 1. Aggregate Quotas, Imports, and Payments Imbalances, 1956-76[1/]

	Quotas		Imports		Payments imbalances: 78 members	Ratio of quotas to: Imports		Ratio of quotas to: Payments imbalances: 78 members
	All members	78 members	World total	78 members		World total	78 members	
	(In billions of SDRs)					(In per cent)		
1956-60	11.2	10.8[2/]	107	91[2/]	8[2/]	10.4	11.9[2/]	135[2/]
1961-65	15.5	14.6[2/]	148	127[2/]	9[2/]	10.5	11.4[2/]	168[2/]
1966-70	22.5	21.1	235	212	15	9.6	10.0	139
1971-75	29.1	26.8	492	444	49	5.9	6.0	55
1966	20.7	19.5	194	173	6	10.7	11.3	324
1967	21.0	19.7	203	178	10	10.3	11.0	199
1968	21.2	19.8	226	204	15	9.4	9.7	130
1969	21.4	19.8	258	234	14	8.3	8.5	146
1970	28.4	26.5	297	269	31	9.6	9.8	85
1971	28.8	26.8	331	309	68	8.7	8.7	39
1972	29.2	26.8	358	323	39	8.1	8.3	69
1973	29.2	26.8	450	401	36	6.5	6.7	74
1974	29.2	26.8	654	604	60	4.5	4.4	45
1975	29.2	26.8	671	581	45	4.4	4.6	59
1976	29.2	26.8	793	684	...	3.7	3.9	...
6th Review/1977[3/]	39.0	35.7	900	800	...	4.3	4.5	...

1/ Quotas at year-end, imports and payments imbalances for calendar years. Data are shown for all members and for a group of 78 members for which data are continuously available from 1966 to date. Payments imbalances are the sums of balances on current and capital account and errors and omissions. These "overall balances" of the 78 members (60 members before 1966) are added without regard to sign.

2/ Refers to 60 countries for which data are continuously available from 1956 on, and which were Fund members from at least 1961 on.

3/ Quotas agreed at the Sixth General Review of Quotas to become effective after the second amendment of the Articles of Agreement enters into force, related to forecast imports for 1977 taken from the World Economic Outlook.

of the fourth credit tranche was so exceptional that members considered that tranche as for all practical purposes, not available. In 1963, the compensatory financing facility for the use of primary exporting countries was introduced, adding a potential 50 per cent of quota to the access of members in a position to use that facility, and in 1969 a further 25 per cent was added through the buffer stock facility. (Maximum access under this facility was 50 per cent of quota but there was a joint limit of 75 per cent of quota on use of the compensatory financing facility and the buffer stock facility combined.) Then came the Extended Fund Facility (1973, adding an additional 65 per cent of quota), the oil facility[1] (1974), the expansion of the compensatory financing facility to 75 per cent of quota and the removal of its joint limit with the buffer stock facility (1975), and the temporary widening of the tranches by 45 per cent (1976). The total of facilities now available is summarized in Table 2. Although in principle a member could use all the facilities shown at the same time (and the oil facility as well) this has never happened and is unlikely to happen for the foreseeable future. The requirements that must be satisfied for drawings on the buffer stock facility and the Extended Fund Facility are such that little use has been made so far of these facilities.

The temporary widening of the tranches was a means of increasing access without raising quotas; in considering what would be a proper level of quotas (with adequate resources for the Fund as well as adequate access for members) it would not be reasonable to assume the continuation of this special measure. It seems hardly relevant to carry the comparison back before 1963, a period when use of the Fund's resources was, on the whole, still quite limited. The comparison will be made with the mid-1960s, when only the compensatory financing facility was in effect. It will be restricted to members (the overwhelming majority in number), that could be expected to have opportunities to use this facility, i.e., predominantly the primary exporting countries. Such members had a maximum access of 150 per cent of quota in the 1960s. Now their access, as shown in Table 2, would be 175 per cent of quota, plus an allowance for their access to the extended facility and the buffer stock facility. Considering the limited use that has been made so far of both of these facilities, a notional allowance of an additional 25 to 50 per cent of quota for both of them combined might seem reasonable at least for the time being. This would suggest a figure for access in the order of 200 to 225 per cent of quota, or about 1 1/3 - 1 1/2 times as much (as per cent of quota) as in the 1960s.

Aggregate Fund quotas (in SDRs) have risen from the end of 1966 to date by over two fifths and they are going to increase further by one third

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1/ The oil facility has now lapsed. It existed from June 1974 to April 1976. Access was governed by a number of factors: the size of the deficit induced by oil price changes, reserve holdings, Fund quota, and the country's overall balance of payments position. The *de facto* ceiling on credit available through this facility was set, however, by the need for the Fund to borrow from members to finance it. Under this facility members drew a total of nearly SDR 7 billion.

Table 2. Credit Facilities in the Fund[1/]

(In per cent of quota)

Type of Facility	Under Regular Policies 2/	Under Temporarily Widened Tranches 2/
(a) First credit tranche	25	36.25
(b) Higher credit tranches	75	108.75
(c) Extended facility	65[3/]	65.00
(d) Compensatory financing facility	75	75.00
(e) Buffer stock financing facility	50	50.00

Source: *IMF Survey*, Supplement, Fall 1976, p.3.

1/ A member may not qualify for all of these facilities. The amounts shown under each of the facilities listed under (b), (c) and (d) are normally made available over a period of two or more years only.

2/ Facilities as described under regular policies applied prior to January 20, 1976, and will under present decisions apply again after the second amendment of the Articles of Agreement; the temporarily widened credit tranches are in effect from January 20, 1976, until the second amendment enters into force.

3/ The limit on use of the Extended Fund Facility is 140 per cent of quota, but part of this is in substitution for (not in addition to) the use of the higher credit tranches.

after the Sixth General Review of Quotas becomes effective. The total increase from 1966 will then be 88 per cent. During the same period, however, world trade as measured by imports denominated in SDRs has quadrupled and aggregate payments imbalances have, if anything, risen even faster (Table 1). The ratio of aggregate Fund quotas to annual world imports had fluctuated between 8 and 13 per cent from the mid-1950s to 1972; between 1972 and 1976 it fell from about 8 per cent to less than 4 per cent. Comparing the ratio of quotas to imports immediately after general quota increases, the ratio was 13 per cent in 1959, 11 per cent in 1966, and 10 per cent in 1970; in 1977 after the implementation of the Sixth General Review of Quotas it is estimated to be only 4.3 per cent. The same observation holds for a constant sample of 78 members for which data are available since 1966. The ratio of quotas to payments imbalances (overall deficits and surpluses summed without regard to sign) has also declined: quotas were equivalent to approximately 18 months' payments imbalances in the 1960s but only to about six months' imbalances in 1974-75.[1/]

In order to restore members' access to Fund credit to the importance it once held, substantial quota increases would have to be agreed under the Seventh General Review. Making the notional allowance suggested above for the expansion in Fund credit relative to quotas since the mid-1960s, quotas in 1977 would have to be higher than those agreed in the Sixth General Review by SDR 25-35 billion to restore the 1966 ratio between access to Fund credit and imports. Bearing in mind that any quota increases agreed in the Seventh General Review probably could not become effective before 1978, and projecting an increase in nominal imports from 1977 to 1978 by 15 per cent (i.e., at the rate at which imports are expected to grow in 1977), a doubling of quotas as the outcome of the Seventh General Review would restore Fund credit to the relative importance it had in 1966. Even a restoration to the position after the general quota increase in 1970 would require a quota increase of SDR 25-35 billion in 1978.

The question arises whether the traditional quantitative approach outlined above yields an appropriate conclusion on the enlargement of quotas under present circumstances. It could be argued, for example, that both private credit facilities (borrowing from commercial banks) as well as non-Fund official financing facilities (like swap agreements and the automatic credit provisions of the European narrow margins arrangement) have reduced the need for Fund credit.

The fact that countries which are creditworthy can in practice obtain finance from private sources does not eliminate the need for substantial credit facilities in the Fund. The problem is not that the total availability of credit is inadequate but that the terms on which it is available are not necessarily the most conducive to the effective working of the

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1/ The importance of these numbers lies in their movement over time, rather than in the absolute ratios. Quotas equal to one and a half years of imbalances are not excessive since individual countries' deficits or surpluses will often persist for a number of years.

adjustment process. Private lenders are naturally primarily concerned with the security of, and the rate of return on, their lending. Although these criteria are related to adjustment needs, they do not necessarily coincide.

There have been occasions in the past when a member was unwilling to accept the Fund's conditionality, because the additional resources it could obtain from so doing were not judged worth the costs in terms of the restraint imposed by the Fund on the member's policies. Only when relatively unconditional outside sources of borrowing dried up did members come to the Fund, and then often in circumstances where the balance of payments situation had been allowed to deteriorate alarmingly. To be effective in influencing the speed and nature of adjustment measures taken by members, the share of international liquidity provided by the Fund through its credit facilities must be substantial in relation to the size of members' payments problems. If the amount of Fund credit that a member can get is insignificant in proportion to its payments problems, it is likely to seek assistance elsewhere or to resort to policies that may be internationally as well as nationally destructive. To the extent that there is a continuation of the large expansion of private credit which has occurred in the last decade, there will be a need for the kind of underpinning which can be provided by adequate access to Fund credit.

Turning to official non-Fund resources, these are typically of a short-term nature (three months or less) and are therefore not a substitute for medium-term balance of payments adjustment assistance.

These considerations suggest that the existence of private and non-Fund official credit facilities is of limited relevance to the appropriate level of Fund quotas. In the assessment of this level considerable weight will have to be attached to a direct judgment of the adequacy of quotas. The Fund has, in effect, made a judgment on the adequacy of existing quotas a number of times in the past few years, when it introduced special facilities or arrangements for the purpose of giving members larger access than their quotas would have permitted.1/ Leaving on one side the compensatory financing and buffer stock financing facilities which are addressed to needs arising from specific causes, there were still several actions to enlarge potential access in the last four years: the oil facility, the Extended Fund Facility, the 45 per cent widening of tranches, and the provision for additional assistance in exceptional cases agreed to in Jamaica. Admittedly, two of these four special measures were intended to meet a temporary need--the oil facility to bridge the time needed for the adjustment of the world trade and payments structure to the higher oil prices, and the extra 45 per cent to bridge the period until the new quotas could go into effect. For this reason, both had terminal provisions. It is clear, however, that the distortion in payments brought about by the

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1/ It should also be noted that when agreement was reached in the Interim Committee on the general size of quota increases under the Sixth Review, it was at the same time agreed that the Seventh Review would be advanced by two years.

higher oil prices will take far more than two years to be absorbed by the system. Moreover, the 45 per cent increase was obviously designed to meet a larger problem than the delay in the quota increases coming into effect, since the size of these increases for the non-oil countries is, on average, only about 27 per cent of quota. Hence, a continuing need for increased credit provision by the Fund exists.

It should also be remembered that all the extensions of access on the basis of unchanged quotas cut deeply into the Fund's liquidity. This requires that steps be taken to supplement the resources available to the Fund even on the basis of present rules for access by members.

The most suitable way to meet members' needs for additional credit and the Fund's need for resources is by an increase in quotas. Experience shows that this involves considerable time. Over the near term, therefore, i.e., up to the implementation of the Seventh Review of Quotas, further action is necessary.

In particular, active consideration is being given to a temporary arrangement for obtaining additional resources by the negotiation of lines of credit from surplus countries. The resources so obtained would be available on a conditional basis to members encountering major financial difficulties. Further, the widening of the tranches agreed in Jamaica could be retained--on a somewhat reduced scale--after the entry into effect of the amended Articles.

Borrowing is not, however, a substitute for a quota increase. Indeed, in some respects the two are complementary, i.e., an expansion in borrowing requires in due course an increase in quotas to enhance the liquidity of the claims on the Fund.

