DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

Mr. L.A. Whittome

Room 9-129

August 30, 1976

To: #11 Senior Staff

From: The Secretary's Department

Subject: Executive Board Meetings 76/128 and 76/129, August 25, 1976, a.m. and p.m.*

Netherlands - Discount Rate

Mr. de Vries reported briefly on increase in discount rate.

Special Drawing Rights - Transactions by Agreement Between Participants

Staff representatives: Cutler, Nicoletopoulos
Discussion: 1 hour, 25 minutes

Most EDs welcomed proposed decision exempting certain transactions by agreement between participants from the requirement of need. It was viewed as a modest step toward enhancing the SDR as a reserve asset. One speaker however believed that it was unwise to anticipate the amendment of the Articles and that the decision should be qualified to specify that Fund would approve such transactions only if they were in its interest and did not adversely affect the designation process, for instance. Other speakers stressed that present Articles already gave Fund necessary authority.

In response to questions, staff explained that members with excess holding ratios, as well as those with low ratios and others in need of SDRs to promote reconstitution, had expressed interest in making voluntary transactions. It was difficult to state in advance whether specific transactions would increase scope for designation, which moreover had not been major reason for the proposal under discussion, as one ED also noted.

Several speakers drew attention to Article XXVIII, under which participants undertook to collaborate to facilitate the effective functioning of the Special Drawing Account. It was also observed that operation of decision could be reviewed at any time. In accordance with usual practice, staff confirmed, Executive Board would be informed of any transaction that was prejudicial to Special Drawing Account. EDs approved decision, on understanding that it could be reviewed at any time and that they would be notified if it proved to be prejudicial to designation process or inconsistent with Article XXVIII.

Fund Liquidity - Review

Staff representatives: Habermeier, Cutler, Nicoletopoulos
Discussion: 2 hours, 30 minutes

EDs welcomed review of Fund's liquidity, which should be a continuing process, they believed. Most speakers felt that there was no need for

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

immediate consideration of measures to increase Fund's available resources which, although under greater strain than in the past, should be sufficient over coming year to meet demands by nonindustrial and small industrial members. However, if one or two large industrial members wished to draw, negotiations for activation of GAB would have to be started. Some EDs were willing to consider earlier restitution of gold to members as means of increasing liquidity, but others felt that this was impractical and that in any event agreed gold sales program should be carried out.

First priority should be given, most speakers said, to extending list of usable currencies. One ED, supported by others, suggested that Executive Board in its report to Interim Committee should indicate responses to Managing Director's approach to members on arrangements necessary for use of their currencies in accordance with Jamaica communiqué and paragraph 4 of Resolution on Sixth Quota Review. Another, however, reminded EDs that a member was not legally bound to make its currency usable until after the second amendment of the Articles had been adopted.

Most speakers felt that the Fund should not at present consider establishing bilateral credit lines with members, although one was willing to agree in principle on negotiations to that end in case such borrowing became necessary. Other EDs noted that not only was it difficult to foresee with any precision the likely use of the Fund's resources in the near future, or the amount of financing available from other sources; such borrowing would reopen the difficult issues of Fund charges, remuneration, and rates of interest on loans to Fund. One speaker commented that increased charges and remuneration might deter use of Fund resources. Another observed that increase of credit tranche by 45 per cent had not been accompanied by a corresponding increase of Fund resources, and suggested considering the establishment of credit lines to extent that members were expected to use their increased access to Fund resources, with proviso that they would lapse when quota increases became effective. Generally, EDs said it would not be appropriate to seek an across-the-board anticipation of quota increases under Sixth Review.

Several EDs believed that the Fund should in its policies stress proper balance between adjustment, when necessary, and the financing of members' balance of payments needs. Others noted that that was long established central function of Fund, its major weapon being use of its resources. Timeliness for shift of emphasis from financing to adjustment seen by some. Several EDs stressed that solution of liquidity problem should not be sought through making access to existing facilities more restricted.

Seminar for Asian Officials

Staff representatives: Tun Thin, Huddleston
Discussion: 15 minutes

EDs accepted the Acting MD's proposal for a seminar for Asian officials on implications of the second amendment of the Articles for their operations and policy planning. Staff made it clear that people to be invited were of high rank, and that IMF Institute was to play a role in presenting the seminar.

Guinea-Bissau - Application for Membership

Without discussion, EDs accepted Acting Chairman's proposal for an ad hoc committee to consider the application by Guinea-Bissau for membership.

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Decisions taken since previous Board meeting to be recorded in minutes of Meeting 76/128

Zambia - Exchange System - Representative Rate (EBD/76/173)
Amendments of Rules and Regulations - Transmittal to Board of Governors (EBD/76/170)
Executive Board Travel (EBAP/76/195, Sup. 1)

August 25, 1976

MEMORANDUM FOR FILES

Subject: Review of Fund Liquidity

The Board this morning discussed the staff paper reviewing the Fund's liquidity. The great majority of speakers took the view that although the liquidity position needed to be watched, it did not now present reason for concern and it would therefore be premature to spend time discussing what measures might need to be taken in some hypothetical future.

This view was put across most strongly by Mr. Cross, who was the first speaker. He, like others after him, chose to throw doubt on some of the projections made by the staff regarding the possible use of Fund resources and he went on to say if the liquidity position did come under strain, then that might be a suitable opportunity to curtail some of the existing facilities (no subsequent speaker took up this point and a few from the LDCs explicitly disagreed with it). Cross and several others after him took the line that the world now needed more adjustment and less financing.

The main points made during a brief discussion of the principal proposals put forward by the staff were:

(1) Use of GAB

Cross managed to give the general impression that he was opposed to its use but in fact was careful only to say that it would be unwise now to assume that it could be used. Several LDC-speakers took the line that it should be used if a member of the G-10 were to borrow. Various G-10 speakers (including the French, the Japanese, the Italians, and the Germans) took the view that the GAB was there to be used but that use would have to be considered on a case-by-case basis and the lending countries could be expected to be generally unenthusiastic given the low rate of return on their lending.

(2) A more widespread use of currencies

All the speakers repeated the point that the Fund's liquidity position would be improved if use could be made of the currencies of all countries in balance of payments surplus. Even Deif lamented the obduracy of certain surplus countries and he promised to take up the matter with his constituents again. He held up no hope in the change of their attitude. In contrast Amuzegar truculently dismissed the subject.

(3) Faster rate of gold restitution

The suggestion was fostered by Kafka who later told me he saw merit in any measure that might put further pressure on the price of gold. It was supported by a small handful, including Dini, Wahl, and Guarnieri, but others were either silent, noncommital, or opposed.

(4) Accelerated repurchases

All who talked on this point favored early repurchases by countries whose position had become sufficiently strong to allow this.

(5) Establishment of lines of credit

Only Dini favored this proposal though Kafka played with it. All others took the position that not only was it not now required but that it could not be justified when the Fund held currencies of surplus countries it could not use. Various side-issues were also raised relating to the cost of such borrowing and the possible repercussions on charges (Dini said that he would oppose any measure that raised charges) and also the question as to whether it was proper that credit extended to the Fund should be used only for specified purposes.

(6) Borrowing in anticipation of quota increases

Discussion of this point merged into the previous one and the two subjects were tackled as one point by the few who spoke on them.

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The overwhelming impression was that the potential creditor countries could not bring themselves to believe that the liquidity position threatened to be dangerous in the short-term and were therefore unwilling to promise any measure in advance.

L. A. Whittome

cc: Division Chiefs
Mr. Van Houtven

DOCUMENT OF INTERNATIONAL MONETARY FUND
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FOR AGENDA

EBS/76/347

CONFIDENTIAL

August 2, 1976

To: Members of the Executive Board

From: The Secretary

Subject: Review of Fund Liquidity

Attached for consideration by the Executive Directors is a paper prepared by the staff on the liquidity of the Fund.

This subject will be brought to the agenda very shortly after the informal recess.

Att: (1)

INTERNATIONAL MONETARY FUND

Review of Fund Liquidity

Prepared by the Treasurer's Department

(In consultation with the Legal and Research Departments)

Approved by W.O. Habermeier

July 30, 1976

Introduction

Since the beginning of 1974, net use of the Fund's resources has grown appreciably. The major part of the increase in purchases and hence outstanding drawings results from purchases under the Oil Facility, which have been financed solely by borrowing, but there have also been substantial net purchases under the Fund's other facilities, particularly, in recent months, the Compensatory Financing Facility. These purchases have been financed from the Fund's holdings of the currencies of those members in relatively strong balance of payments and reserve positions with whom there are arrangements for the use of their currencies. Mainly as a result of sales of currency, the Fund's total holdings of these usable currencies have markedly declined; at June 11, 1976, when the currency budget for the quarter ending August 31, 1976 was agreed, they totaled SDR 6.8 billion compared with some SDR 13 billion at the start of 1975. On July 9, 1976 they were SDR 6.3 billion, and, if the present currency budget were to be fully utilized, these holdings would fall by a further SDR 465 million to about SDR 5.8 billion by August 31, 1976.

In line with the increases in net use of the Fund's resources, reserve positions in the Fund, including loan claims of SDR 6.9 billion, have substantially increased in recent years and now exceed SDR 16 billion compared with SDR 8.8 billion at the beginning of 1975 and SDR 6.2 billion at the start of 1974. The increase of around SDR 7.2 billion since the beginning of 1975 reflects the reduction in holdings of usable currency and an increase in loan claims.

These developments, and the prospect of a continued high volume of purchases, bring into sharp focus the Fund's ability to meet further, substantial demands for the use of its financial resources. This memorandum has been prepared as a basis for a discussion by the Executive Directors of the various issues that arise in connection with the Fund's liquidity as it may evolve over the period up to June 30, 1977 and on the assumption that the present Articles will not be effective for that period. Under the amended Articles, new factors will have a bearing on the Fund's liquidity such as increased quotas and possible sales of gold to members.

I. Demand for Use of Fund Resources

1. General economic outlook

In broad terms, the outlook for 1976 described in ID/76/1, dated July 8, 1976, "World Economic Outlook General Survey," suggests that: (i) in spite of the improvement of the volume of world trade, the combined current account deficits of non-oil developing countries will remain very large for the third consecutive year; (ii) the deficits of the more developed primary producing countries will again be substantial, and it is unlikely that they will be willing to run down still further their already depleted reserves; (iii) the major oil exporting countries will increase their current account surpluses; and (iv) the payments situations of most (but obviously not all) industrial countries will remain reasonably comfortable.