III. The Provision of Reserves by the Fund

1. Introduction

Broadly speaking, the previous section, arguing the case for increased quotas, covered familiar ground. This will not be the case in the following discussion which gives consideration to the question of whether the Fund should or should not create additional reserves by an SDR allocation. There have been substantial changes in the international monetary system since the first allocation of SDRs including the altered role of gold, the rapid growth of private sources of credit, some increased use of exchange rates for balance of payments adjustment and the floating of the U.S. dollar. For countries in a position to borrow on the international money and capital markets, these changes have led to a more elastic response of foreign exchange reserves to reserve needs. These changes in the nature of the supply of and demand for international reserves lead to an analysis of the adequacy of reserves which differs considerably from that which was appropriate in the past.

Given the new setting for these issues, it may be useful to begin with the provisions of the Articles concerning SDR allocations. Article XXIV, Section 1(a), provides that "In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world." It will also be recalled that an addition has been made to the General Obligations of Participants in the Proposed Second Amendment, and under the new Article XXII each member that is a participant in the Special Drawing Account undertakes to collaborate with the Fund and other participants, not only "in order to facilitate the functioning of the Special Drawing Rights Department and the proper use of special drawing rights in accordance with this agreement," but also "with the objective of making the special drawing right the principal reserve asset in the international monetary system."

The considerations which bear upon seeking to meet the "long-term global need, as and when it arises, to supplement existing reserve assets" and the avoidance of "economic stagnation and the inflation as well as excess demand and inflation in the world" will be discussed below. It is worth emphasizing, however, that in addition reference is made to doing these things "in such a manner as will promote the attainment of its (the Fund's) purposes." This suggests that in reaching a decision on an SDR allocation considerations bearing upon the long-term future of the system should play a part.

If "the objective of making the special drawing right the principal reserve asset in the international monetary system" is not to be entirely devoid of content, regard must be paid to the long-term viability of the asset. It is difficult to see how this can be done without an early resumption of SDR allocations. The displacement of gold as the basic reserve asset of the system has left a gap that can only be filled by an internationally created reserve asset. The holding of SDRs as part of a country's liquid reserves is becoming the only alternative to holding the currencies of particular countries. If, therefore, an allocation of SDRs can be made without exacerbating the problem of inflation, and without an unwarranted permanent transfer of resources among member countries, then considerable weight should be given to the contribution that the SDR can be expected to make to the long-term stability of the international monetary system.

2. Methods of assessing reserve adequacy

In the past, two methods were used for assessing the adequacy of reserves. The first approach relied on a comparison of actual, or forecast, reserves with the volume of reserves considered appropriate in the light of statistical projections from past periods when reserves were judged to have been adequate. These projections were based on observed relationships between reserve holdings and variables intended to measure the need for reserves, primarily payments imbalances or imports as a proxy for imbalances.

It was always necessary to consider modifying the results of the purely statistical extrapolations, in order to make allowance for observed changes in the structure of underlying relationships. When major changes had occurred, the results of this approach were held to be of questionable reliability and greater weight was placed on another approach (see, for instance, *Annual Report 1974*, pp. 37-46).

Under this second approach, countries' own appraisal of the degree of adequacy of their reserves was inferred from their conduct of economic policy, particularly from measures clearly directed toward the balance of payments such as exchange rate policy, trade and exchange controls, and international borrowing. The effect of any excessive reserve ease or stringency in the system could be judged from the deviation of the use of these policy measures from a level considered appropriate, and that could be assumed to prevail if reserves were at the right level. Although this second approach did not yield an estimate of the amount by which global reserves were deficient or excessive, it could be relied on to give qualitative support to tentative quantitative conclusions arrived at by the first approach.

In the course of the preparatory work in 1969 for the first allocation of SDRs, the finding that global reserves were inadequate was supported by qualitative considerations following the second approach, in particular by evidence of an increase in restrictions on international transactions and of increased resort to international borrowing and other arrangements for balance of payments financing. The quantitative estimate of the need to supplement existing reserve assets, which followed the first approach, was based on the projection of reserve needs in accordance with trends in imports and payments imbalances and on estimates of the future growth of reserves in the form of traditional reserve assets.

Important changes have occurred in the international monetary system since the time of the first decision on SDR allocations. One of these changes relates to the role of gold. As long as gold could be sold readily at the official price, it was, without question, a liquid reserve asset comparable to reserve currencies, SDRs, and reserve positions in the Fund. Gold is now no longer readily used as a reserve asset as most members show little inclination to sell gold from their holdings even when their payments situation is precarious. Although the ownership of gold still contributes to a country's overall reserve ease--for instance, it can be used as collateral--there is now clearly a question of the degree of its liquidity.

A further set of changes has resulted from the greater availability of private credit and the extent to which exchange rates are free to vary. As a result of these changes, countries are, in general, in a much better position now than they were in the 1960s to acquire the amount of reserves that they want to hold on average over the years. Most governments can increase their reserves by borrowing foreign currencies from commercial banks or other private sources and placing the funds raised in the market. Moreover, to a much larger extent than a decade ago, countries--in

particular those with floating rates--can influence the amount of foreign currency they acquire or give up in the foreign exchange markets by adjusting their exchange rate and their intervention policies.[1]

The change in the international monetary system that was, however, mainly responsible for making the supply of reserves more readily adjustable to the demand for them was the change in the way in which U.S. dollars were supplied. Until August 1971, and particularly in the few years before that date, U.S. balance of payments policy, and hence the supply of dollars abroad, was influenced by the need to constrain the growth of such dollar holdings in order not to jeopardize confidence in the ability and willingness of the United States to convert them. After gold convertibility was abolished by the United States in 1971, and the U.S. dollar allowed to float, this constraint no longer existed. Moreover, the generation of U.S. dollar balances through the offshore currency markets was expanding during the 1960s and had become substantial by the early 1970s.

These developments have led to increases in gross foreign exchange reserves that have not been clearly inadequate in relation to growing needs, as analyzed in successive Annual Reports. From that point of view there does not seem to be a clear case for resumption of SDR allocations.

This approach overlooks, however, the fact that practically the whole increase in international liquidity has come about by borrowing. The concern that is now developing with respect to the sustainability of present commercial bank lending to deficit countries raises the question whether this form of borrowing as a source of international liquidity creation should continue to play the same preponderant role in the future.

The analysis above indicates that in present circumstances the impact of any decision on SDR allocation may differ from the impact that was envisaged at the first allocation. Then the SDR allocation was seen as providing a needed increase in the supply of reserves in order to avoid the untoward consequences feared from a reserve shortage. Now a decision to allocate or not to allocate SDRs is likely to affect primarily the composition of reserves. It is true that this will not be the case for countries in chronic payments difficulties that have tended to keep their reserves at a minimal level. For this group of countries an SDR allocation would neither lead to any significant increase in reserves nor, except to the extent required by reconstitution provisions, to any significant change in composition. But a high proportion of countries are either lenders or creditworthy borrowers, and for these countries the primary effect of an SDR allocation would be to shift the composition of their reserves. For some countries, such as the United States and Germany, whose reserves are adequate or more than adequate, there would simply be an addition of the SDR allocation to their existing reserves, and they would neither change their lending nor their borrowing.

1/ The extent to which they will be free to do so in the future will be affected by the arrangements made for surveillance over exchange rate policies.

Most other countries will substitute allocated SDRs for increases in foreign exchange holdings that they would otherwise have acquired. This shift would be more important in terms of its effects than the simple fact that the increment of their reserves would consist mainly of SDRs rather than of reserve currencies. These countries would also avoid the assumption of a corresponding increase in their indebtedness, with the attendant weakening of their debt profile. By contrast, the receipt of an SDR allocation does not carry any obligation of repayment, except in the event of use to the extent that the reconstitution provisions come into play. To look at the same point from a slightly different angle, SDR allocations increase both a country's gross and its net reserves, while reserves acquired by borrowing, in particular by relatively short-term borrowing, raise the level of gross reserves but not that of net reserves.

3. Conditions relevant to the allocation of SDRs

One major concern in considering the possibility of a further allocation of SDRs is that, by adding to global expenditures, it might add to the thrust of inflation. Any expansionary impact on the world economy through the extension of additional credit in any form--including, for this purpose, the use of SDRs in the concept of credit extension--arises from the fact that the money put at the disposal of the borrower is spent.

It is, of course, impossible to predict the response of individual countries to an SDR allocation; nor is precise knowledge of this kind necessary to the conduct of the business of the Fund. For individual members, quotas (which determine allocations) may be large or small in relation to their customary reserve levels, and allocations may occur at a time of strong or difficult payments situations. These and other factors will determine the amount of SDR use as a result of an allocation. While SDR allocations have been characterized as serving a need for "reserves to be held" rather than "reserves to be spent," this characterization is appropriate only for the average participant, over time. The crucial issue for the Fund in this context is that the allocation of SDRs to meet a need for reserves does not, to any important extent, become the vehicle for the permanent transfer of real resources. Concern that many countries--in particular developing countries--would likely spend any reserve additions which came their way without ever restoring their holdings was expressed over a decade ago when various schemes for reserve creation were under consideration. This proposition was analyzed in considerable detail in the Fund's *Annual Report* for 1966. The following conclusion was drawn:

> The need for reserve growth is shared by all countries, whatever their stage of industrialization or development. While the scarcity of resources of all kinds in many less developed countries causes them to maintain a level of reserves lower than would otherwise be desirable, the fluctuating nature of their trade in many cases makes them more dependent on the use of reserves and other forms of compensatory financing than are most industrial countries. As has been indicated in the preceding section of this chapter, the proportion of reserves to imports

maintained by developing countries, though it has declined substantially compared with the postwar years, is not now markedly lower than that of industrial countries, whose reserves have also declined in relation to trade. Moreover, in many of the developing countries, as indeed in the United States also, it has been influenced by the fact that in the early postwar years these reserves stood at a relatively high level. These exceptional reserves have now almost universally disappeared and it is to be expected that most of the less developed countries will find it necessary to add to their reserves as their transactions expand. The expansion of developing countries' reserves in the past three years lends support to this view.

A review of similar data brought up to the present supports the same conclusion. Indeed, the developing countries that are not major oil exporters have, in the succeeding decade, maintained their aggregate rates of reserves to imports better than the developed countries (Table 3).1/

That considerable emphasis is placed on the need for reserves is evidenced by the hesitation shown by many countries to make any significant use of their reserves to meet the large deficits of 1974 and 1975, main reliance being placed instead on borrowing. This was also shown by the eagerness with which countries took advantage in 1976 of some easing of the availability of credit--including credit from the Fund--to add to reserves. It is interesting to note, in Table 4, that in 1976 non-oil developing countries financed virtually the whole of their current account deficits by official grants or by long-term flows and made additions to their reserves which totaled almost as much as their "other net borrowing." It is also noteworthy that staff estimates suggest that in 1977 a high proportion of the "other net borrowing" of these countries will again go into additions to reserves.

1/ It might be thought that there would be some difficulty in reconciling these results with the net use by participants of their past SDR allocations. After all, of the 110 participants that received allocations in 1970-72, the holdings of 87 were below their allocations by more than the amount of the annual assessments as of the end of 1976, and the holdings of 57 on that date were less than one half of their allocation. Although this experience might seem to point to a widespread tendency on the part of members to spend rather than hold allocated reserves, additional facts suggest a different answer. Information available for 76 of the 87 members that were net users of SDRs at the end of 1976 shows that 87 per cent (65 members) increased their total reserves during the period 1970-76. Two plausible considerations can be offered in explanation of these data. First, members have found it convenient to use SDRs, for example, for repurchases or payment of charges to the Fund; most countries with small allocations have had little opportunity to restore their holdings after use, unless the use was extensive enough to call for reconstitution. Second, in many countries SDRs have been less attractive as reserve assets than reserve currencies, specifically in terms of their rate of interest.