The first two of these developments imply a continuing substantial demand for the use of Fund resources by many members, though perhaps with less emphasis on the use of the Compensatory Financing Facility as world trade expands, and more emphasis on the use of the regular credit tranches.

The second two developments--the surpluses of the major oil producers and the positions of most industrial countries--are also important for the Fund's liquidity, in two ways. First, they suggest that the Fund is unlikely to be faced in the near future with the need to finance the use of these members' reserve positions in the Fund. Second, members in these groups will continue to be the main sources for the financing of Fund transactions. In this connection, one problem facing the Fund is that, with certain exceptions, the Fund's holdings of the currencies of these members have already been reduced considerably, or are small in absolute amounts because of the size of the members' present quotas; another problem is that some members have not yet agreed to make arrangements for the Fund to use its holdings of their currencies.

2. Prospective purchases

a. Prospects until end of 1976

It is always difficult to make accurate forecasts of future purchases as they depend not only on balance of payments developments but also on the various considerations that affect members' readiness to draw on the Fund, such as the degree of conditionality applicable under the various Fund facilities and the availability and cost of alternative means of financing their deficits. Forecasts by Area Departments suggest that purchases in the period from July 1, 1976 to the end of this year are likely to be in the range of SDR 1.7-2.3 billion. These forecasts do not however, include any allowance for the possibility of substantial purchases by industrial countries. After the end of 1976, present indications are that there may be some slowing down of purchases, mainly as a result of reduced use of the Compensatory Financing Facility. Under the present currency budget for the quarter ending August 31, 1976, the amount available for purchases for July and August was about

SDR 0.8 billion. Thus, on the basis of the present budget and the above forecasts of purchases, further sales of currency in the range of SDR 0.9-1.5 billion may be necessary in the period September-December 1976.

As mentioned above, possible purchases by industrial countries are not included in the forecasts. At present, two industrial countries, Italy and the United Kingdom, are using Fund credit and the total of their unused credit facilities in the (enlarged) credit tranches is SDR 3.8 billion. As pointed out in earlier memoranda, the staff's view is that, because of the Fund's present and prospective liquidity, a proposal would be made to activate the General Arrangements to Borrow to finance a transaction by a participant in those arrangements.1/

b. Prospects until middle of 1977

For a period of approximately six months ahead, the information currently available to the Area Departments provides the clearest guidance as to future purchases even though the figures are necessarily somewhat tentative as members' intentions are not firmly known. A view of possible purchases over a longer period, say up to June 30, 1977, is even more tentative but, for planning purposes, a broad estimate may be derived from the following schematic approach:

(1) There are some 66 nonindustrial members currently using the Fund's resources. If India is excluded because of the recent improvement in its external position, the unused credit facilities of these members total SDR 6.2 billion. If it were assumed that members that have one half of the quotas of these 65 members would use their available credit facilities to the full extent, this would involve purchases of about SDR 3.1 billion. This figure would seem to be on the high side, especially in view of the fact that the present use of the regular tranches by these members is SDR 1.1 billion. A doubling of this net use, which would imply gross purchases of the order of SDR 1.4-1.7 billion, would appear to be a more plausible assumption.

(2) As regards the Compensatory Financing Facility, there are now 33 members with outstanding purchases under this facility. If all these members had an additional need to purchase between now and June 30, 1977 up to the limit of 75 per cent of their quotas, the total amount involved would be about SDR 0.6 billion.

(3) There are also a number of members that are not using Fund credit at present but that have external positions judged insufficiently strong for them to be included in the currency budget or designation plan. Their quotas total about SDR 2.7 billion, and their present reserve tranche positions are a little over SDR 700 million. If it were again assumed that members having half of the quotas of this group were to purchase under the tranche policy or the Fund's other facilities so as to raise the Fund's holdings of their currencies to 150 per cent of quotas, the amount involved would be about SDR 1 billion.

1/ A more detailed discussion of the implications of borrowing by the Fund is set out in Section II below.

Summing up, purchases by nonindustrial countries envisaged as possible under (1), (2), and (3) in the preceding paragraph would total SDR 3.0-3.3 billion. On the basis of information currently available, this estimate would be consistent with purchases of about SDR 1 billion each in the period June-August 1976, the period September-December 1976, and in the first half of 1977. Purchases by industrial countries, to be financed by borrowing, conceivably could double the total amount.

3. Other uses of currency

Interest on borrowing, which is now approximately SDR 500 million annually, is predominantly paid in U.S. dollars, although some amounts are paid in SDRs and in the currencies of the creditors themselves. Provided, however, that the Fund's income from charges, which are mainly settled in SDRs, exceed or equal the Fund's expenses, these payments of interest (and remuneration and administrative expenditures) will not have adverse effects on the Fund's liquidity.

II. Sources of Fund Financing

1. Fund liquid assets and liabilities

The assets of the Fund consist of its holdings of currencies, in particular those that are usable in the light of the strength of members' balance of payments and reserve positions, and its holdings of gold and SDRs. The most liquid liabilities of the Fund are reserve tranche positions, which can be drawn without challenge in response to a payments need; loan claims, which have somewhat similar characteristics as regards the ability of the lenders to obtain repayment; and undrawn balances of stand-by arrangements. Less liquid liabilities are demands on the use of Fund's resources that members can make in accordance with the Fund's policies, provided they meet the necessary requirements for such purchases.

The most important development in the relationship between the Fund's liquid assets and the demands that can be made on them has been the recent large increase in reserve tranche positions and loan claims and the decline in the Fund's holdings of usable currencies.

The general evolution of the Fund's liquidity is shown in Appendix Tables 1 and 2. These tables show that if the present currency budget is utilized in full, reserve positions in the Fund at the end of August 1976 will be over SDR 17 billion, while holdings of currencies that the Fund is at present using will fall further to below SDR 6 billion and holdings of SDRs will be about SDR 400 million. The ratio of usable currencies to reserve positions in the Fund would be about 33 per cent, which would be less than half the low point of 76.5 per cent reached in 1969. Generally, holdings of usable currencies have been substantially more than reserve positions in the Fund. These developments suggest that the Fund's holdings of usable currencies cannot be considered as available *in toto* to finance additional purchases owing to the need for the Fund to be in a position to repay, in case of need, its liquid liabilities and have some room for maneuver in the management of its resources.

The developments in the Fund's liquidity also underline the importance of widening the list of usable currencies, of considering other sources of Fund financing, and of encouraging members to accelerate repurchases in the light of improvements in their balance of payments and reserve positions. These various issues are discussed below.

2. Holdings of usable currencies

At June 11, 1976, when the present currency budget was adopted, the Fund's holdings of the currencies included in the budget totaled the equivalent of SDR 6,614 million (see Appendix Table 3). Of this total, holdings of U.S. dollars represented SDR 3,863 million, or 58 per cent. If the present currency budget is fully executed, U.S. dollar holdings would be SDR 3,388 million at the end of August 1976, equal to about 50 per cent of the U.S. quota. Holdings of usable currencies other than U.S. dollars totaled SDR 2,751 million as at June 11, 1976, equivalent to about 42 per cent of the total of SDR 6,614 million. They consist of the currencies of 19 members. As mentioned, however, the holdings of some of these currencies are small, either in absolute terms or as percentages of the members' quotas. Of the present list of usable currencies other than the U.S. dollar, only seven are held in amounts exceeding SDR 100 million, and the balance of payments positions of these members will be an important element in the Fund's future ability to finance purchases from its currency holdings.[1/] It is evident at the present time that this leaves the Fund's holdings of U.S. dollars as the principal source of its liquidity. The Fund's ability to continue to make net use of this major component of its holdings of usable currencies will depend on the future balance of payments position of the United States and the strength of the U.S. dollar. It should also be kept in mind that the U.S. dollar serves as a final means of settlement in a number of the borrowing agreements for the Oil Facility in case no other currency of settlement, including the member's own currency, or SDRs, could be agreed upon for this purpose. While agreement on the use of other currencies might not prove difficult, there can be no assurance that the Fund would not have to exercise the option to pay U.S. dollars.

In the staff's view, however, it is not likely that, in the near future, the balance of payments position of any major lender to the Fund will be such as to give rise to a request for advance repayment. Also, if such a request were made, it may prove possible to arrange for transfers of loan claims from one lender to another, or for some partial transfer of the claims to private lenders. Nevertheless, it is necessary to keep in mind the possible need for advance repayment and consequently the desirability of maintaining holdings of U.S. dollars sufficient to meet such contingencies, at least in part. Similar operational difficulties exist in reducing the Fund's holdings of other usable currency to very low levels in relation to quotas. For example, it is necessary to make allowance for the possible use of these currencies in interest and remuneration payments and for purchases made in connection with intra-EEC settlements.

1/ These members are Brazil, Canada, France, Japan, the Netherlands, Norway, and Sweden.