Table 3. Ratio of Reserves to Imports, 1966-75[1/]

(In per cent)

	World	Industrial Countries	Other Developed Countries	Major Oil Exporters	Other Less Developed Countries[2/]
1966	37	40	31	43	27
1967	36	38	29	46	28
1968	33	34	30	45	28
1969	30	30	30	43	28
1970	29	28	28	43	29
1971	32	33	33	52	28
1972	33	37	48	63	32
1973	34	31	47	59	34
1974	26	21	29	78	25
1975	28	22	26	93	23

Source: The figures are those given in IMF *Annual Report, 1976* (Table 16).

1/ Reserves are centered quarterly averages for the years shown.

2/ The figures for "other less developed countries" in this table include a number of nonmembers for which aggregate imports are substantial but reserves are negligible. The ratio for less developed Fund members alone (excluding major oil exporters) is several percentage points higher in each year than that shown above.

Table 4. Non-Oil Developing Countries:
Balance of Payments Summary, 1973-77

(In billions of U.S. dollars)

	1973	1974	1975	1976	1977 (projected)
Current account deficit	-10.8	-30.2	-38.4	-28.0	-29
Direct investment inflows, net	3.7	4.5	5.3	5.5	6
Official grants and long-term loans received, net	10.5	14.5	18.5	19.9	20
Total	3.4	-11.2	-14.6	-2.6	-3
Reserve changes (accumulation -)	-7.7	-2.4	0.9	-11.0	-5
Total	-4.3	-13.6	-13.7	-13.6	-8
Use of Fund credit	0.2	1.4	1.6	2.1	--
Other borrowing, net	4.1	12.2	12.1	11.5	8

Source: World Economic Outlook, paper No. 3, Table 15, and *International Financial Statistics*.

Even if the main direct effect arising from any SDR allocation would be to substitute SDRs for additions to currency holdings, what is the possibility of significant indirect effects through the replacement of private lending by international reserve creation? If the countries which substituted SDRs for additional currency reserves felt that their net liquidity position was a good deal easier because they did not have to borrow to meet their reserve needs, they might feel inclined, or might be encouraged, to borrow more from private lenders and increase their spending.

It would be difficult to estimate how strong these tendencies might be, but it is not necessary to make such estimates. The containment of world-wide inflation does not depend on the desire to borrow by this or that potential debtor, or on the willingness of banks or others to grant more credit to certain customers. The essential pre-condition for the control of inflation in the world lies with the national monetary and fiscal authorities. Since SDR creation is a monetary measure, the proper offsetting action should occur in the monetary field. Concretely, this would mean that national monetary authorities, in particular in the main countries, should make allowance for the amount of SDR creation in determining the noninflationary expansion in monetary aggregates they would permit.

In more normal circumstances, one might be satisfied with adequate limitations on the total supply of credit in the world. At present, however, qualitative problems of international bank credit may be as important as the overall quantitative problems. There is a risk of commercial banks overextending credit to individual countries, beyond reasonable limits for debt service, and also of the flow of international credit to certain countries suddenly drying up.

The role of the Fund in this context can be of great importance. Where the Fund believes that a certain member fails to adjust and engages in excessive borrowing, the Fund will strongly advise the member to take adjustment action. In such circumstances, the Fund will be prepared to make its resources available, on conditional terms. The amounts that may be needed to restore confidence after adjustment action has been taken may in certain circumstances be very large in relation to a member's quota, but the Fund should be ready and able to act on a large scale in such circumstances. It is, of course, always preferable to prevent difficulties from occurring than to deal with them after they have arisen. It might, therefore, be useful to explore the possibility of cooperation between the Fund and members with the aim of ensuring that international lending and borrowing conform to a sustainable pattern.

As indicated, any credit extended by the Fund as part of its role in the adjustment process should be conditional credit. The question arises whether the possibility that, over the next few years, the Fund may have to deal with a number of such cases--perhaps on a major scale--should be seen as counterindicative to the allocation of SDRs. The answer to that question depends on the importance that countries can be seen to attach to a secular rise in their reserves. To the extent that countries that

unduly delay needed adjustment and borrow excessively also tend to use up their reserves, the allocation of SDRs to such countries would risk delaying adjustment even longer. But insofar as such countries--whatever the weakness of their other policies--do tend to maintain and increase their reserves, SDR allocation would promote a substitution of SDRs for currencies in reserves for these as well as for other countries, and would minimize the problems of indebtedness for countries generally. The evidence presented above suggests that the desire for secular reserve accumulation is broadly held among countries. This would suggest that the Fund's function of supplying all of its participating members with needed reserves through SDR allocations should not be expected to interfere seriously with its at least equally important function of promoting timely adjustment for some of its members. A further safeguard in this respect would be that, on any reasonable assumptions, annual SDR allocations would be only a small percentage of members' quotas,1/ which would hardly be significant in the context of the very large amounts likely to be involved in any Fund stabilization action.

If participants' evaluation of these various factors lead to the conclusion that the problems posed by the possible inflationary impact could be dealt with in a satisfactory manner, and that allocations would be desirable, questions of the possible size and timing will require consideration. Some material relevant to the question of the possible size of an SDR allocation is presented in the Annex to this paper. Some estimates are given there indicating what increase would be consistent with particular assumptions on the appropriate base period, the most useful definition of reserves and the estimated trend increase in world trade.

A number of assumptions are necessary in deciding on the appropriate size of an SDR allocation and these become increasingly tenuous the longer the period for which it is decided to allocate SDRs. These uncertainties would seem to argue in favor of a relatively short basic period, perhaps three years, as in the first basic period, rather than the standard five years.

Because of the substantial uncertainties that prevail at this stage with respect to some features of the system--such as the future role of gold in reserves--it would seem advisable to put more weight than has been done in the past on the Fund's annual review of the international liquidity situation, and to envisage from the outset the possibility of a change in annual allocations during the basic period in the event of "unexpected major developments" (Article XXIV, Section 3). It is worth recalling that reductions in the rate of allocation during a basic period can be brought about by a simple majority of total voting power (Article XXIV, Section 4(d)).

Nevertheless, only major developments could provide sufficient evidence to change the rate of allocation. Reserve changes of individual countries--and even to some extent of the system as a whole--have a large random

1/ See last paragraph of Annex.

component, which limits the significance of one-year changes. Countries' responses to changes in their reserves are distributed over time, so that the prevailing degree of reserve ease can be inferred from the observed policy climate only over a somewhat extended time period. In short, the Fund's policy on the supply of reserves cannot aim at "fine tuning" and it should not try to do so.

Allocation of SDRs provides costless reserves to participants, so long as the reserves are not used. To the extent that they are used, the cost of using them--the rate of interest on the SDR--is the same for all participants. The use of SDRs depends on their interest rate (yield) compared with the yields on alternative reserve assets. The role of the rate of interest in the large net use of SDRs by many members has been referred to above. It would seem likely that a substantial increase in the stock of SDRs would require some increase in the rate of interest to avoid putting undue reliance on the provisions concerning the holding, acceptance, use and reconstitution of SDRs. It would, further, be desirable in any event to give some reconsideration to the existing reconstitution provisions.

IV. Concluding Remarks

The increase in access to Fund credit has fallen far behind the growth in the need for credit resources of this type. Entry into force of the proposed Second Amendment of the Articles of Agreement will allow implementation of the Sixth General Review of Quotas. This quota increase, however, will fill the gap between credit needs and resources only to a small extent. The Seventh General Review of Quotas is to be completed in February of 1978. A substantial quota increase on this occasion, of the order of 75 - 100 per cent, would restore the relation between the need for Fund credit and its availability that was observed in the middle of the 1960s and in the early part of the 1970s.

Even a substantial quota increase will not fill the entire need for conditional liquidity that may arise in the present exceptional circumstances. As indicated above, thought is being given to temporary arrangements to borrow a substantial amount of resources to enable the Fund to increase access to conditional credit in order to assist members in coping with major financial difficulties. A paper on this subject is being prepared by the staff.

Increasing attention is being given to the preponderant role of commercial borrowing in recent years in financing payment deficits. The authorities in some major countries are considering closer surveillance over the foreign lending activities of their commercial banks. If this changing climate leads to a reduction in bank lending, this would at the same time, directly or indirectly, reduce the creation of international reserves. In fact, the curious situation at the moment is--as Table 4 shows--that while the financial community is concerned about deficit financing by developing countries, bank lending to this group of countries has in fact mostly served to increase their gross reserves.

If it were felt that this process of increasing international liquidity should not continue much longer to the same extent, a resumption of SDR allocations might be considered. This would strengthen the international monetary system and contribute to its long-term stability by making a primary reserve asset available to members and by improving the composition of reserves. In addition, an SDR allocation of appropriate magnitude[1/] can also serve, under adequate safeguards, to strengthen the stability of the system by slowing down the growth of international indebtedness.

As indicated earlier, this would require that national monetary authorities, particularly those of countries issuing reserve currencies, cooperate by making allowance, in deciding on their monetary policies, for the amount of SDR creation that is concurrently taking place. Further, as suggested above, it should be recognized at the outset that, if unexpected major developments make such action advisable, a proposal will be made to bring about a reduction in the rate of allocation during the basic period.

1/ The magnitude of an SDR allocation that may be appropriate in present circumstances is discussed in the Annex.

Quantitative Considerations Relevant to the Allocation of SDRs

Since the volume of SDRs has not increased since the end of 1972, the share of this component of international liquidity has been progressively reduced. When the allocation of SDRs for 1970-72 was decided upon at the end of 1969, the projections made at the time implied that at the end of the allocation period, i.e., at the beginning of 1972, SDRs would account for 10 per cent of total reserves (16 per cent of reserves excluding gold), and it was widely expected that thereafter SDR creation would continue to account for the bulk of reserve increases. In the event, holdings of reserve currencies increased very much faster than had been anticipated and the actual share of SDR holdings in total reserves at the beginning of 1972 was about 7 per cent, and the share in liquid reserves about 10 per cent. Since then, the share of SDRs in liquid reserves has declined further to less than 5 per cent at the end of 1976 (Table 5). There has, however, been a large increase in reserve positions in the Fund (whose value is also maintained in SDRs), so that the share of all Fund related assets in total liquid reserves was about 14 per cent at end-1976.

In developing an order of magnitude for possible SDR allocations for the next few years it is assumed that no attempt would be made to reverse the large accumulation of holdings of reserve currencies that has taken place over the last six years. The calculations that follow proceed from the assumption that the creation of SDRs would be limited to a conservative estimate of the need for future reserve increases, less the estimated reserve creation that could be expected to take place as the by-product of the net expansion in Fund credit.

The following framework is suggested as a basis for arriving at an estimate of the magnitude of annual SDR allocations for the next few years:

(a) The calculations would take as their base the liquid reserves at the end of 1976 of countries other than the oil exporting countries characterized by a low capacity to absorb imports, i.e., a round figure of SDR 150 billion. This approach would assume (i) that further "reserve" increases of certain oil exporters, which would in any event be of an investment character, could suitably take place mostly in reserve currencies; and (ii) that whatever the contribution to reserve ease provided by gold reserves, members' reserves in other forms need not be increased to compensate for the fact that their gold reserves are unlikely to increase in volume.

(b) It would be assumed that the stock of liquid reserves at the end of the second basic period, at year-end 1977, was reasonably adequate. This assumption would reflect the view that, over the medium term, the stock of liquid reserves was largely determined by countries' decisions on the preferred level of such reserves, and that the increase in the reserves of non-oil countries that had taken place in 1976 (over SDR 15 billion) and in 1977 fully offset any insufficiency in the two preceding years.

Table 5. Composition and Distribution of International Reserves, End of Years 1969-76

		Composition of reserves					Distribution of reserves				
		Liquid reserves							Major oil exporters		
	Total reserves	All liquid assets	Foreign exchange	Reserve positions in Fund	SDRs	Gold 1/	Industrial countries	Other developed countries	High absorption countries 2/	Low absorption countries 3/	Other developing countries
	(In billions of SDRs)										
1969	78.7	39.8	33.0	6.7	--	38.9	55.0	7.6	2.4	1.7	11.9
1970	93.2	56.3	45.4	7.7	3.1	37.0	65.8	8.5	2.5	2.4	13.9
1971	123.2	87.3	75.1	6.4	5.9	35.9	88.8	12.1	3.7	4.1	14.5
1972	146.5	110.9	95.9	6.3	8.7	35.6	97.5	19.4	4.7	5.4	19.7
1973	152.2	116.6	101.7	6.2	8.8	35.6	95.8	19.9	6.5	5.5	24.5
1974	180.2	144.5	126.8	8.8	8.9	35.6	97.9	17.2	22.2	16.2	26.5
1975	194.3	158.8	137.4	12.6	8.8	35.5	104.1	15.3	24.1	24.2	26.5
1976 4/	221.0	185.6	159.2	17.7	8.7	35.4	113.5	15.8	26.7	29.5	35.5
	(In billions of U.S. dollars)										
1971	133.8	94.8	81.5	6.9	6.4	39.0	96.4	13.2	4.0	4.4	15.8
1972	159.1	120.4	104.1	6.9	9.4	38.7	105.8	21.0	5.1	5.8	21.3
1973	183.7	140.7	122.6	7.4	10.6	43.0	115.5	24.0	7.9	6.7	29.6
1974	220.6	177.1	155.4	10.8	10.8	43.5	119.9	21.2	27.2	19.8	32.4
1975	227.4	185.8	160.8	14.8	10.3	41.6	121.9	17.9	28.3	28.3	31.1
1976 4/	256.7	215.6	184.9	20.6	10.1	41.1	131.8	18.3	31.0	34.3	41.3

Source: *International Financial Statistics.*

1/ Valued at SDR 35 per troy ounce.

2/ Algeria, Indonesia, Iran, Iraq, Nigeria, Oman, and Venezuela.

3/ Kuwait, Libyan Arab Republic, Qatar, Saudi Arabia, and United Arab Emirates.

4/ Staff estimates.

(c) It would be assumed that global holdings of liquid reserves, excluding those of the low-absorption oil exporting countries, tend to grow at a rate roughly related to the rate of increase of international transactions. This assumption is necessarily crude but it may be reasonable for a short series of years. Over the longer run, one would have to take into account such other elements as any further increase that might be observed in the use of exchange rate flexibility or any recognizable difference in the contribution that countries' gold holdings made to the adequacy of their liquid reserves.

(d) A plausible assumption would need to be made about the trend increase in the volume of world trade over the next few years, and this might be accompanied by a policy decision, inspired by the cautious approach suggested earlier, that deliberate reserve creation by the Fund should not validate expected price increases in international trade.

The approach set out above contains elements of both potential underestimation and overestimation of the future growth of liquid reserves, but it would seem on balance to be slanted in the direction of caution in the creation of SDRs. This implies that it would probably not fully meet the demand for liquid reserves, and that there would still be some reserve creation in the form of reserve currencies, outside the planned increase in that form of the "reserves" of oil exporting countries with a low absorptive capacity.

If the approach sketched appeared broadly satisfactory, it would still leave a considerable margin of judgment as to the precise amount of SDRs to be created annually. A percentage trend growth rate of the volume of world trade of 5, 6, or 7 per cent applied to a base of SDR 150 billion, would lead to annual figures of SDR 7.5 billion, SDR 9.0 billion, or SDR 10.5 billion. From such mumbers, a considerable amount should be deducted on account of reserve creation through net addition to the Fund's outstanding credit--perhaps as much as SDR 2 or 3 billion.[1] These calculations would work out at a range for annual SDR creation--within the framework of the approach sketched and assuming a moderate rate of increase in world trade--of some SDR 5-8 billion per annum, or some 12 1/2 to 20 per cent of the quotas resulting from the Sixth Quinquennial Review.

1/ These deductions may be on the high side. They are intended to allow not only for the creation of reserves in the form of reserve positions in the Fund that are the counterpart of any net Fund transactions, but in addition for the creation of dollars that arises when the Fund sells that currency.

Mr. Whittome

INTERNATIONAL MONETARY FUND

March 16, 1977

Suggested amendments by the Managing Director on Mr. Polak's draft, of yesterday, on the Adequacy of International Liquidity.

Managing Director

Office Memorandum

TO : Mr. Familton

DATE: March 15, 1977

FROM : Ernest Sturc

SUBJECT : Draft Paper on "Fund's Future Role"

We were very surprised at the features that would be proposed for the lending side of the expanded role for the Fund and are strongly opposed to them. In particular, we do not believe that the legal problems related to uniformity of charges need be so overriding that a separate facility is the only possible solution. As was discussed at the meeting, higher costs could be covered by increased charges above a certain level of holdings in the credit tranches. Our understanding was that this solution would be advocated. We believe very strongly that for reasons relating to uniformity of conditionality it would be bad policy to segregate a new facility from existing credit tranche facilities.

Our difficulties can be expressed in many ways. For example, there are several problems with the listing of separate criteria attempted in 4.b on page 3. We believe that an attempt to segregate members by such vague criteria would be impossible to operate. Moreover, the use of special criteria would have an important weakening effect on conditionality. As in the case of the oil facility it would create a presumption of a right to the credit because certain of the prescribed circumstances had been met; this was barely manageable in the case of the oil facility because of the associated conditionality of the first credit tranche. This problem would be aggravated by a proposed new level of conditionality--"a fairly high degree"--which would need separate analysis and justification. It is not at all apparent how this could be operated in parallel with our present standards in, for example, Italy, Mexico, and the United Kingdom.

We urge that you drop the entire discussion of a separate facility and instead face the financing issue directly and propose that charges be progressively increased as holdings rise to a degree adequate to cover the higher costs of borrowing. If you cannot agree to this basic change in concept, we recommend that there be an early meeting with the management to decide the basic lines of approach.

cc: Messrs. Gold and Polak

Given to me by Mr Stone on March 17 and said by him to illustrate his views

From the operational point of view, the most appropriate way to expand the availability of Fund credit to member countries would be to increase the normal 100 per cent limit of purchases in the credit tranches to 200 per cent of the new quotas. The amounts available in the first credit tranche would be the normal 25 per cent of quota and that in the upper credit tranches would be 175 per cent of quota. Alternatively, the amount available in the first credit tranche could be increased to 31.25 per cent of the new quotas, in which case the amount available in the upper credit tranches would be 168.75 per cent of the new quotas. The conditionality in the first and upper credit tranches will remain as at present. This proposal is an extension of the present policies and practices of the Fund on the use of its resources and member countries are familiar with them.

Purchases in the first credit tranche will continue to be made in the form of either a direct purchase or purchases under a stand-by arrangement; such purchases would not be subject to phasing and performance criteria. Purchases in the upper credit tranches will be made under a stand-by arrangement and be subject to phasing and performance criteria. The amounts available would be so allocated as to finance the prospective balance of payments need of the two- or three-year period. The stand-by arrangement of the first year will be for an amount consistent with this objective. The program in support of which the stand-by arrangement is requested would cover in specific terms the policies to be implemented in the first year with an indication of a continuation of these policies and the introduction of any additional measures necessary in the subsequent years.

Preliminary calculations suggest that an expanded availability of Fund credit (financed from lines of credit to the Fund as and when the need arises) of the order of SDR 10-15 billion would be adequate to meet anticipated additional requests under the procedure outlined above of potential users in the period until the seventh review of quotas goes into effect. Potential users with large financing needs may include Brazil, Egypt, France, Israel, Italy, Mexico, Pakistan, Spain, the United Kingdom, a number of smaller European countries, as well as several developing countries in Asia and Africa. Many of these countries currently rely heavily on borrowing from commercial banks, and an added availability of Fund credit of SDR 10-15 billion would replace a substantial part of such borrowing over a two-to three-year period.

(Table attached)

Potential Users of Expanded Facility

(In millions of SDRs)

	New Quotas (6th Review)	Access Beyond 100 per cent of New Quotas (4 Credit Tranches) Already Assured	Additional Access with Limit for Expanded Facility plus Regular Credit Tranches of 200 per cent of New Quota 5/
	(1)	(2)	(3) = (2) - (1)
EUR			6,863
U.K.	2,925	-435	2,490
Italy	1,240	-210 1/	1,030
France	1,919		1,919
Denmark	310		310
Greece	185		185
Portugal	172		172
Spain	557		557
Turkey	200		200
WHD			1,288
Brazil	665		665
Mexico	535	-76 2/	459
Peru	164		164
MED			718
Egypt	228		228
Israel	205		205
Pakistan	285		285
ASD 3/	344		344
AFR 4/	600		600
Total	10,534		9,803

1/ Under negotiation.
2/ Depending on treatment of extended Fund facility, this figure may be reduced to zero.
3/ Bangladesh, Burma, Sri Lanka.
4/ Congo, PDR, Ivory Coast, Morocco, Tanzania, Tunisia, Zaire, Others.
5/ Note: this column excludes any access within regular tranches which might be available to members (presumably financed out of liquidity increase of Fund coming from 6th Review Quota increase).

INTERNATIONAL MONI

WASHINGTON, D.C. 20431

Mr Whittome
Pj

CABLE ADDRE
INTERFUND

March 15, 1977

MEMORANDUM

TO: The Managing Director

FROM: J. J. Polak JJP

SUBJECT: The Adequacy of International Liquidity

I attach a revised version of the latter portion of the paper on The Adequacy of International Liquidity.

As you will see, we have deleted the sections of the paper to which you had some objections, rearranged the order along the lines discussed, inserted a new piece on pages 24 and 25 outlining your general position, and introduced a new Part IV summarizing the conclusions of the whole paper.

cc: The Deputy Managing Director
Mr. Gold
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mr. Tun Thin
✓ Mr. Whittome
Mr. Zulu

Mr Whittome

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

March 9, 1977

MEMORANDUM

TO: The Managing Director

FROM: J. J. Polak

SUBJECT: The Adequacy of International Liquidity

I attach a revision of Section III (now entitled "The Provision of Reserves by the Fund") and the Annex of this paper.

I draw your attention in particular to the new introduction (pp. 13-14), the expanded discussion of the difference between borrowed reserves and allocated SDRs (bottom of page 20) and the strengthened section on inflation (pp. 25-26). For the rest, there has been some rearrangement and some shortening and a toning down of "advantages."

We are also making some changes in Sections I and II in the light of comments received.

cc: The Deputy Managing Director
Mr. Gold
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mr. Tun Thin
✓ Mr. Whittome
Mr. Zulu

Mr. Whittome

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

MEMORANDUM

TO: Managing Director

FROM: J. J. Polak

SUBJECT: Adequacy of International Liquidity

February 28, 1977

As Mr. Gold has pointed out the draft paper of February 23rd does not give an adequate discussion of the relative merits of a large quota increase as against an extension of access financed by borrowing. I attach substitute language which would take care of this.

I am submitting this to you now (although there will no doubt be need for other changes in the paper) because it is a matter of considerable importance how we put this issue to the Board and how strongly we argue in favor of one solution against the other. The attached text expresses a preference for the quota route, but not an overwhelming one.

cc: Deputy Managing Director
Mr. Gold
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mr. Tun Thin
Mr. Whittome
Mr. Zulu
Mr. Green

Office Memorandum

TO : Mr. J. J. Polak

DATE: February 25, 1977

FROM : Joseph Gold JG

SUBJECT : Adequacy of International Liquidity

I refer to your draft of February 23, 1977.

1. The first part of the paper in its present state may provoke the response that the Fund could make more resources available to members by borrowing instead of increasing quotas. I can see that the avoidance of increases in quotas would have certain attractions for some members. There are effective replies to arguments for the avoidance of increases in quotas and sole reliance on borrowing. I think it would be advisable to discuss the issue.