3. Extending the list of usable currencies

The memorandum accompanying the present currency budget indicated that, in the opinion of the staff, there were 22 members not included in the budget whose balance of payments and reserve positions would appear to justify the sale of their currencies by the Fund. These members were not proposed for inclusion principally because most of them had not made the necessary arrangements for the conversion of their currencies, although in two cases the members were unwilling to permit such use. Three of these 22 members (India, Spain and El Salvador) are currently using the Fund's resources. The remaining 19 members, whose currencies are all held by the Fund either close to or below 75 per cent of quota, are listed in Appendix Table 4. If holdings of the currencies of these members were wholly usable, the total amount of use would be in the order of SDR 1 billion, but similar considerations to those mentioned above would preclude reducing holdings of these currencies to zero. The Managing Director has approached these members, as well as other members, on the arrangements necessary for the use of their currencies in accordance with paragraph 4 of the Resolution on Quota Increases adopted by the Board of Governors on March 22, 1976.1/

4. Repurchases

a. The flow of currencies into the General Account as a result of repurchases is difficult to forecast accurately because of the possibility of advance repurchases or of requests to reschedule repurchases. Also, the calculation of repurchase obligations under Article V, Section 7(b), relating to members' positions as of April 30, 1976 is not yet complete. At present, in the 12 months ending June 30, 1977, scheduled repurchases and amounts falling due for repurchase at the end of the three-year period total about SDR 1 billion, of which about SDR 400 million relates to the rest of 1976, and the balance of SDR 600 million to the first six months of 1977. If certain amounts falling due for repurchase in 1977 were to be scheduled for repurchase in installments, this latter amount might be reduced to about SDR 400 million. The amounts might also, of course, be increased by any new repurchase obligations calculated under Article V, Section 7(b).

b. In accordance with the Decision of February 13, 1952 on "Use of the Fund's Resources and Repurchases," a member that has purchased in the year in which its reserves fell is expected to repurchase as its balance of payments position improves. The amended Articles embody this

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1/ This paragraph reads as follows:

"4. A member shall, within six months after the date of the adoption of this Resolution, make arrangements satisfactory to the Fund for the use of the member's currency in the operations and transactions of the Fund in accordance with its policies, provided that the Executive Directors may extend the period within which such arrangements shall be made."

principle in the new Article V, Section 7(b).[1/] In the period before the amended Articles become effective, the Fund's liquidity, and its ability to assist members in more immediate balance of payments difficulties, will be enhanced if members whose external positions are improving are encouraged to accelerate their repurchases.

Advance repurchases of Oil Facility drawings will not increase the Fund's holdings of usable currencies because the Fund will be required to repay the lenders. Such repurchases will, however, improve the Fund's liquidity in a broad sense by reducing the amount of liquid loan claims on the Fund.

5. Replenishment in gold or SDRs

Over a period of approximately 12 months, the General Account will receive in usable currencies the equivalent (at SDR 35 per ounce) of the gold sold in eight auctions and also the equivalent of one quarter of the total amount of gold to be restituted to members in proportion to their quotas as of August 31, 1975. This will add to the Fund's holdings of usable currencies an amount of SDR 437 million, assuming no members opt for restitution after the amended Articles become effective. If restitution were made at a faster rate either over two years instead of four or in one single operation later this year, the holdings of usable currencies would be augmented by either an additional SDR 219 million or SDR 656 million.

The SDR holdings of the General Account at present are about SDR 535 million and it seems unlikely that on average they will increase much over the period to August 31, 1976. SDRs are transferred by participants to the General Account in repurchases and the payment of charges and are used to pay remuneration and interest; in addition, there are transfers to participants with a need to reconstitute their holdings against the payment of currency. While a modest proportion of the present SDR holdings might be used to replenish currencies, a major part of these holdings should be preserved so as to facilitate reconstitution and the payment of charges in SDRs. If the present balance were to increase, there would be the possibilities of some use of SDRs in replenishment of needed currencies or of the direct use of SDRs in purchases. The net increase in SDR holdings does not represent an addition to the Fund's liquidity, except qualitatively, as an increase in the Fund's

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1/ This reads as follows:

"(b) A member that has made a purchase under Section 3 of this Article will be expected normally, as its balance of payments and reserve position improves, to repurchase the Fund's holdings of its currency that result from the purchase and are subject to charges under Section 8(b) of this Article. A member shall repurchase these holdings if, in accordance with policies on repurchase that the Fund shall adopt and after consultation with the member, the Fund represents to the member that it should repurchase because of an improvement in its balance of payments and reserve position," (Draft Article V, Section 7(b)).

SDR holdings can occur only instead of an increase of the Fund's holdings of usable currencies, unless the Fund's income exceeds its expenses.1/

6. Borrowing

a. As indicated above, the staff would favor the activation of the General Arrangements to Borrow (GAB) if a purchase were made by a participant. If Italy and the United Kingdom are not included in the list of those countries whose balance of payments and reserve positions would justify their lending to the Fund, the total amount available would be about SDR 4,558 million. This might be supplemented by about SDR 300 million if Switzerland, which is associated with the GAB, were to lend to a GAB participant. The fact that the GAB might be activated for a particular purchase would not preclude borrowing from other members to finance that purchase, presumably on the same terms as the GAB. Some members, particularly those with substantial surpluses whose reserves are large in relation to their quotas, might be willing to make contemporaneous loans to the Fund.

b. As regards other borrowing, the present low levels of the Fund's holdings of usable currencies suggest that this would be desirable in order to supplement the financing of demands on the Fund's resources from holdings of usable currency. Against this, it may be felt that the current high level of purchases, though likely to continue to the end of the year, is likely to be reduced thereafter as the recovery in economic activity proceeds. An important factor also is that the Sixth Quota Increase can be expected to become effective in the course of 1977. This will provide the Fund with substantial additional resources at that time. For these reasons, and if the list of usable currencies is significantly extended, borrowing other than for financing purchases by GAB participants may not be necessary. In view of the uncertainties about the supply of and demands on the Fund's liquidity, it would in any case be useful if certain credit lines could be made available. If additional credit lines were felt to be appropriate, they preferably should not be tied to a specific use of Fund facilities, like the GAB and the Oil Facility borrowing. The credit lines should be available for financing purchases under any of the Fund's facilities. It would also be for consideration whether the Fund's arrangements to borrow should be for a minimum period (say, two years) so that the Fund would not add to its immediately liquid liabilities. If a minimum period would entail an interest rate higher than the present rate of remuneration, some adjustment in charges might be necessary.

1/ If the increase in SDR holdings occurs as a result of repurchases in SDRs, this means that the total of usable currencies is that much less than if currencies had been used to make the repurchases. If the increase results from payments of charges in SDRs, currency holdings will fall because interest is mainly paid in currency (see Section 1, paragraph 3, above). In recent years, the Fund's SDR holdings have tended to stabilize, with the inflow being matched by the outflow; the latter is predominantly the acquisition of SDRs for reconstitution against the payment of currencies to the Fund. To the extent these currencies are currently usable, the Fund's liquidity is not affected.

In developing a policy on the use of credit lines in the present period additional to the GAB, an approach, suggested in previous discussions of the Fund's liquidity, that might usefully be taken would be to link arrangements to borrow to quota increases. The Fund would establish credit lines with those members in surplus that had the legal authority to lend to the Fund in amounts equal to their quota increases under the Sixth Review. Balances resulting from the use of any such credit lines might then be repaid at the time the quota increase becomes effective and the Fund's liquidity improved. If this approach were adopted and all the 41 members whose currencies the staff would propose to use in purchases at present agreed to extend credit lines, the amount would total SDR 6.9 billion; if GAB participants are excluded, the amount would total SDR 2.9 billion.

Summary and conclusions

1. The present economic outlook suggests that the relatively heavy demand for the use of the Fund's resources is likely to continue to the end of this year. This is borne out by the forecasts of the Area Departments, which indicate purchases by nonindustrial countries from the end of June through December 31, 1976 in the range of SDR 1.7-2.3 billion. Purchases by industrial countries could more than double those amounts.

2. If there are substantial purchases by one or more members with large quotas, it will be desirable and perhaps necessary to finance them by borrowing. As mentioned, the staff would favor the activation of the GAB to finance purchases by GAB participants. However, members that are not participants in the GAB should also consider making arrangements to provide resources for the financing of purchases, particularly if their reserve levels are high.

3. Although these estimates can only be tentative and are subject to a margin of error, gross purchases by nonindustrial countries might be expected to develop as follows: about SDR 2 billion until the end of 1976, of which SDR 1 billion would be under the currency budget which runs to the end of August and SDR 1 billion in the last four months of the year, and perhaps a further SDR 1 billion in the first half of 1977.

4. The present currency budget should be adequate to cover purchases of SDR 1 billion by nonindustrial countries through to the end of August 1976. This would leave a further SDR 1 billion of such purchases to be financed in the remainder of 1976 and another SDR 1 billion in the first half of 1977. Assuming the continuation of the present distribution of surpluses and deficits and exchange market conditions, purchases of SDR 2 billion might be financed as follows:

a. Approximately SDR 1 billion from the inflow of currencies from repurchases (about SDR 600 million) and from replenishment by gold sales and restitution (over SDR 400 million).

b. To finance the balance of SDR 1 billion, some further use might be made of currencies included in the existing currency budget, but this is becoming increasingly difficult because of the relatively low holdings of several currencies in relation to quota. This tends to

concentrate sales on relatively few currencies and to involve significant proportions of the members' foreign exchange holdings. The position would be considerably eased if all members in relatively strong balance of payments and reserve positions would make their currencies usable in accordance with the Resolution on Quota Increases. This would make available an additional amount up to SDR 1 billion.

5. Although the possibility exists to continue up to mid-1977 to finance purchases other than those by industrial countries from the Fund's existing holdings of currencies, it is essential to extend the list of usable currencies in accordance with the Resolution on Quota Increases. The forecasts of net drawings over a period of 12 months may be short of the mark. Moreover, it may be seriously questioned whether it is advisable to contemplate reducing the total of the Fund's holdings of presently usable currencies, including U.S. dollars, substantially below the levels envisaged in the currency budget agreed on June 11, 1976. To avoid this, it would be very useful if certain credit lines could be available as a cover against unforeseen demands on the Fund's liquidity, in any event to bridge the time until the amendments and the quota increase become effective. Unlike the GAB and Oil Facility borrowing, the use of such credit lines should not be tied to specific uses. It is also for consideration whether the Fund should borrow for some minimum period, say, up to the date the quota increase becomes effective, rather than add to the Fund's immediate liabilities. If the interest rate to be paid on such borrowing were to exceed the rate of remuneration, it may be necessary to raise charges. It would be helpful if members in strong balance of payments and reserve positions were prepared to make arrangements to lend the amounts they will be paying to the Fund for quota increases, with the repayment of any use of such borrowing possibly linked to their quota payments.