2. If an objective formula for the allocation of SDRs in relation to global reserves could be established, there would be no necessity for a further decision of the Board of Governors to reduce the rate of allocation because of "unexpected major developments." This criterion is not likely to be helpful if taken seriously. For this and other reasons, a condition precedent might recruit more support for allocations than a condition subsequent.

3. Some minor technical points are shown in the copies of some pages that I attach.

cc: The Managing Director
The Deputy Managing Director
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mr. Tun Thin
Mr. Whittome
Mr. Zulu

Mr Whittome

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

MEMORANDUM

TO: Mr. Gold February 25, 1977

FROM: J. J. Polak

SUBJECT: Adequacy of International Liquidity

These are my reactions to the two points mentioned in your memorandum of February 25, 1977.

(1) I agree that on page 12 there should be a more explicit discussion why quota increases are preferable to simply enlarging access financed by borrowing. The argumentation should not be overdone, however, because larger access together with large borrowing is not all that much less suitable a solution.

(2) I would have thought that the argumentation on page 27 shows convincingly that a formula adjustment for the rate of allocation is not a reasonable possibility.

cc: Managing Director
Deputy Managing Director
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mr. Tun Thin
✓ Mr. Whittome
Mr. Zulu

INTERNATIONAL MONETARY FUND

March 16, 1977

Mr. Del Canto
Mr. Gunter
Mr. Tun Thin
Mr. Whittome
Mr. Zulu

The Managing Director has asked that I circulate the attached Aide Memoire.

R. J. Familton

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: March 16, 1977

FROM : R. J. Familton

SUBJECT : The Fund's Future Role in the Financing of Payments and Balances and the Establishment of Lines of Credit by the Fund

Attached is a draft Aide Memoire prepared by Mr. Cutler on the basis of the discussions and comments from the Research, Legal and Exchange and Trade Relations Departments on an earlier draft. You will note that there is an alternative formulation of paragraph 8, prepared by the Research Department to support the figure of SDR 15 billion.

As the idea of a separate facility raises major issues, especially regarding access, you may wish to have a meeting on this draft.

Attachment

cc: Mr. Gold
Mr. Polak
Mr. Sturc
Mr. Green

Office Memorandum

mr. Whittome
2

TO : The Managing Director DATE: March 2, 1977

FROM : W. O. Habermeier

SUBJECT : Adequacy of International Liquidity

I refer to the substitute paragraphs submitted to you by Mr. Polak on February 28 on the question of quota increases vs. alternative means of enlarging the financial role of the Fund. I agree that this is a very important section and therefore suggest the following changes:

(i) Mr. Polak argues that a large quota increase would "at the same time supplement the Fund's resources and enhance its liquidity". There is, of course, no dispute that a quota increase would supplement the Fund's resources. However, the argument that it would enhance its liquidity is of very doubtful validity. It would only be convincing if the quota increase were slanted in favor of those members which are expected to be in surplus in the near future, or unless there is already a bias on the existing quota structure in favor of the surplus countries. This last point is difficult to sustain even after the oil countries have a 10 per cent share in quota. In general, the liquidity of the Fund is a function of the use that is made of such increases by deficit countries, and access to and use of Fund credit has in the last few years been rising much more than quotas.

The liquidity of the Fund would, of course, be enhanced if there were to be selective increases in quotas especially for the surplus countries (the oil exporters and a few others), but this would tend to militate against the preference of a quick equiproportional quota increase. A quota increase tends to improve the Fund's liquidity only initially. The invigorating effect tends to disappear rapidly if the need for balance of payments financing is large and deficit countries draw on their enlarged credit facilities.

(ii) In my view, another point deserves attention. Although the Fund is a fairly unique financial institution, it would be prudent to increase quotas in some measure in relation to the expansion of the liabilities which would result from enlarged borrowing. While it would be difficult to establish a capital/liabilities ratio for the Fund, borrowing is not a full substitute for a quota increase. A further large expansion in borrowing would warrant an increase in the Fund's quotas because the Fund will need a measure of "owned" liquidity (a) to safeguard the liquidity of the claims on the Fund, and (b) perhaps also so as not to make the Fund too dependent on the willingness of creditors to prolong or renew their loans at a time when the debtors have not been able to fully adjust and to repay the debts financed by Fund borrowing. The second paragraph in Mr. Polak's draft does not do adequate justice to these considerations.

(iii) The drafting of Mr. Polak's last sentence may be prejudicial because of the emphasis put on a "substantial" difference between the rate of remuneration and the interest paid on borrowing by the Fund. I feel there is also a slight hint that the continuation of a lower rate of remuneration is an assumption that will not for long be borne out by the facts.

I would suggest that this important section of the paper could usefully be redrafted by emphasizing (i) for the near term (the next two years) a substantial credit line may be needed for a number of reasons (as discussed in my briefing paper to you on "Establishment of Lines of Credit", February 9, 1977); (ii) partly in support of such borrowing but also partly to consolidate the financial expansion of the Fund to cope with continuing imbalances, a further quota increase will also be needed.

cc: The Deputy Managing Director
Mr. Gold
Mr. Polak/Mr. Crockett
Mr. Sturc
Area Department Heads

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DM/77/18

INTERNATIONAL MONETARY FUND

Research Department

Control over International Liquidity

A Summary of the Views Expressed by the Participants in the Fleming Memorial Conference

Prepared by the Financial Studies Division

Approved by H. Robert Heller

February 28, 1977

At the Fleming Memorial Conference the two papers by Professor Haberler and Professor Grubel addressed themselves directly to the question of "How Important is Control over International Reserves?" In addition, the two papers by Professor Kenen and Mr. Solomon considered the ancillary question of appropriate "Techniques to Control International Reserves." This paper presents a summary of the analyses and opinions presented in the papers as well as in the ensuing discussion. Of course it is difficult in such a brief survey to give full justice to all the nuances and qualifications with which many of the opinions were expressed at the conference. Instead, an attempt is made to set forth to the extent possible the contrasting viewpoints and to try to pinpoint some of the crucial factors brought forward on the issues of the importance and the desirability of control over international reserves.

This paper begins with a summary of the views of the conference participants on the history of reserve adequacy and inadequacy. The second and third topics summarized are whether flexible exchange rates or the emergence of private capital markets have made the question of control over international reserves less important. The paper concludes with the views expressed by a few of the conference participants on the question whether under present circumstances an SDR allocation might be inflationary.

1. Has lack of control over international liquidity been a problem in the past?

Professor Haberler and Mr. Solomon both considered the question whether lack of control over international reserves has been a problem in the past. Professor Haberler began his historical review with the observation that

"the problem of the adequacy of international liquidity--or, better, of international monetary reserves--has been discussed almost as long as there has been serious discussion of the international monetary system. According to Jacob Viner, 'from the late 1820s to the end of the century a continuous succession of writers called attention to the inadequacy of gold reserves' . . .". He noted that "the long period of falling prices from the 1870s to the 1890s, the 'downswing of the Kontratieff cycle,' gave rise to lively discussions in all major countries on international monetary reform: the bimetal-list controversy." But then "in the 1890s, the bimetallist controversy died down, . . . [as] gold production picked up rapidly . . . and the declining trend of prices gave rise to an upward trend. Thus there could be no further discussion about the adequacy of international monetary reserves until after the First World War."

Mr. Solomon noted that "the first international effort to 'control' international reserves [at the Genoa Conference] was designed to avoid a shortage rather than an overabundance, . . . [but] in the mid-1930s there was some discussion of a 'plethora of gold' and the possibility of reducing the official price of gold."

Both Professor Haberler and Mr. Solomon noted the main concern in the 1950s and 1960s was with a lack of adequate growth in world reserves. Consequently Mr. Solomon was able to conclude that "the history recounted above reveals little concern with the need to control the growth of reserves in the aggregate. One reason was that, until 1970, reserves increased at a moderate pace, . . . [and] virtually no one was claiming that the growth of world reserves was excessive."

Mr. Solomon continues: "All of this changed in the early 1970s, . . . [when] world reserves almost doubled, measured in SDRs from the end of 1969 to the end of 1972. Thus the 'better management of global liquidity' became one of the objectives of the Committee of Twenty.. . ." Also Professor Haberler noted that when "it became clear that inflation, not deflation, was the menace, the diagnosis of an existing or impending shortage of international liquidity gradually shifted to one of excessive international liquidity."

With the introduction of widespread floating in 1973 the question whether international liquidity should be controlled took on a new meaning. Professor Haberler observed that "the demise of the fixed-rate system has invalidated . . . much of recent theorizing on international liquidity.. . . There has been very little systematic analysis of the problem of international liquidity under floating."

2. Control over reserves as a constraint on national economic policies

Dr. Emminger indicated that one of the "reasons why we are interested in a certain control over the volume of reserves is that even in the present system it means more or less balance of payments constraint."

Professor Haberler associated himself with the opinions that had been expressed in recent years by Mr. Fleming, Mr. Polak and Professor Sohmen, that while there are similarities between private money holdings and official reserves, the correlation between changes in international reserves and world inflation is bound to be rather loose. He argued that "public policies bearing on the holding of international reserves are subject to frequent and large changes over time both cyclical and long run. They often differ from country to country and are sometimes unpredictable or even internally inconsistent."

Professor Whitman analyzed the relationship between world reserves and global inflation or deflation as follows: "Control means the avoidance of either excess or inadequacy of aggregate reserves. This whole concept is, of course, based on what Professor Haberler referred to as the international quantity theory. I think he has already covered quite adequately the looseness of some of the linkages there but nonetheless it does remain a matter of some concern."

Professor Triffin also took a cautionary stance and argued that an expansion of international reserves does not necessarily cause, but could "undoubtedly facilitate, the adoption of additional expansionist policies between governments and central banks of the reserve accumulating countries."

Mr. Solomon emphasized the nexus between reserves--and changes therein--and balance of payments adjustment. He noted that "reserves are created as the result of imbalances in international payments . . . and what happens to world reserves will depend to a large degree on countries' actions in the face of strains on their balance of payments positions." From this he concluded that "if control techniques are needed, they should be directed at the financing of payments imbalances and at the potential for transferring foreign exchange reserves from one market to another. . . . Consideration of techniques to control reserves in present conditions thus overlaps with the question of IMF surveillance over exchange rates."

3. Do flexible exchange rates make control over international liquidity less important?

This brings us to the second point to be considered, namely, whether flexible exchange rates have made control of international reserves much less important under fixed exchange rates, or even completely unimportant.

Professor Haberler argued that "generalized floating and other developments have made obsolete any attempt to define an optimum level of international reserves; similarly, control of international reserves is no longer an important task for the Fund." He recognized, however, that "it does not follow, of course, that the problem of international liquidity vanishes altogether under floating. If there are official interventions in the exchange markets, as there probably always will be, there is some need (or demand) for reserves. But since under floating the authorities are not tied down in their interventions by a rigid barrier, unless they restrict themselves which would be tantamount to giving up the float, the need for reserves cannot be greater under floating than it is under the adjustable peg."

Professor Kenen stated similar views when he argued "that the close control of global reserves is not the important objective it was (or should have been) under the par value system." He continued that "it is utterly unrealistic to suppose that limitations on reserve supplies can prevent or correct damaging policies." Finally, he concluded that "with the legalization of floating exchange rates, it is no longer necessary to exercise close control under the volume of currency reserves."

These views were challenged by Professor Triffin who claimed that the arguments presented "should not lead us to abandon the conclusions previously reached (notably in the last report of the Committee of XX) about the shortcomings of an unbridled system of reserve creation, particularly about the inflationary and maladjustment potential of the widespread use of national currencies as international reserves." He maintained that "some attempt to control the mechanism of reserve creation would help improve the functioning of the flexible rate system with which we shall have to live for a long, if not indefinite future." He noted that "there is no doubt that floating exchange rates have made it possible for the surplus countries to regain control over their money printing presses and to stem the inflationary flood of dollar balances which they had to absorb before under fixed exchange rates. Yet this is not so entirely new either. The alternative of currency appreciation was by no means barred under the Bretton Woods system and we can all understand the political reasons why it was not used more and more quickly than it was. Moreover, countries have continued to accumulate huge amounts of reserves and after that began floating." He summarized his view by stating that "I think that some control or some orientation of reserve increase will be as essential to the satisfactory functioning of a flexible rate system as to the survival of a pegged rate system and it seems very surprising to me that this is taken as an alternative somehow."

Professor Grubel argued that also under flexible exchange rates "there exists a unique quantity of reserves the world wishes to hold in equilibrium at a given interest rate on reserves and with a given stock of real resources and output. If the aggregate supply falls short of the optimum quantity demanded, some individual countries are induced to engage in restrictive payments policies, including currency devaluations, to influence the expected pattern of imbalances toward the achievement of more or greater surpluses. . . . In analogy with the cost of having aggregate reserve supplies short of demand, there are social costs from having supplies exceed demand. Countries with excess supplies tend to engage in expansionary balance of payments policies, including currency appreciation, to change the probability towards a smaller frequency and size of payments surpluses. But because such policies are undertaken simultaneously by more countries than are policies in the opposite direction, the world economy suffers from an inflationary bias. . . . From this analysis it follows that it is important for the world community of nations to cooperate and institutionalize a system which assures the creation of optimal aggregate supplies of international reserves."

Mr. de Vries stated that "in the sixties we put far too much emphasis on the control of liquidity and liquidity creation and far too little on adjustment. But it seems to me that we should not now make the other mistake and work only at adjustment and say that control of liquidity does not matter any longer. It seems to me that it does matter."

Professor Kenen argued in the discussion that "I am somewhat concerned by the polarity of our discussion between fixed and flexible rates when we live in fact in a world in which the large majority of countries do peg their rates to one currency or another, or to some group of currencies including the SDR. Therefore they continue to need reserves just as they needed reserve before."

The same point was made by Professor Williamson who stated that "it is very clear, I think, that in the sort of global monetarist world that Bob Mundell wrote about . . . where you have fixed exchange rates . . . the level of reserves in the system is absolutely crucial. It essentially determines the monetary expansion of the whole system. It is equally clear that if we had a system of free floating without intervention, then the total level of reserves in the system is quite unimportant because in that case whatever the fixed level of the international component of the monetary base has zero influence on changes in the domestic component. The two are completely divorced and therefore there is no significance. The difficult question is, what significance has the level of reserves in the mixed world that we actually live in, where currencies float, but where this floating is managed and where it is managed in the light of some notion of what target exchange rates are."

Dr. Emminger listed among the reasons for a continuing interest in the control of international reserves the "direct effects of reserve accumulation. Here we might say that in a system of floating, surplus countries can avoid the accumulation of reserves--except where we have a fixed rate commitment, when we cannot avoid it. If we cannot avoid it we have to create high-powered money and this is of course a highly inflationary process. If there are too many reserves or reserve credit, we still have this direct liquidity effect because we live in a mixed system."

4. Does the existence of private capital markets make control over official reserves less meaningful?

The existence of private capital markets, in particular the Euro-dollar market, was discussed by several conference participants as it related to the issue of control over official international reserves. The main concern centered around the question whether the existence of these alternative sources of balances of payments finance might make any control over official reserves themselves meaningless.

Addressing himself to this point Mr. Lamfalussy asked the question: "How important is control over international reserves?" And answered it implicitly by observing: "The question really is how important is control over international liquidity, which includes international bank lending? What could the control over reserves do in that respect?"

Also Professor Katz noted that "what seems to be happening is that balance of payments settlements now are being made primarily . . . through private channels, and not through official channels. I can see a world awash in liquidity in some meaningful sense. This is disturbing."

Professor Williamson echoed these views when he said that he wished to "associate myself with the thought advanced . . . by Lamfalussy and others that controlling international reserves is probably not the most urgent aspect of controlling international liquidity in present circumstances. International borrowing surely does require regulation, but with a view to stabilizing rather than necessarily curtailing international borrowing, which is fulfilling a very important welfare function."

Professor Haberler observed that foreign borrowing by public or semi-public enterprise "has blurred the dividing line between changes in monetary reserves and changes in autonomous foreign investment or disinvestment. There have always existed borderline cases which made the distinction between 'autonomous' transactions and 'accommodating' reserve movements somewhat fuzzy on the edges. But it stands to reason that the rapidly increasing involvement of government policy and the enormous growth of the public sector in many countries have made the distinction increasingly meaningless. One consequence of this development is that it casts doubt on any attempt to define, however cautiously, an optimum level of reserves."

Professor Grubel challenged the view that the emergence of reserve substitutes made control over the amount of international reserves itself meaningless. He compared this problem to the debate about the effectiveness of monetary control in a domestic economy in the presence of money substitutes. He argued "as long as the elasticity of substitution between the different assets is less than perfect, there will be a determined maximum amount of liquidity which the financial intermediaries can create at any given level of money supply. . . . I would say that this parallel is very strong and very relevant to the debate . . . as to whether there is any sense in controlling [reserves] and what we should do about the private market created substitutes for that kind of liquidity."

5. <u>Are SDR allocations inflationary?</u>

A great deal of discussion was prompted by Professor Haberler's assertion that "a step that would add to inflationary pressures would be an additional distribution of SDRs, especially if linked to foreign aid. . . . Unconditional lending is likely to have the . . . effect . . . of inducing countries to delay anti-inflationary measures and exchange rate changes."

Professor Triffin pointed out that he considered this "a rather astonishing conclusion . . . since the total allocation of SDRs and other related operations of the Fund, both conditional and unconditional, have contributed less than 12 per cent of the reserve increase over the past six years. And this leaves out the 88 per cent where I think the problem really lies."

Also Professor Williamson saw "no reason on grounds of monetary control for refraining from immediate substantial and sustained new issues of SDRs."

Professor Grubel pointed out in this connection that the interest rate on the SDR is important. He maintained that the current interest rate yielded negative real rates of returns to holders and "unless these methods [of valuation] are changed, rates can be expected to be negative in the future, induce an inefficiently low holding of SDRs on average, and encourage debtor nations to use and favor the new creation of SDRs to finance deficits and surplus nations to resist their use and new creation."

European Dept
9-120

Office Memorandum

TO : The Managing Director

DATE: February 11, 1977

FROM : Jorge Del Canto

SUBJECT : The Potential Borrowing Exercise

The figures in the attached table for the Latin American and Commonwealth Caribbean countries are very tentative. The Fund's holdings of currencies (in terms of the new quota) for countries expected to use the Fund resources would be raised by the end of 1978 as follows:

Countries	Holdings of Currencies as Per Cent of New Quota
Brazil	125
Argentina	225
Chile	203
Peru	205
Jamaica	200
Grenada	200
Guyana	175
Barbados	125
Dominican Republic	155
Haiti	156
Panama	144

In addition, Mexico would use its full entitlement under the current EFF arrangement, raising the Fund's holdings of Mexican pesos to 228 per cent of the new quota. The Central American countries, Venezuela, Colombia, Ecuador, Bolivia, Paraguay, Trinidad and Tobago, Uruguay, Bahamas, and Surinam are assumed not to use the Fund resources.

cc: The Deputy Managing Director
Mr. Gold
Mr. Polak
Mr. Habermeier
Other Area Departments

Estimated Deficits and Potential Drawings Over the Two Years 1977 and 1978

(In millions of SDRs)

	Deficit[2] (1)	New quota (2)	Fund holdings of currency[3] (3)	"Maximum"[1] potential drawings[4] (4)	Maximum assumed drawings (5)
Chile	450	217	277	374	163
Peru	200-400	164	213	279	123
Ecuador	--[5]	70	70	140	--
Colombia	--[5]	193	193	386	--
Costa Rica	--[5]	41	36	87	--
El Salvador	--[5]	43	38	91	--
Guatemala	--[5]	51	39	114	--
Honduras	--[5]	34	34	68	--
Nicaragua	--[5]	34	27	75	--
Brazil	9,750	665	503	1,492	329
Guyana	50	25	32	43	12
Surinam	--[5]	25	32	43	--
Venezuela	--[5]	660	344	1,636	--
Argentina	--[5]	535	695	910	509[6]
Bolivia	215	45	39	96	--
Paraguay	--[5]	23	17	52	--
Uruguay	--[5]	84	84	168	--
Bahamas	10	33	28	71	--
Barbados	35	17	14	37	4
Grenada	--[5]	3	4	5	2
Jamaica	73	74	74	148	74
Trinidad & Tobago	--[5]	82	64	182	--
Dominican Republic	20	55	55	110	30
Haiti	5	23	26	43	10
Mexico	2,567	535	669	936	551
Panama	200	45	45	90	20
Total	13,570-13,770	3,775	3,562	7,763	1,827

WITHDRAWAL NOTICE

PROJECT

Project number	2008-008
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DOCUMENT

Series / File	EUR/AI/Subject Files/Liquidity
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To	The Files
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COMMENTS

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Entered by vsmallen Entered on 5/6/2008

Office Memorandum

TO : The Managing Director
DATE: February 10, 1977
FROM : Joseph Gold JG
SUBJECT : Lines of Credit - Private Creditors

I regret that circumstances prevent me from attending your meeting on the subject of lines of credit this afternoon. I should like to make a few comments, however, on the proposals with respect to the negotiability or transferability of claims insofar as the transmission of them to private holders is involved. These issues should be borne in mind if you were to consider offering the possibility of transferring claims as an inducement to prospective lenders.

1. I have mentioned already the fact that the SDR clause may be invalid in some jurisdictions, including the United States.

2. If loans are negotiated in U.S. dollars with provision for transfer of the claims to private parties, and the loans include an SDR clause, the United States might refuse to give its consent to the loans in the first instance because of the invalidity of the SDR clause.

3. It may be impossible to transfer claims to private parties unless the Fund waives its immunity. Waivers could raise serious questions of policy. You will recall that we have not waived immunity in our dealings with bidders in the gold auctions. If the private purchasers of claims required the waiver of immunity, we would have to consider whether we would have to waive immunity from both suit and execution. If we submit to suit, in which tribunals do we submit?

4. If the Fund wished to enter into domestic capital markets, as Mr. Robert Solomon proposed before the Joint Economic Committee two days ago, the Fund would have to qualify under domestic legislation. The procedure might be a lengthy one.

cc: Deputy Managing Director
Mr. Polak
Mr. Sturc
Mr. Whittome

Office Memorandum

MR WHITTOME

TO : The Managing Director

DATE: February 9, 1977

FROM : W. O. Habermeier

SUBJECT : Establishment of Lines of Credit by the Fund

As requested, attached is a note on the above matter.

You will see that nothing is said about the question of whether these lines of credit should be bilateral or should take the form of a group arrangement, nor is there any discussion of the extent to which these bear on the GAB.

The possibility of combining lines of credit with borrowing from the market is touched upon but in accordance with your request we are looking at this matter separately.

Attachment

cc: The Deputy Managing Director
Mr. Gold
Mr. Polak
Mr. Sturc
Mr. Whittome
Mr. Green

Establishment of Lines of Credit by the Fund

1. For the following reasons, substantial lines of credit should be arranged as soon as possible:

a. The continuation of large payments imbalances and the substantial role of financial markets in helping to finance these imbalances make it desirable for the Fund to be in a position to augment its role as a financial intermediary.

b. This need for credit lines is reinforced by the fact that the payments surpluses and deficits continue to be very unevenly distributed and, in several instances, are large in relation to the members' present Fund quotas.

c. The Fund's holdings of immediately usable assets are at a relatively low level, and the margin under the GAB is relatively small.

d. As "lender of last resort" in the international monetary system, the Fund needs at all times to command sufficient resources to play a decisive role if a major disruption of the system seems likely to emerge.