Table 1. Fund Liquidity - Relevant Data: 1967-76 (End-year Positions)

(In billions of SDRs)

	1967	1968	1969	1970	1971	1972	1973	1974	1975	End-June 1976
A. Quotas	20.99	21.20	21.35	28.43	28.81	29.17	29.19	29.19	29.21	29.21
B. Use of Fund credit[1/]	2.48	3.69	4.01	3.23	1.34	1.08	1.03	3.74	7.44	11.25
a. Compensatory Financing Facility	0.26	0.25	0.23	0.13	0.13	0.38	0.46	0.54	0.72	1.48
b. Oil Facility	--	--	--	--	--	--	--	1.72	4.76	6.90
C. Reserve positions in the Fund	5.75	6.49	6.73	7.70	6.35	6.32	6.17	8.84	12.62	16.38
a. Reserve tranche positions	4.97	5.19	5.76	6.96	6.35	6.32	6.17	7.12	7.86	9.48
b. Loan claims	0.78	1.30	0.97	0.74	--	--	--	1.72	4.76	6.90
D. Usable currencies[2/]	8.67	8.85	5.15	13.70	9.10	5.34	9.96	13.10	9.06	6.70
a. U.S. dollars	3.87	3.87	2.69	4.75	--	--	5.03	5.16	4.81	3.91
b. U.K. pounds	1.83	1.83	--	2.10	2.10	--	--	2.10	--	--
E. SDR holdings	--	--	--	0.29	0.49	0.63	0.51	0.46	0.55	0.55
F. Gold holdings[3/]	3.76	3.36	3.37	4.93	5.30	5.37	5.37	5.37	5.37	5.35
G. Available borrowing facilities	5.33	4.81	5.17	5.42	6.06	5.77	5.58	6.87	6.93	5.46
a. GAB	5.33	4.81	5.17	5.42	6.06	5.77	5.58	5.54	5.52	5.46
b. Oil Facility	--	--	--	--	--	--	--	1.33	1.41	--

1/ Represents use of Fund's resources other than in the gold tranche.

2/ Usable currencies are defined as those included in the currency budget at the time, including holdings of up to 75 per cent of quota of currencies suggested for use below the line.

3/ Includes gold investment up to February 1972.

Table 1a. Use of Fund Credit (End-1973 - End-June 1976)

(In millions of SDRs)

Date (end of month)	Credit tranches	Oil Facility	Compensatory Financing	Other 1/	Total use of credit
1973					
December	554	--	460	14	1,028
1974					
January	545	--	446	14	1,005
February	567	--	529	14	1,110
March	547	--	553	5	1,105
April	526	--	553	5	1,084
May	724	--	553	5	1,282
June	762	--	552	5	1,319
July	744	--	551	5	1,300
August	883	--	542	5	1,430
September	1,379	527	542	5	2,453
October	1,375	845	542	5	2,767
November	1,457	1,104	542	5	3,108
December	1,484	1,716	535	5	3,740
1975					
January	1,482	1,921	511	5	3,919
February	1,518	2,037	511	5	4,071
March	1,835	2,485	529	3	4,852
April	1,842	2,499	528	3	4,872
May	1,862	2,544	522	7	4,935
June	1,852	2,676	519	7	5,054
July	1,897	2,749	569	7	5,222
August	1,872	3,115	567	15	5,569
September	1,870	4,105	565	15	6,555
October	1,885	4,252	560	15	6,712
November	1,937	4,490	610	13	7,050
December	1,949	4,759	718	13	7,439
1976					
January	2,053	5,860	716	13	8,642
February	2,053	6,065	720	13	8,851
March	2,096	6,301	925	13	9,335
April	2,120	6,465	1,208	13	9,806
May	2,848	6,902	1,294	13	11,057
June	2,857	6,902	1,482	13	11,254

1/ Buffer Stock and, since August 1975, Extended Fund Facility.

Table 2. Fund Liquidity Ratios: 1967-76

(In per cent)

	1967	1968	1969	1970	1971	1972	1973	1974	1975	End-June 1976
1. Use of Fund credit as a per cent of quotas	11.8	17.4	18.8	11.4	4.7	3.7	3.5	12.8	25.5	38.5(102.3)
a. Compensatory Financing Facility	1.2	1.2	1.1	0.5	0.5	1.3	1.6	1.8	2.5	5.1 (13.5)
b. Oil Facility	--	--	--	--	--	--	--	5.9	16.3	23.6 (62.7)
2. Usable currencies as a per cent of										
a. Reserve tranche positions	174.4	170.5	89.4	196.8	143.3	84.5	161.4	184.0	115.3	70.7
b. Total reserve positions[1/]	150.8	136.4	76.5	177.9	143.3	84.5	161.4	148.2	71.8	40.9

Note: Ratios in brackets relate to quotas of all members using Fund credit.

1/ Including loan claims.

Table 3. Projected Fund Holdings of Currencies of Members Included in the Currency Budget for June-August 1976

(In millions of SDRs)

	Quota (1)	Fund's currency holdings[1] as of June 11, 1976 Amount (2)	% of quota (3)	Proposed use in currency budget June-August 1976 Purchases (4)	Repurchases (5)	Projected currency holdings: End-August 1976 Amount (6)	% of quota (7)
Austria	270	42	16	27	9	24	9
Bahrain	10	--	3	--	--	--	3
Belgium	650	61	9	38	24	47	7
Brazil	440	299	68	19	6	286	65
Canada	1,100	708	64	120	16	604	55
Ecuador	33	18	54	3	1	16	48
France	1,500	738	49	60	32	710	47
Germany	1,600	54	3	--	63	117	7
Ireland	121	67	55	17	2	52	43
Japan	1,200	159	13	141	40	58	5
Kuwait	65	8	13	--	2	10	15
Luxembourg	20	15	75	3	--	12	60
Malta	16	5	33	3	--	2	13
Netherlands	700	219	31	58	19	180	26
Norway	240	125	52	19	5	111	46
Qatar	20	4	18	1	1	4	18
Sweden	325	186	57	31	5	160	49
United Arab Emirates	15	1	6	--	2	3	20
Venezuela	330	42	13	33	11	20	6
	8,655	2,751	32	573	238	2,416	28
United States	6,700	3,863	58	586	112	3,389	50
	15,355	6,614	43	1,159	350	5,805	38

1/ As of May 31, 1976, adjusted for actual and advised Fund transactions through June 11, 1976, on which date the Executive Directors considered the existing currency budget.

Table 4. Possible Sales of Currencies Not Presently Used in Fund Transactions[1]

(In millions of SDRs)

	Gold and foreign exchange holdings[2]	Quota	Fund's holdings of currencies[3]	
			Amount	Per cent of quota
Colombia	546	157	118	75.0
Fiji	86	13	10	75.0
Gabon[4]	130	15	11	75.0
Guatemala	377	36	27	75.0
Iran	6,433	192	124	64.6
Iraq	1,958	109	82	75.0
Jordan	387	23	17	75.0
Libyan Arab Republic	1,992	24	18	74.8
Malaysia	1,396	186	132	71.1
Mauritius	107	22	17	75.0
Nigeria	4,934	135	101	75.0
Paraguay	106	19	14	74.9
Saudi Arabia	18,058	134	79	58.9
Singapore	2,647	37	28	74.7
Syrian Arab Republic	958	50	43	85.7
Thailand	1,603	134	100	75.0
Trinidad & Tobago	706	63	47	75.0
Tunisia	281	48	36	75.0
Yemen Arab Republic	420	10	7	75.0
	43,125	1,407	1,011	71.9

1/ These members are those mentioned in the memorandum of June 4, 1976 accompanying the present currency budget as sufficiently strong for their currencies to be sold. India, Spain, and El Salvador were also mentioned as being sufficiently strong. Their currencies are held in excess of quota.

2/ Latest available date; in most cases, May 1976.

3/ As of May 31, 1976.

4/ Subscription not yet paid in full; nevertheless, holdings are shown as 75 per cent of quota.

Mr. Whittome

Office Memorandum

LNH

TO : The Managing Director

DATE: July 2, 1976

FROM : Ernest Sturc

SUBJECT : Adequacy of Global Reserves

I would like to associate myself with the views expressed on the above subject by Mr. Whittome in his memorandum to you of June 28. A discussion of conditionality in the tranches and our whole tranche policy will, in due course, have to be held by the Executive Directors. I believe that a substantial increase in the Fund's quotas, for the reasons mentioned by Mr. Whittome, would ease our task and strengthen our ability to retain a type of conditionality in the use of Fund resources which would substantially contribute toward our effectiveness in helping the international adjustment process and in maintaining a trade and payments system in the world reasonably free of restrictions and discrimination. It would also, in my view, help retain the image of the Fund serving the rich and the poor, the developed and the developing, equally well, and this is especially important with the present tendency to sharpen the polarization among our members propagated with apparent success by the UNCTAD Secretariat and others.

cc: The Deputy Managing Director
Mr. Whittome
Mr. Gold
Mr. Polak
Mr. Del Canto
Mr. Gunter
Mr. Habermeier
Mr. Touré
Mr. Tun Thin
Mr. Green

INTERNATIONAL MONETARY FUND

Mr. Whittome

Attached is draft chapter 2 of the Annual Report (first & second part)

E. Brehmer 6/29

B. Developments in International Liquidity

Reserve Changes in 1975

The value of the official reserves of Fund members and Switzerland, expressed in SDRs, was nearly SDR 195 billion at the end of 1975, a rise of some SDR 14 billion during that year (Table 1).[1/] The rate of increase, about 8 per cent, was less than one half that of the previous year. The pace of growth picked up again in the first quarter of 1976; preliminary figures for that period show an increase of SDR 8.4 billion, which represents an annual rate of 17 per cent. The growth rate for reserves, however, tends to be very uneven from quarter to quarter, as the figures can be strongly affected by seasonal factors and random influences. The latter, including exchange market disturbances in March, appear to have been largely responsible for the recent acceleration.

The rapid accumulation of official reserves in 1974 and 1975 by the Fund members classified as major oil exporters obscures the experience that has been more typical of the vast majority of countries in recent years (Table 2). After the three-year period of global expansion, unprecedented in size, that ended in 1972, the reserves of the non-oil countries as a group have since shown little further growth. The compound rate of increase for the period 1973-75 was less than 2 per cent annually, a

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1/ The term "reserves" used in this chapter refers to countries' official holdings of gold, SDRs, and foreign exchange and their reserve positions in the Fund. A country's reserve position in the Fund is the excess, if positive, of its quota over the Fund's (adjusted) holdings of its currency. Gold is valued at SDR 35 per ounce; foreign exchange balances are valued in SDRs by converting them at parity or central rates for end-1973 and earlier dates (except for floating currencies, for which market rates were used) and at SDR transactions values based on market rates thereafter. (See introductory pages of International Financial Statistics for further explanation.)

figure much the same as that recorded for the decade preceding 1970. For the year 1975 alone, growth for the non-oil group amounted to 2.7 per cent.