2. The area departments foresee a demand for Fund credit in 1977 in the order of SDR 2.5 billion (gross) and of SDR 1.0-1.5 billion (net). This could still be accommodated from present usable assets which include SDR 3.0-3.5 billion of immediately usable currencies (largely U.S. dollars) and the margin of unused GAB commitments. The room for maneuver is, however, both very small and diminishing and is not sufficient to cope with large and unexpected demands.

Potentially, such unexpected demands could be considerable. Reserve tranches and loan claims outstanding against the Fund now amount to SDR 18.5 billion and are estimated to rise to around SDR 20 billion by the

end of 1977. While a high proportion of these reserve positions is held by countries which may not be either able or willing to use them, the ratio of immediately available assets, excluding gold, to such positions is very low. Moreover, under the Fund's credit facilities, the maximum access (excluding the Extended Fund Facility) available to members, other than oil exporters and industrial countries, that are forecast to be in payments deficit in 1977 amounts to SDR 5-6 billion; in addition, there may be further demands from industrial countries. These figures of maximum potential demand leave aside the possibility that some emergency credit may need to be extended in accordance with the agreement reached in Jamaica.

3. The pending quota increase of SDR 10 billion will, at least initially, substantially improve the immediate liquid resources of the Fund, mainly as a result of enlarging the quota share of major oil exporters. The Fund's holdings of their currencies will then amount to SDR 2.25 billion and its holdings of other usable currencies may rise by about SDR 4 billion. However, the increases may not be effective before the end of 1977. Once they are in effect, access to the Fund's resources will also increase, and it can be expected that the use of the Fund's regular facilities will expand, reflecting members' need to repay their heavy borrowing in recent years, including drawings from the Fund. Also, at the end of 1977, the Fund will start to repay loans under the Oil Facility and it can be assumed that, at the same time, some members that drew under the Oil Facility will wish to draw on the regular credit tranches of the Fund so as to finance their Oil Facility repurchases. The loan repayments will, however, diminish the currency holdings available for financing these new drawings.

4. The Fund also needs to be in a position, in which it has traditionally been, to cope with large and unexpected demands on its resources. The GAB has met this purpose for the major industrial countries though to an extent that may have diminished in view of the fact that actual and potential drawings on the Fund by two GAB participants may exceed SDR 8 billion, compared with total commitments of the remaining eight participants of SDR 5.2 billion. Large-scale demand could arise from nonindustrial countries if normal lending to them through commercial channels were to slacken or were to be disrupted by a loss of confidence in their ability to service their indebtedness and their willingness to adjust their balance of payments.

5. The circumstances outlined justify early steps to enable the Fund to mobilize additional resources, at least until the time when the Seventh Review of Quotas, which is about to start, is completed. The most expeditious way to arrange for additional resources would be to establish substantial lines of credit with countries that would be able to lend to the Fund, in case of need. These lines of credit should be substantial even though they may be used only in part. A substantial amount would give assurance to the private markets that the Fund would be able to deal with large-scale demands from members that are in need of financing and that are following appropriate adjustment policies. It has been suggested that a part of the need to supplement the Fund's liquidity could be met by the Fund issuing securities on the market. The lines of credit would give both time to consider this suggestion and further assurance to the market about the Fund's ability to meet its financial obligations.

6. Total size of credit lines

A number of measures can be used to indicate in broad terms an overall size for the credit lines that the Fund might wish to establish. In 1976 the ratio of the Fund's holdings of usable assets (excluding its gold holdings) to unused credit tranches plus immediate liabilities 1/ was 22 per cent compared with 38 per cent for the period immediately preceding the emergence of major imbalances in the international payments in 1973 and with 40 per cent over the last decade. This ratio can be expected to fall further this year. If the Fund's holdings of usable assets were to be the same ratio as in 1973, the Fund would need to establish lines of credit of close to SDR 12.5 billion. Alternatively, the total size of the credit lines could be expressed as a proportion of official foreign exchange holdings of the 13 main creditor countries, either in terms of their present reserves or of their prospective reserves. Prospective reserves have been estimated on the basis of the current account surpluses forecast for the World Economic Outlook for 1977, adjusted for the proportion by which current account surpluses in the three years 1974-76 were transformed into reserve increaes for each of these creditor countries. At present, these countries hold about 10 per cent of their foreign exchange reserves in the form of reserve positions (including loan claims) in the Fund. If one were to envisage a potential doubling of this ratio, an aggregate size of the lines of credit between SDR 10 billion, on present reserves, and SDR 12 billion, on prospective foreign exchange reserves, would be indicated. Such orders of magnitude would be about one quarter of the aggregate current account surpluses estimated for these

1/ Reserve positions in the Fund (including loan claims) and commitments under stand-by and extended arrangements, including the stand-by agreed for the United Kingdom.

members in 1977.

7. Although it is expected that the United States will have a substantial current account deficit, it would seem appropriate, in view of the unique position of the U.S. dollar in international payments, to include the United States as a potential lender. The size of the credit line to be arranged with the United States could reasonably be equal to the largest line of credit calculated for any one of the prospective surplus countries. On this basis, the total amount of credit lines would be between SDR 12.3 billion and SDR 15.4 billion.

8. <u>Distribution of credit lines among potential lenders</u>

An illustrative allocation of credit lines, other than for the United States, has been made by using the prospective foreign exchange holdings, as explained above, as a distribution key. Including a potential amount for the United States equal to that of Saudi Arabia, the share of the industrial countries would be slightly more than one half of the lines of credit (see the attached table for details).

9. As a starting point for discussions, and rounding the figures to the nearest SDR 100 million, the potential lines of credit could be in the following ranges:

	Member	Amount (SDR millions)
Industrial countries	United States	2,300 - 2,900
	Belgium	100 - 200
	Germany	1,900 - 2,300
	Japan	1,000 - 1,200
	Netherlands	300 - 300
	Switzerland	900 - 1,000
		6,500 - 7,900
Oil exporting countries	Iran	700 - 800
	Iraq	300 - 400
	Kuwait	1,400 - 1,800
	Nigeria	400 - 400
	Qatar	100 - 100
	Saudi Arabia	2,300 - 2,900
	United Arab Emirates	200 - 200
	Venezuela	500 - 600
		5,900 - 7,200
	Total	12,400 - 15,100

10. Financial characteristics of the credit lines and possible loans under them

While it is too early to indicate the details of the financial terms and conditions, the major characteristics of the lines of credit and any loan made under them could broadly be as follows:

a. The credit lines would be irrevocable for a period of two years. Their activation should require no further decisions by the lenders that the Fund would take into account their reserves and balance of payments situations. They might be terminated when the Seventh Review of Quotas comes into effect; the amounts could also be reduced if the Fund were able to borrow from the market.

b. The claims would have an outside maturity consistent with the 3-5 years maturity of drawings on the Fund. However, the claims would be liquid, encashable with the Fund at face value in the event of a balance of payments

need of the lender. Alternatively, the claims could be made transferable in accordance with general terms and conditions established by the Fund. The liquid character of the claims would make them suitable for inclusion in member's official reserves and among the external assets of central banks.

c. If the lender wished to have a longer fixed-term maturity without a liquidity clause but with greater transferability, including transferability to private holders, this could also be considered.

d. The rate of interest on these liquid claims could be related to the weighted average short-term interest rate, which is used to determine the rate of remuneration and could float in accordance with changes in the average. This would necessitate a similar floating of charges of the Fund.

Selected Data of Countries with Expected Large Current Account Surpluses in 1977

(In millions of SDRs)

	Gold and Foreign Exchange (GFX) End December 1976 (1)	Of which Foreign Exchange (2)	Reserve Positions in Fund including Loan Claims (RPF) 1/ End January 1977 (3)	Projected Current Account Surplus 1977 2/ (4)	Adjusted Foreign Exchange Holdings 3/ (5)	Distributions: SDR 10 billion in proportion to Col. (5) (6)	Distributions: SDR 12.5 billion in proportion to Col. (5) (7)	Present RPF/GFX (%) (8)	New RPF/Adjusted GFX: Adjusted for Col. (6) (9)	New RPF/Adjusted GFX: Adjusted for Col. (7) (10)
United States:	9,890	275	4,063			2,300	2,900			
Other Industrial Countries:										
Belgium	3,269	1,793	849	907	1,873	154	193	26.0	31.4	33.0
Germany	26,072	21,956	2,906	7,619	22,748	1,875	2,343	11.1	19.1	21.4
Japan	12,688	11,949	1,680	--	11,949	985	1,231	13.2	22.8	25.4
Netherlands	4,926	3,025	1,001	2,558	3,442	284	355	20.3	25.4	27.2
Switzerland	10,933	8,018	550	3,833	10,636	876	1,096	5.0	11.3	13.2
Oil Exporting Countries:										
Iran	6,873 4/	6,742 4/	998	3,511	7,999	659	824	14.5	22.2	24.9
Iraq	3,283 4/	3,139 4/	27	1,250	3,602	297	371	0.8	9.4	11.8
Kuwait	14,695 5/	14,500 5/	741	3,996	17,149	1,413	1,766	5.0	13.5	16.1
Nigeria	4,083	4,063	334	346	4,347	358	448	8.2	17.3	20.0
Qatar	606 5/	600 5/	15	951	693	57	71	2.5	11.2	13.7
Saudi Arabia	21,055	20,947	2,205	20,330	28,550	2,353	2,941	10.5	17.3	20.0
U.A.E.	1,510 4/	1,510 4/	113	4,770	2,168	179	223	7.5	14.7	17.3
Venezuela	6,332	5,941	916	346	6,195	510	638	14.5	23.5	26.1
Total	116,325	104,183	12,335	50,417	121,351	10,000	12,500	10.6	18.1	20.5
Grand Total						12,300	15,400			

1/ Includes for the industrial countries listed the total calls which the Fund is entitled to make under the GAB with regard to the stand-by for the United Kingdom.

2/ Projections by Fund staff. Japan is expected to experience a small current account deficit in 1977, but is included in view of its high reserves.

3/ Foreign exchange holdings at end 1976 plus a proportion of the projected current account surplus in 1977. The proportion for each country has been taken as the ratio of increases in reserves to current account surpluses over the period 1974 to 1976.

4/ End November 1976.

5/ Estimated by Fund staff on basis of monetary reserves data and overall balance of payments.

Mr. Whittome

Mr. Polak February 8, 1977

J. B. Zulu

The Adequacy of International Reserves

The paper is basically concerned with establishing two propositions: (1) that there is a need for creation of additional liquidity in the near future, and (2) that practically all of this need should be satisfied through the Fund, partly by the allocation of SDRs and partly by the increase in quotas. I am afraid the reasoning in the paper could leave the reader unconvinced about the validity of either of the two propositions.

The main thesis of the paper is that in the past few years the creation of international reserves had been demand determined, and that the supply had adjusted to the demand for reserves. Although there is doubt in my mind about this proposition, it may partially explain why the inadequacy of reserves was not felt during the 1970s when the ratio of reserves to imports declined substantially from over 37 per cent in 1966 to 28 per cent in 1975. But, if reserves are demand determined, the paper should be arguing as to why this process is not going to continue in the near future, or why the international community should take specific measures to change that process.

Our tentative perceptions are slightly different. Given that the oil producing countries would continue to generate large surpluses which they will be investing in financial assets, it would appear that the demand-determined creation of reserves is likely to continue and, on past experience, should assure adequate creation of reserves. In that case, a more important reason for attempting to change that process may be the concern about the growing debt servicing problem. Although the problem is of concern, it is, however, confined mainly to LDCs which account for only a small part of the total demand for reserves.

It is obvious that the question of the overall adequacy of reserves cannot be resolved unless an agreed view is also established as to the role of the commercial banks as intermediaries and, in particular, the magnitude of finance that should be provided through that channel. If the future need for reserves should be satisfied through the Fund, how can the international community restrict the creation of unconditional liquidity. I believe that in order to construct a more watertight case, this potential source of liquidity needs to be clarified. Some people take refuge in this in an attempt to deny any increase in Fund resources.