Foreign exchange formed the largest component of the overall reserve increase in 1975, as it has in all recent years (Table 3). More noteworthy, therefore, is the role played by reserve positions in the Fund, which in the last two years have more than doubled, from an aggregate of SDR 6.2 billion at the end of 1973 to SDR 12.6 billion in December 1975. The increment during 1975 was SDR 3.8 billion; the pace showed no sign of slackening in the first quarter of 1976, when another SDR 1.8 billion was added to the total. Fund-related reserves--SDRs and reserve positions in the Fund--came to exceed 10 per cent of members' total reserve holdings for the first time during 1975, and by March 1976 the proportion was approaching 12 per cent.

The rise in the foreign exchange component, in fact, was due almost as much to the appreciation in the value of the U.S. dollar in terms of the SDR as it was to balance of payments transactions; that appreciation amounted to 4.5 per cent from the end of 1974 to the end of 1975. Since the stock of foreign exchange holdings reached SDR 138 billion at the end of 1975, with at least four fifths of those holdings denominated in U.S. dollars, the increase in the SDR value of the dollar (net of the loss in value of some other currencies in which reserves are held) is estimated to have accounted for some SDR 4.2 billion of the total increase of SDR 10.6 billion in foreign exchange during 1975 (Table 4). A further appreciation of over

1 per cent occurred in the first quarter of 1976, contributing perhaps SDR 1 billion to the reserve increase for that quarter.[1/]

The combined reserves of the industrial countries, which had remained rather stable in the preceding two years, rose by SDR 6 billion in 1975, equivalent to an annual rate of 6 per cent. This development was accentuated in the first quarter of 1976, when the increase came to SDR 5.5 billion. Although the magnitude of the increase was similar in the two periods, the experience of individual countries was widely different. In 1975, Austria, France, Sweden, and Switzerland showed gains ranging upward from SDR 1 billion, the highest being that of France with SDR 3.5 billion. Large declines were limited to two countries, the figures being SDR 1.6 billion for Italy and SDR 1 billion for the United Kingdom. Among the other industrial countries, gains of SDR 0.5 billion or less predominated over a few negligible losses.

The only industrial country to show a significant decline in the first quarter of 1976 was France, for which the previous year's large increase was partly offset by the loss of SDR 1.1 billion. In contrast, notable increments accrued to Germany and Japan (SDR 3.5 billion and SDR 1.3 billion, respectively), while more moderate gains were once again the most

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1/ The value of the stocks of official foreign exchange holdings changes in terms of SDRs not only because of transactions in these assets but also because of changes in the SDR value of the currencies in which they are originally expressed. As from end-July 1974, non-dollar foreign exchange is converted to U.S. dollar equivalents at end-of-month market rates or, in the absence of market rate quotations, at other prevailing official rates. The totals in U.S. dollars are then converted into SDR equivalents at U.S. dollar/SDR transactions value. (See introductory pages of International Financial Statistics for further explanation.)

common experience among other industrial countries. The currencies of all of the countries in this group are floating, and a main cause of the reserve changes, both in 1975 and the first quarter of 1976, was intervention from time to time in the exchange markets. Several countries also engaged in foreign borrowing to augment their reserves or to prevent them from declining more sharply.

Among the developments affecting the less developed primary producing countries, reference has already been made to the large increase in reserve holdings for the major oil exporting countries as a group. That increment, was cut, however, from SDR 26.8 billion in 1974 to SDR 10.4 billion in 1975, as a sizable reduction in exports coincided with an expansion in those countries' imports. Indeed, the reserves of at least six countries in the group showed a decline, while the only increases that exceeded SDR 0.5 billion among the remaining countries were those for Iran (SDR 0.6 billion), Saudi Arabia (SDR 8.3 billion) and Venezuela (SDR 2.2 billion).

The reserves of the less developed primary producing countries other than the major oil exporters decreased by SDR 0.4 billion. Although the decline amounted to less than 2 per cent of these countries' total reserves, it was the first actual attrition in any year since the 1961-62 period. After that time, the group's holdings as a proportion of the worldwide total went up to a peak of 16 per cent at the end of 1973; developments in the following two years brought this ratio down again to 13 per cent.

The more developed primary producing countries experienced a decline in official reserves in both 1974 and 1975. From a high point of nearly SDR 20 billion at the end of 1973, the aggregate reserves for this group were down to SDR 15.3 billion two years later. This unfavorable tendency was widely shared throughout the group; the only major exceptions were Ireland and Malta, each of whose holdings showed an increase of more than 50 per cent during the 1974-75 period.

The country distribution of reserve increases and decreases is one factor that has a bearing on the composition of net reserve changes, because various countries' preferences for one or another type of reserves can be quite different (Table 5). These preferences as to form of holdings in turn determine the effect that any appreciation (or depreciation) of currencies in which foreign exchange holdings are denominated relative to the SDR as the unit of account will have on given countries. Finally, the availability of alternative means for financing payments deficits, apart from any preference for one form or another that deficit countries may have, has an impact on the particular type of reserve that figures in a change in the aggregate of all reserves.

The major oil exporting countries, to which reserve increases through transactions during 1975 mostly accrued, tend to place a large part of their surplus foreign exchange earnings in the Euro-dollar market. The addition by these countries to their Euro-dollar holdings that has been identified was nearly SDR 7 billion in 1975. Some of the countries in this group, including some that experienced a decline in their overall reserves, reduced their holdings of sterling claims on the United Kingdom.

The group's reserve position in the Fund increased by SDR 2.5 billion, reflecting in large part Fund borrowings under the oil facility.

The industrial and more developed primary producing countries hold large amounts of dollar-denominated foreign exchange. These countries experienced an appreciation in the SDR value of such holdings in 1975, which in fact was the major source of increase in reserves for this group. Net transactions were confined virtually to an increase of reserve positions in the Fund, which came about from the Fund's use of their currencies, both from its holdings and from borrowings.

Table 1. Official Reserves, End of Years 1955-75 and End of March 1976 1/

(In billions of SDRs)

	Gold	SDRs	Reserve Positions in Fund	Foreign Exchange 1/	Total 1/
1955	35.0	--	1.9	18.1	55.0
1956	35.7	--	2.3	19.2	57.1
1957	36.9	--	2.3	18.4	57.7
1958	37.6	--	2.6	18.5	58.7
1959	37.6	--	3.3	17.5	58.3
1960	37.7	--	3.6	19.9	61.2
1961	38.6	--	4.2	20.5	63.3
1962	38.9	--	3.8	21.3	64.0
1963	39.8	--	3.9	24.1	67.9
1964	40.5	--	4.2	25.6	70.3
1965	41.5	--	5.4	25.4	72.3
1966	40.7	--	6.4	26.1	73.2
1967	39.4	--	5.7	29.3	74.4
1968	38.7	--	6.5	32.5	77.8
1969	38.9	--	6.7	33.0	78.7
1970	37.0	3.1	7.7	45.4	93.2
1971	35.9	5.9	6.4	75.1	123.2
1972	35.6	8.7	6.3	95.9	146.5
1973	35.6	8.8	6.2	102.0	152.6
1974	35.6	8.9	8.8	127.0	180.3
1975	35.5	8.8	12.6	137.6	194.5
March 1976	35.3	8.8	14.5	144.3	202.9

Source: International Financial Statistics.

1/ Official reserves of Fund members and Switzerland. The figures for 1973 include official French claims on the European Monetary Cooperation Fund.

Table 2. Distribution of Reserves, End of Years 1950, 1960, and 1970-75 and End of March 1976 1/

(In billions of SDRs)

	1950	1960	1970	1971	1972	1973	1974	1975	March 1976
Industrial countries									
United States	24.3	19.4	14.5	12.1	12.1	11.9	13.1	13.6	14.2
United Kingdom	4.8	5.1	2.8	8.1	5.2	5.4	5.7	4.7	5.1
Subtotal	29.1	24.5	17.3	20.3	17.3	17.3	18.8	18.2	19.4
Belgium	0.8	1.5	2.8	3.2	3.6	4.2	4.4	5.0	4.6
France	0.8	2.3	5.0	7.6	9.2	7.4	7.2	10.8	9.6
Germany, Federal Republic of	0.2	7.0	13.6	17.2	21.9	27.5	26.5	26.5	30.0
Italy	0.7	3.3	5.4	6.3	5.6	5.3	5.7	4.1	4.2
Netherlands	0.5	1.9	3.2	3.5	4.4	5.4	5.7	6.1	6.3
Switzerland	1.6	2.3	5.1	6.4	7.0	7.1	7.4	8.9	8.6
Other industrial Europe 3/	0.5	1.8	3.8	4.9	6.0	6.9	6.6	9.1	9.5
Subtotal, continental industrial Europe	5.2	20.1	39.0	49.1	57.6	63.8	63.3	70.4	72.9
Canada	1.8	2.0	4.7	5.3	5.6	4.8	4.8	4.5	5.0
Japan	0.6	1.9	4.8	14.1	16.9	10.2	11.0	10.9	12.3
Total, industrial countries	36.8	48.5	65.8	88.8	97.5	96.0	97.9	104.1	109.6
Primary producing countries									
More developed countries									
Other European countries 4/	1.6	2.3	5.6	8.0	11.7	13.4	12.3	11.1	11.3
Australia, New Zealand, South Africa	2.1	1.3	3.0	4.2	7.6	6.5	5.0	4.2	4.6
Subtotal, more developed primary producing countries	3.7	3.6	8.5	12.1	19.4	19.9	17.2	15.3	15.9
Less developed countries									
Major oil exporting countries 5/	1.3	2.4	5.2	8.0	10.3	12.4	39.2	49.6	49.9
Other Western Hemisphere 6/	2.4	2.2	4.3	4.4	7.3	9.7	9.1	7.6	7.9
Other Middle East 7/	1.1	0.7	1.6	2.0	2.6	3.6	4.0	4.5	4.6
Other Asia 8/	3.7	2.7	5.8	6.3	7.6	8.8	10.5	11.2	12.7
Other Africa 9/	0.6	0.9	1.9	1.6	1.9	2.2	2.4	2.2	2.3
Subtotal, less developed countries 10/	9.8	9.0	18.9	22.3	29.7	36.6	65.1	75.2	77.4
Total	50.3	61.2	93.2	123.2	146.5	152.6	180.3	194.5	202.9

Source: International Financial Statistics.

1/ A minor difference between these data and those published in IFS is noted in Table 1, footnote 1. Totals may not add because of rounding and because some totals include unpublished data for component areas.

2/ The value of the official French reserve stock, at end-1975 and end-March 1976, as shown in this table, differs from that published in official French statistics because, since January 1975, France has adopted a system of valuing gold based on market prices.

3/ Austria, Denmark, Luxembourg, Norway, and Sweden.

4/ Finland, Greece, Iceland, Ireland, Malta, Portugal, Spain, Turkey, Yugoslavia, and, beginning in 1972, Romania's reserve position in the Fund and holdings of SDRs.

5/ Algeria, Ecuador, Indonesia, Iran, Iraq, Kuwait, the Libyan Arab Republic, Nigeria, Saud Arabia, Trinidad and Tobago, Venezuela, and, beginning in 1960, Gabon, in 1965, Bahrain, in 1966, Qatar, in 1970, Oman, and in 1973, the United Arab Emirates.

6/ Argentina, Bolivia, Brazil, Central America, Chile, Colombia, the Dominican Republic, Guyana, Haiti, Jamaica, Mexico, Panama, Paraguay, Peru, Surinam, Uruguay, and beginning in 1966 Barbados, and in 1968, Bahamas and the Netherlands Antilles.

7/ Cyprus, Egypt, Israel, Jordan, Lebanon, the Syrian Arab Republic, and beginning in 1965, the People's Democratic Republic of Yemen, and in 1973, the Yemen Arab Republic.

8/ Afghanistan, Burma, the Republic of China, Fiji, India, Korea, Lao People's Democratic Republic, Malaysia, Nepal, Pakistan, the Philippines, Singapore, South Viet-Nam, Sri Lanka, Thailand, Western Samoa, and, beginning in 1973, Bangladesh.

9/ African Fund members other than Algeria, Gabon, the Libyan Arab Republic, Nigeria, and South Africa.

10/ Includes residual.

Table 3. Composition of Reserve Change, 1969-75[1/]

(In billions of SDRs)

	1969	1970	1971	1972	1973	1974	1975
Net annual transactions in reserves							
Gold							
Monetary gold	0.1	0.3	-0.1	0.2	--	--	--
Gold transactions (acquisitions -) by IMF, BIS, and European Fund	0.1	-2.2	-1.0	-0.5	--	--	--
Countries' gold reserves	0.2	-1.9	-1.1	-0.3	--	-0.1	-0.1
Special drawing rights							
Allocation of SDRs	--	3.4	3.0	3.0	--	--	--
IMF holdings of SDRs (increase -)	--	-0.3	-0.2	-0.1	0.1	0.1	-0.1
Countries' SDR holdings	--	3.1	2.8	2.8	0.1	0.1	-0.1
Reserve position in the Fund							
Use of IMF credit	0.3	-0.8	-1.9	-0.3	-0.1	2.7	3.7
IMF gold transactions (inflow +)[2/]	--	1.6	0.4	0.1	--	--	--
IMF transactions in SDRs (inflow +)	--	0.3	0.2	0.1	-0.1	-0.1	-0.1
IMF surplus (increase -)	-0.1	-1.0	--	--	--	--	--
Reserve positions in the Fund	0.2	1.0	-1.3	--	-0.2	2.7	3.8
Official foreign exchange holdings							
Official claims on the United States[3/]	-1.5	7.8	27.4	10.0	4.7	8.2	2.5
Other official claims	2.1	4.6	6.6	8.7	10.1	17.5	3.9
Official sterling claims on United Kingdom	0.7	0.5	1.7	0.7	0.3	2.7	-1.2
Official deutsche mark claims on the Federal Republic of Germany	0.1	0.8	-0.4	0.1	-0.6	0.2	0.2
Official French franc claims on France	-0.1	0.2	0.2	0.3	0.2	-0.2	0.3
Other official claims on other countries denominated in the claimant's own currency	...[4/]	...[4/]	0.1	-0.1	0.7	-0.4	1.4
Foreign exchange claims arising from swap credits and related assistance	-0.1	-2.2	-0.7	--	0.4	1.2	-0.4
Identified holdings of Euro-dollars[5/]	1.1	5.5	0.8	6.6	5.1	11.3	4.8
Identified official holdings of other Euro-currencies	...[4/]	...[4/]	0.7	2.0	1.7	0.2	1.9
Identified official claims on IBRD and IDA	0.1	0.1	--	--	0.1	--	0.4
Residual 6/	0.3	-0.3	4.2	-0.9	2.2	2.5	-3.5
Total official foreign exchange holdings	0.6	12.4	34.0	18.7	14.8	25.7	6.4
Effect of valuation changes on stock of reserves 7/	-0.1	--	-4.4	--	-8.6	-0.7	4.2
Total reserve change	0.9	14.6	30.0	21.2	6.1	27.7	14.2

Sources: International Financial Statistics and Fund staff information and estimates.

1/ A minor difference between these data and those published in IFS is noted in Table 1, footnote 1. Table 5 provides comparable stock data concerning official holdings of foreign exchange. Note, however, that in some years changes in outstanding stocks do not coincide with the estimated transactions value recorded here because of changes in the relationship between the currency of denomination and the SDR. Footnote 1 to Table 5 notes these cases.

2/ Variations in IMF gold investments and gold deposits are excluded because they do not give rise to net creditor positions in the Fund.

3/ Covers only claims of countries, including those denominated in the claimant's own currency.

4/ The underlying stock data were not available prior to 1970; therefore, the value of transactions in these assets is included with the residuals until 1971.

5/ See Table 5 for more details concerning these Fund staff estimates.

6/ Table 5, footnote 5, provides details.

7/ For explanation, see _____ and Annual Report, 1972, page 25, footnote 2.

Table 4. Composition of Reserve Changes by Area, 1975 1/

(In billions of SDRs)

	Industrial and More Developed Primary Producing Countries		Less Developed Primary Producing Countries		
	United States	Other countries	Major oil exporting countries	Other countries 2/	Total
Net transactions in reserves					
Gold	--	--	--	--	-0.1
SDR holdings	0.1	--	--	-0.1	-0.1
Reserve positions in Fund	0.4	1.0	2.5	-0.1	3.8
Official foreign exchange holdings 3/	--	0.1	7.0	-0.8	6.4
Official claims on United States 4/	--	3.9	-0.2	-1.2	2.5
Official sterling claims on United Kingdom	--	-0.6	-1.8	1.2	-1.2
Identified official holdings of Euro-dollars	--	0.8	6.7	-2.7	4.8
Residual holdings of foreign exchange 5/	--	-4.0	2.3	1.9	0.3
Effect of valuation changes on stock of reserves 6/	--	2.7	0.9	0.6	4.2
Total reserve change	0.5	3.8	10.4	-0.4	14.2

Sources: International Financial Statistics and Fund staff information and estimates.

1/ Table 3 provides more detailed information on the composition of changes in official reserves of all countries, including comparable data for earlier years.

2/ The transactions values of the components of foreign exchange shown for this group were derived as residuals and therefore include any omissions, errors, and asymmetries included in the transactions values estimated for the other groups.

3/ Area details are based on data provided by those holders of these claims that report this information to the Fund.

4/ Covers only claims of countries, including those denominated in the claimant's own currency.

5/ More details of this residual are provided in Table 3.

6/ For explanation, see _____.

Table 5. Official Holdings of Foreign Exchange, by Type of Claim, End of Years 1969-75 1/

(In billions of SDRs)

	1969	1970	1971	1972	1973	1974	1975
Official claims on United States 2/	16.0	23.8	46.6	56.7	55.4	62.6	68.3
Official sterling claims on United Kingdom	5.2	5.7	7.3	8.1	6.5	8.3	6.4
Official deutsche mark claims on FR of Germany	0.5	1.3	1.0	1.1	0.6	0.8	0.9
Official French franc claims on France	0.4	0.6	0.8	1.0	1.2	1.0	1.3
Other official claims on countries denominated in the claimant's own currency	... 3/	0.8	0.9	0.7	1.4	1.2	2.5
Official foreign exchange claims arising from swap credits and related assistance	2.8	0.7	--	--	0.4	1.6 4/	1.3 4/
Identified official holdings of Euro-currencies							
Euro-dollars							
Industrial countries	2.2	5.1	3.4	5.6	7.3	6.3	6.2
Primary producing countries							
More developed countries	0.6	1.5	1.6	3.1	3.2	2.9	3.7
Less developed countries	2.1	3.7	5.3	9.1	10.2	24.6	30.7
Western Hemisphere	0.6	1.0	1.5	3.5	4.0	5.0	5.7
Middle East	0.4	0.6	1.1	1.9	2.3	14.0	19.9
Asia	0.6	1.1	1.0	2.0	2.7	3.0	3.3
Africa	0.6	1.1	1.6	1.7	1.3	2.6	1.9
Memorandum item: Major oil exporting countries	0.8	1.6	2.8	3.9	4.1	17.5	24.2
Total identified Euro-dollars	4.9	10.4	10.3	17.8	20.8	33.7	40.6
Other Euro-currencies	... 3/	0.3	1.0	3.0	4.7	5.3	6.5
Total identified holdings of Euro-currencies	4.9	10.7	11.3	20.8	25.5	39.0	47.1
Identified claims on IBRD and IDA	0.6	0.7	0.6	0.6	0.6	0.7	1.1
Residual 5/	2.6	1.1	6.6	6.9	10.4	11.8	8.7
Total official holdings of foreign exchange	33.0	45.4	75.1	95.9	102.0	127.0	137.6

Sources: International Financial Statistics and Fund staff information and estimates.

1/ Includes the estimated change in the level of holdings owing to the French franc devaluation in 1969, the general realignment of currencies in 1971, the U.S. dollar devaluation in 1973, and the widespread floating of currencies since 1974.

2/ Covers only claims of countries, including those denominated in the claimant's own currency.

3/ These data were not available prior to 1970; therefore, the figure for 1969 is included with the residual.