There are equally important reservations coming to my mind against the paper's argument for a new allocation of SDRs. The benefits to the system from such allocations, as enumerated on page 20 of the paper, do not appear to be persuasive. I can foresee another benefit, not mentioned in the paper, namely that unlike the demand created reserves, allocation of SDRs would distribute reserves more equitably (assuming that the present system of quotas is equitable). But here you have to be able to demonstrate that this would not make member countries even more reluctant than hitherto to use conditional reserves and, therefore, delay the adjustment process which the Managing Director has emphasized on several occasions in the recent past.

Apart from the above general reservations, I have the following additional points to make:

1. You seem to concede that the floating rate regime may have reduced the need for reserves but then suggest that the sharp increase in world trade and capital movements may have made the level of reserves since 1973 less satisfactory (page 16). In evidence you cite the "great hesitation" to meet significant use of reserves in 1974 and 1975. In fact, except for the oil producing countries, reserves as a proportion of imports declined substantially in those two years.

2. The justification of comparing quotas to the sum of deficits and surpluses (as indicators of payments imbalances) is not clear. Will it not be more appropriate to compare the quotas to overall deficits only?

3. In trying to minimize the possible inflationary impact of SDR allocations, you cite the experience of LDCs who have maintained their aggregate ratio of reserves to imports. However, as Table 4 on page 23 demonstrates, the ratio has declined substantially for industrial countries. Should you therefore not demonstrate that this latter group of countries will conserve SDRs in their foreign exchange portfolio?

4. On page 26 you say you are making a "reasonable" assumption that the need for reserves would grow roughly proportionately to the growth in international trade. But in recent years, when reserves are supposed to have grown in response to need, reserves have not so increased. In the light of that experience, why is the proportionate assumption reasonable now? This and similar doubts need to be resolved.

I do not wish to give the impression that there is no case for an increase in Fund-related reserves; the idea is very attractive. But, if we have to put up a case for an increase in quotas, for an issue of SDRs and for supplementary borrowing by the Fund to meet balance of payments financing, it must be a strong one.

cc: Mr. Gold
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mr. Goode
Mr. Tun Thin
Mr. Whittome

Office Memorandum

TO : Mr. J. J. Polak

DATE: February 8, 1977

FROM : Joseph Gold JG

SUBJECT : SDRs as a Supplement to Existing Reserve Assets

In the discussion in the Managing Director's office yesterday of the paper on liquidity, one of the questions that arose was the justification for allocating SDRs as a "substitute" for another reserve asset that would be held in the absence of allocations. The phrase "to supplement existing reserve assets" is one that was chosen deliberately to convey four ideas. In order to be sure that we would be able to recall the intricacy of this language, I recorded my impressions in Pamphlet No. 15 in 1971. The question referred to above is discussed on page 24 in connection with one of the four ideas that the words were meant to communicate.

I take the liberty of quoting a paragraph from page 24:

> " In brief, therefore, members may cease to hold other types of reserve assets if they wish and may agree among themselves to do this, but it is not a condition of the allocation of special drawing rights that they must eliminate other types of assets from their reserves. It is in this sense that special drawing rights are not intended to be a substitute for other kinds of reserves assets. In another sense, however, they would be a substitute. If members should decide not to hold certain reserve assets, either by reducing or by not expanding holdings of them, and special drawing rights were allocated to meet global needs, it could be said that special drawing rights were not only a supplement to existing reserve assets but also a substitute for those that might have been held had there been no allocations."

cc: The Managing Director
The Deputy Managing Director
Mr. Del Canto
Mr. Gunter
Mr. Habermeier
Mr. Sturc
Mr. Tun Thin
✓ Mr. Whittome
Mr. Zulu

Office Memorandum

TO : Mr. J. J. Polak

DATE: February 7, 1977

FROM : G. Nicoletopoulos

SUBJECT : The Adequacy of International Liquidity

In addition to the comments transmitted to you by Mr. Gold, I have the following comments on your draft memorandum of February 3, 1977 on the above subject.

1. The treatment of gold held in reserves under the draft is not convincing. Gold held by members is still regarded by them as part of their reserves and will probably be so regarded for some time. The fact that there is some difficulty in determining the price of gold and that some countries are rather unwilling to use gold in present circumstances does not provide a sufficient justification for excluding gold holdings from reserve calculations.

2. Similarly, the memorandum does not make a convincing case that there is a need "to supplement existing reserve assets", as required by the Articles. If the system can generate the reserves it needs in other ways, in particular through increases in reserve currencies and in Fund-related assets, and at the same time there is no deflation or increase in restrictive measures, the question becomes one of the relative quality of the SDR or of the desirable distribution. The draft seems to base the allocation of SDRs on purely qualitative considerations while the Articles appear to require the establishment of a need in quantitative terms.

3. The first paragraph on page 26 implies that the liquid reserves of the oil exporting countries would be excluded. I find it difficult to see why we should exclude the reserves of such countries as Algeria, Indonesia, or even Iran.

4. The proposal at the bottom of page 27 would in effect provide for a greater increase in the reserves of those members that have no need for such an increase. This would be the result of the proposed link between allocations of SDRs and the payment with SDRs of part of the increases in quotas. In this connection it should be kept in mind that the Fund would not need to rely on this kind of technique for increasing its stock of SDRs because, after the Second Amendment becomes effective,it would have various other ways to increase its holdings of SDRs.

5. The paper should point out that the abolition of the reconstitution requirement would in effect increase the usability of the SDR as members would not need to maintain a specified percentage of their SDR holdings over time.

cc: Mr. Gold
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mr. Tun Thin
Mr. Whittome
Mr. Zulu

Office Memorandum

Mr. Whittome

TO : Mr. Polak

DATE: February 7, 1977

FROM : Jorge Del Canto

SUBJECT : The Adequacy of International Liquidity

Before taking up specific issues posed by this paper, we would like to raise a question concerning the strategy to be pursued in striving to improve the capacity of the Fund to deal with problems in this area. The paper suggests a need to achieve a balanced expansion of conditional and unconditional liquidity, and marshals arguments for a large increase in quotas and substantial issues of SDRs. This approach may be quite appropriate as a general principle, but in the actual negotiations increases in quotas and allocations of SDRs mayl be viewed as alternatives, and the more that is done in one field, the less in the other. Should we not have a view--in the light of adjustment requirements as we now see them--about the relative importance of actions in respect of conditional and unconditional liquidity? Perhaps the point raised here goes beyond the paper under review, but we think it ought to be borne in mind in writing this paper. We should say that in our view the case for a large increase in quotas is overwhelming while the case for new SDR allocations is rather weak.

Turning to the draft paper, the first two sections (through page 13) do not raise any major problems insofar as we are concerned. Nevertheless, there are a few points we would draw to your attention.

--On page 5 it is said that Table 1 shows a tendency for total imbalances to increase more than in proportion to total imports. But an examination of "imports of 78 members" and "payments imbalances of 78 members" indicates that there is no such trend. The ratio was around 8 per cent in 1956-65, 7 per cent in 1966-70, 8 per cent in 1975, and probably below 8 per cent in 1976. To be sure the ratio was appreciably higher in 1971-72 (when the par value system was coming apart) and in 1974 (the first year after oil prices soared), but these periods are sufficiently special to be excluded from observations about tendencies or trends. The comment here also affects the presentation in the middle of page 10. Of course, none of the above affects the important observation that the ratio of quotas to payments imbalances has declined sharply.

--On page 11, second full paragraph, it is indicated that the loan terms of private creditors do not necessarily promote adjustment. Probably this is correct, but it would seem that something more needs to be said to distinguish the operations of the Fund from those of banks in regard to adjustment. Also we found the last paragraph on this page a bit too defensive.

We have greater difficulty with Section III, "The Adequacy of Reserves," and we are in general uneasy with the line of reasoning developed in this part of the paper.

A central point in this section is that the stock of reserves has come to be "demand-determined." Although it is not said so explicitly, it is suggested that this change occurred in the recent past, or in the not-too-distant past. Questions arise as to when this happened, and what were the factors behind the change. It is suggested that borrowing is now readily used to obtain the reserves desired (pp. 15-16), but it is not established that there has been a quantum jump in this regard. Reference is also made to the use of exchange rates and intervention to acquire reserves--particularly by countries with floating rates--but it is also suggested in the paper that genuine floating is exceptional rather than commonplace (p. 16). The discussion of gold in this connection (p. 14) left us unsure as to what you wished to conclude; also, even though there are problems in treating gold sensibly in present circumstances, we wonder whether there is justification for going so far as to drop it from the stock of reserve assets.

In brief, we do not think the statement that there has been a shift from, say, supply-determined reserves to demand-determined reserves is either self-evident or documented in this paper. Perhaps reserves always have been (more or less) demand-determined. In any event, we feel that the line of argumentation in this portion of the paper has to be developed more fully and more carefully.

On a related matter, we were mystified by the point made on page 19 in regard to liquidity control. It is said that the "fact" that reserves are demand-determined does not mean that the problem of control over international liquidity has been solved; reference is then made to "new measures" which might be devised to deal with the problem. What is "the problem," and what are the "new measures" you have in mind? If the solution referred to (but not spelled out) involves a restoration of fixed rates all around with tight asset settlement (and reserve indicators), it is so remote that the whole paragraph might best be dropped.

The next major issue taken up in Section III concerns the possible inflationary impact of SDR allocations (pp. 20-24). Building upon the assumption of demand-determined reserves, it is argued that new issues of SDRs (presumably carrying market-related interest rates, although it is not clear how far it is likely to be possible to go in this direction) in amounts up to the estimated global demand for reserves would generally replace reserve currencies in reserves, and therefore would not be inflationary. The paper goes on to examine evidence on past use of SDRs, but the relevance of this examination is not established and the conclusion to be drawn is not entirely clear.

As it stands, the discussion of the effects of SDR issues on global demand is not, in our view, complete. To be specific, it would appear to us that an enlargement of credit facilities (which is what issues of SDRs would be) at market-related rates of interest but <u>without</u> conditions attached to the use of such credits would operate to augment aggregate demand and to add to inflationary pressures. What the size of such pressures might be is open to question, but we doubt that the magnitude can be inferred from calculations of the kind developed in the first paragraph of page 22. Of course this is not an argument for not issuing SDRs, but the possible credit creating effects of SDR operations would seem to require a fuller treatment.

Indeed, this point comes up again in another form in the last paragraph of the paper (p. 28). After the comment that reconstitution as handled at present is of dubious value, it is suggested that consideration be given to new rules to ensure that "each participant would normally, over time, hold an appropriate share of the total stock of SDRs in circulation." If we understand this suggestion, it would introduce powerful restraints on the use of SDRs. Perhaps such restraints are needed to avoid abuse of SDRs, but if so serious questions arise about the SDR route to meeting reserve needs.

cc: Mr. Gold
Mr. Gunter
Mr. Habermeier
Mr. Sturc
Mr. Tun Thin
Mr. Whittome
Mr. Zulu

Mr. Whittome

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

cc: BR
AHM
ACW
PNF
PH

CABLE ADDRESS
INTERFUND

MEMORANDUM

TO: Mr. Gold
Mr. Habermeier
Mr. Sturc
Mr. Del Canto
Mr. Gunter
Mt. Tun Thin
Mr. Whittome
Mr. Zulu

February 3, 1977

76 ~~80~~ ~~108~~
+ 15 in oil reg...

FROM: J. J. Polak

SUBJECT: The Adequacy of International Liquidity

I attach a draft paper to the Board on this subject. I would be most grateful for comments by the close of business on Monday, February 7, 1977.

(a) How does it fit in with a stand-by paper [is it a good idea?]

(b) Apart from that OK on quotas ? make more of adj ? mention of more figs esp given (a)

(c) On SDR doesn't lead logically
(i) looks more like aid than liq
(ii) in accordance with Arts?
(iii) unwise to base argument on ...