4/ Comprises the double deposit arrangement for US$2 billion between the Deutsche Bundesbank and the Bank of Italy.

5/ Part of this residual occurs because some member countries do not classify all the foreign exchange claims that they report to the Fund. It also includes asymmetries arising because data on U.S. and U.K. currency liabilities are more comprehensive than data on official foreign exchange as shown in International Financial Statistics.

Factors Affecting the Adequacy of Reserves

This subsection contains the review of the adequacy of global reserves that the Executive Directors are required to make under Section 10 of the By-Laws of the International Monetary Fund. It deals not only with the topic of reserve adequacy in the narrow sense, namely, with the sufficiency of the existing global volume of reserve assets in matching the global need for reserves, but also with some of its broader aspects. These include the effects on reserve adequacy of the distribution of reserves among countries, the asset composition of a given reserve volume, the availability of public and private liquid resources other than reserves, and the adaptability of the supply of reserve assets to the existing demand.

The diversity of exchange market behavior, discussed in Section A of this chapter, that characterizes present international monetary arrangements and is also envisaged under the regime of the amended Article IV of the Fund Agreement is reflected in a corresponding diversity among countries in the use of international liquidity and the role of reserve holdings. As a result, it is now more difficult to apply the concept of adequacy of global reserves than in the 1960's, when it was first formulated.

Quantitative assessment of changes in the degree of reserve ease was in part based on the behavior over time of the ratio of reserves to imports. Even then, in the Bretton Woods system, important differences existed in the attitudes of countries toward the desired speed of balance of payments adjustment, and, indeed, toward the magnitude of payments imbalances they would allow to occur, as well as in their access to international borrowing facilities and their willingness to use them. These divergencies resulted in different reserve needs relative to

imports and, therefore, in differences in the normal ratios of reserves to imports. Nevertheless, common adherence to the par value system and the inability or disinclination of many countries to have recourse to international capital markets for financing external deficits determined a relatively narrow range for the presumptive ratio of reserve needs to imports. In these circumstances, it was plausible to assume that future reserve needs would bear a similar relation to estimated future imports as past actual reserves did to past imports, except where deviations of past ratios of reserves to imports from the normal range pointed to instances of excessive reserve holdings or to shortfalls.

At present, a greater divergence among countries can be expected in the relation between reserve needs and imports, partly because use of reserves for the financing of payments disequilibria plays a different role in the balance of payments policy of different countries and partly because certain other functions of reserve holdings have become important for some countries, though not for others.

The majority of Fund members continue to peg their currencies to one of a number of major currencies, to the SDR, or to a similar composite. Their reserve needs in relation to expected external imbalances have probably not changed drastically from those experienced under the par value system, except that some reduction in need may be implied by two developments: the first is the greater readiness to alter the peg in response to exchange market or balance of payments developments in comparison with attitudes prevalent under the par value regime; the second is the rapid growth in recent years of international borrowing facilities and the willingness of countries to make use of them.

The currencies of a number of countries (at the latest count about 30 countries with 73 per cent of the world reserves at the end of 1975), including those

of the largest Fund members, are floating, however, and their need to hold reserves for the purpose of financing future balance of payments deficits is likely to be smaller than it used to be when these countries still adhered to the par value system. Members participating in the European narrow margins arrangements (accounting for 22 per cent of world reserves at the end of 1975) are classified as having floating currencies; nevertheless, their reserve needs arising from transactions within the group of participants are comparable to the needs of countries with pegged rates, and the reduction in their reserve need as a result of floating is confined to that part of the need which formerly arose from their transactions with countries outside the narrow margins arrangements.

Three functions of international reserves beyond that of financing future deficits deserve to be mentioned. First, even when imbalances are intended to be largely financed by compensatory external borrowing and repayment, reserves are still needed in order to establish and maintain international creditworthiness. Second, countries with floating currencies may wish to hold larger reserves than they presently require for the conduct of foreign exchange market intervention because of the possibility that a change in the international monetary system may make it necessary or desirable for them to have command over larger liquid resources. Third, countries that have recently experienced large balance of payments surpluses may hold part of their foreign exchange reserves as a temporary investment of these surpluses pending more permanent placement.

The relations between countries' reserve needs and their imports may thus be neither similar nor constant over time. All the same, the level of imports, taken as representative of external transactions, is a useful indicator of the scale of

reserve needs, especially during a period of rapidly rising values of international transactions. Subject to the qualifications contained in the preceding observations, the evolution of reserve needs may, therefore, be assessed in the light of developments in the ratios of reserves to imports. For all major country groups except oil exporting countries, these ratios were on average much lower in 1974 and 1975 than they had been in the preceding years (Table 6). This decline can be ascribed to the sharp rise from 1973 to 1974 in the value of world imports (measured in SDRs) by 47 per cent, followed by a much smaller increase of 4 per cent from 1974 to 1975, while the yearly average level of world reserves increased during these periods by about 10 per cent and 13 per cent, respectively. As a result, the average ratio of reserves to imports for the world as a whole fell from 33 per cent in 1973 to 26 per cent and 28 per cent, respectively, in 1974 and 1975.

The increase in 1974 and 1975 in the reserve holdings of oil exporting countries relative to the level of their external transactions has no doubt increased the reserve ease experienced by them; in many of these countries, in fact, economic policy was such as to induce rapid balance of payments adjustment ever since the first appearance of large current account surpluses and rising reserves in 1974. For many oil exporting countries this adjustment has progressed to the point where reserves are no longer rising. In any event, at least part of their reserve holdings must be regarded as a temporary investment, and permanent placement of these funds will in due course result in a decline in the ratio of reserves to imports.

The industrial countries as a group reached a substantially lower ratio of reserves to imports in 1974 and 1975 than they had during the entire postwar period.

Table 6. Ratios of Reserves to Imports, 1966-75[1/]

(In per cent)

	World	Industrial countries	Primary Producing Countries		
			More developed	Oil exporters	Other less developed
1966	37	40	31	44	27
1967	36	38	28	46	28
1968	33	34	30	45	28
1969	30	30	30	43	28
1970	29	28	28	44	29
1971	34	34	34	53	28
1972	38	37	48	64	32
1973	33	30	46	59	34
1974	26	21	29	80	25
1975	28	22	25	88	24

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

This is largely the result of a reduction in the ratio for a number of large countries with independently floating currencies, particularly the United States. The non-oil primary producing countries attained ratios that were substantially lower than those of the early 1970's and lower, too, than the ratios experienced during the latter part of the 1960's.

The uniformity among the groups of non-oil countries in the ratios of reserves to imports reached in 1975 is quite remarkable. The industrial countries' ratio of 22 per cent, which, although slightly below the 24-25 per cent ratio of the non-oil primary producing countries, may represent somewhat greater reserve ease, since this group contains a larger proportion of countries with floating rates.

As was discussed in previous Annual Reports, the distribution of reserves among countries affects the degree of global reserve ease afforded by a given volume of reserves. In this connection, it is relevant that almost nine tenths of the global increase in reserves of about SDR 42 billion from end-1973 to end-1975 was accounted for by the group of major oil exporting countries, with the other countries sharing a negligible increase amounting to an average annual growth in their reserves of less than 1½ per cent. The distribution of reserves among industrial countries and among countries within the group of non-oil primary producers has not changed radically, however, during the last two years. While there are large differences in holdings in countries' reserves relative to the level of external transactions, these differences have not increased during the year under review.

Quantitative assessment of the adequacy of the existing volume of reserves is made difficult by the uncertainty surrounding the proper valuation of gold holdings. On the one hand, the difference between the market price of gold and the price at which it is carried in the accounts of most central banks (and shown in the tables of this chapter) points to a greater degree of reserve ease attained at present relative to that of past years than may be indicated by a comparison of present and past ratios of reserves to imports. On the other hand, gold holdings may in present circumstances be a less liquid asset than other components of reserves, since they cannot be readily used at their present market value, so that their effect on the degree of reserve ease should be subject to a suitable discount. It is not clear on balance, then, what adjustment should be made in present circumstances for the fact that reserves are held partly in the form of gold.

A factor continuing to exercise a positive influence on the degree of reserve ease is the adaptability of the supply of reserves to the demand. Widespread use has been made during recent years of the possibilities of influencing reserves through borrowing or through intervention in the exchange market.

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In sum, it is very difficult to assess shifts in the adequacy of global reserves over the past several years in view of the substantial changes that have occurred in exchange rate arrangements, in countries' readiness to borrow in private capital markets, and in the availability of public and private funds for international borrowing. Also important in this regard is the special character of the sharp buildup that has taken place in reserves of the oil

exporting countries. Indeed, because of these developments, the concepts of global "reserve need" and "adequacy of reserves" have suffered in precision and significance.

Nevertheless, certain specific aspects of the situation relating to international reserves merit attention. These may be noted briefly.

First, examination of the relevant data suggests that there was no marked change in the degree of reserve ease from 1974 to 1975. This conclusion derives mainly from the fact that the relationship between reserves and imports did not show substantial change for non-oil member countries as a group. In most of these countries, reserves were relatively flat at a time of little or no increase in the volume of imports because of the international recession. This situation, however, is now changing; with economic recovery in the major industrial countries having gotten under way in the course of 1975, world trade activity is once again in an expansionary phase.

Within the broad category of non-oil member countries, assessment of reserve adequacy is perhaps least difficult for the primary producing group. Countries in this group have for the most part not resorted to floating, and the greater use they are making of the exchange rate as a policy instrument affords them relatively limited relief from balance of payments pressures. Furthermore, borrowing on international credit markets to protect reserves is not a feasible policy for many of these countries, and even those that have used it in the past may not be able to continue using it to the same extent in the future.

For the non-oil primary producing group of countries, therefore, the reduction in ratios of reserves to imports that has occurred in the past few years

would seem to reflect some genuine decrease in reserve adequacy. In this connection, indication of need to conserve official reserves may be found in the recent tendency among these countries toward greater use of import controls and other restraints on current transactions. It may also be significant that in the past year the non-oil primary primary producing countries as a group chose to finance their overall balance of payments deficit almost entirely through the use of conditional liquidity, and only to a very limited extent through the drawing down of owned reserves.

Last year's Annual Report stated that, "In the present situation of considerable uncertainty as to the future development of many of the factors affecting reserve adequacy, the contribution that the Fund could most suitably make to its continued maintenance probably lies in the provision of conditional liquidity." At that time, as the Report observed, the potential volume of conditional liquidity had already been substantially increased during 1974 and 1975. Since then, while the oil facility has lapsed, the compensatory financing facility has been modified so as to provide greater access by members encountering balance of payments difficulties caused by temporary export shortfalls, and there has been a temporary liberalization of the access by members to the Fund's resources through enlargement of the size of each credit tranche by 45 per cent. In the period ahead, there will be a continuing need to assess the adequacy of conditional liquidity provided through the Fund and to keep under review the question of the appropriate relationship between this type of liquidity and official reserves.

Chap-2 (part) Ann Report

Developments in Exchange Rate Arrangements

Exchange Rate Practices

The proposed amendments to the Articles of Agreement, approved by the Board of Governors in April 1976,--and now awaiting acceptance by members--permit countries considerable freedom in their choice of exchange arrangements. Under the proposed Article IV, "exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of the members' choice." In place of formal obligations on exchange practices, the proposed article emphasizes the general obligation of members to follow exchange rate policies compatible with agreed objectives of economic and financial stability and the effective working of the adjustment process.

The formal recognition of greater freedom in choice of exchange arrangements reflects an increasing diversity in members' exchange practices since the adoption of floating by most major countries in early 1973. (See Appendix I, Table I). Last year's Annual Report classified the exchange rate practices of members into five major categories, according to the particular variant of pegging or floating being used. This classification, however, has become less useful, as the variety of specific exchange practices has increased. In principle, a distinction is possible between those countries which prefer to let their exchange rate serve as the instrument to equilibrate the balance of payments, by letting it find

its own level, subject perhaps to smoothing intervention, and those which prefer to rely primarily on the instruments of domestic policy for balance of payments adjustment and would not resort to changes in exchange rates except to correct major disequilibria. No such clear distinction is possible in practice, however, since many members have a policy towards their exchange rate intermediate between these two polar cases. Furthermore, the label applied to a country's exchange arrangement can be a misleading guide to the actual policy being followed. Currencies that are officially floating are often managed (sometimes at the cost of large changes in reserves) to achieve a result that may be little different from formal pegging. Conversely, with countries which maintain a formal peg, frequent adjustments of the peg, or relatively wide margins within which a currency is allowed to fluctuate around its peg, may be used to obviate policy changes or reserve movements that might otherwise have been necessary to maintain the pegged value.

The past year has witnessed a tendency towards greater diversity in exchange rate practices among members, and also some movement towards arrangements which permit greater flexibility in determining rates. For example, a number of countries pegging their currency to that of a single major country, in particular to sterling, experienced difficulty in matching their domestic policies and exchange rate movements to those required by the movements in the peg currency. Among such peggers there was a tendency to alleviate the difficulties of coordinating their policies with those of the country to whose currency they were pegged by switching to a peg on the SDR or on a trade-weighted basket of currencies. In addition, several pegging countries widened the permitted margins of variability for their currency in relation to its peg value. Among countries which pursue mutual

intervention arrangements, tensions developed and resulted, in March 1976, in the termination of the special arrangement between the Benelux currencies and the departure of the French Franc from the European common margins arrangement (the "snake").

The decision on the part of the major industrial countries to permit their currencies to float has been reinforced over the past year by the difficulties of identifying an appropriate pattern of exchange rates for the medium-term and by the fact that this pattern is clearly changing through time. Indeed, as the levels of economic activity and rates of inflation (both realized and expected) have continued to differ among countries whose currencies are floating, frequent exchange rate variations have been a major form of balance of payments adjustment. Even those countries which have attempted through heavy reserve use to manage the development of the exchange rate for their currencies have at times had to allow their rate to change quite substantially.

Experience in the past year has underlined the difficulty of sustaining a particular pattern of exchange rates in the face of strong speculative pressure for change. The existence of formal exchange rate relationships, or the informal pursuit of a target value through rate management, can certainly strengthen a tendency towards stabilizing capital flows when the rate being maintained is judged by the market to be broadly appropriate, and when there is belief in the determination and ability of the authorities to achieve their objective. However, experience has also demonstrated the difficulties of maintaining target exchange rates when the underlying economic and financial policies of the countries concerned are not sufficiently harmonized. In such circumstances, the

observance of margins, or target rates, may serve to focus the attention of market participants on the problems of maintaining a given rate structure, and thus add to pressure in the exchange market.

At the same time as countries have tended to emphasize arrangements which permit more flexibility in rates in response to changes in underlying economic circumstances, there has been a growing recognition that wide fluctuations in exchange rate relationships are undesirable and that efforts must be made at the domesic policy level to help limit such fluctuations. A central theme of the Rambouillet Summit of November 1975 was the need for countries to follow policies that promote the kind of domestic economic conditions which contribute to world monetary stability. The proposed new Article IV on exchange arrangements similarly emphasizes the obligations of member countries to "promote stability by fostering underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."

In order to limit potentially disruptive effects on trade of exchange rate variability, several heavily interdependent European countries have continued their arrangement to limit mutual rate movements within a narrow band which itself floats against other currencies.[1/] When the exchange rate between the currencies of two "snake" members reaches the permitted margin of fluctuation around its parity (2 1/4 per cent), each country agrees to intervene in the currency of the other to prevent further movement; intervention may also take place in dollars. In practice, developments in the exchange markets for currencies of the larger members of the snake have

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1/ The participants in the European narrow margins arrangement as at [May 31, 1976] were Belgium (Luxembourg, Denmark, the Federal Republic of Germany, the Netherlands, Norway and Germany. France, Ireland, Italy and the United Kingdom had previously participated in the arrangement, but had withdrawn.

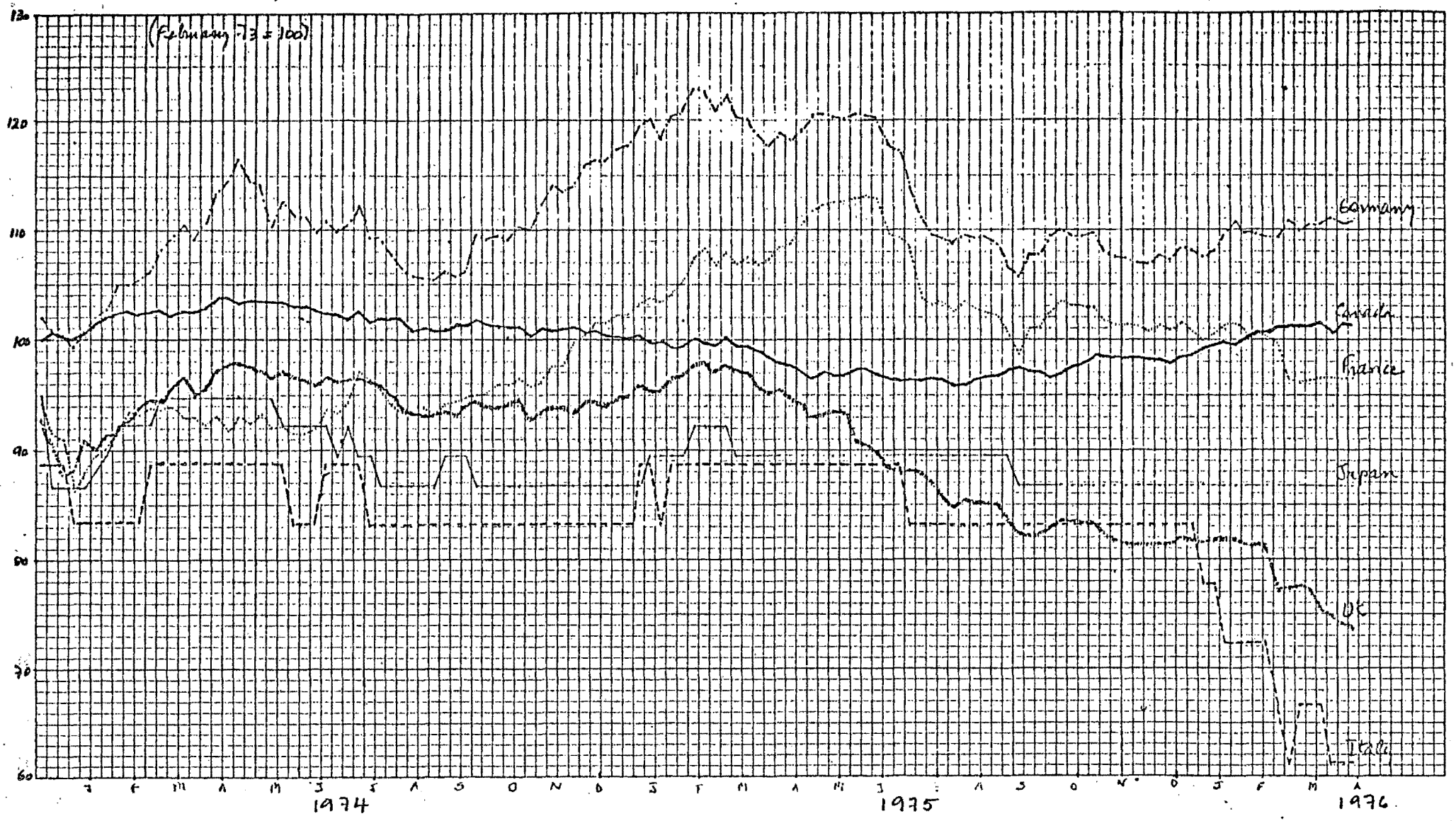
have heavily influenced movements of the snake currencies taken as a group. The same intervention operation will have a greater effect on the exchange rate of a smaller than of a larger country, so that mutual intervention at the margins of the snake will therefore tend to reduce pressure on the smaller countries' currencies rather than on the larger countries' currencies and the snake will tend to float according to pressures put on the larger countries. This conclusion is not substantially altered by the growing importance of intervention in dollars by snake countries.

Exchange Rate Developments

By mid-1976 the major industrial countries had been operating under a more flexible exchange rate regime for a period of over three years. The initial disturbances caused by the collapse of the previous central rate regime and by the immediate balance of payments consequences of the oil price increase had been absorbed. It begins to be possible, therefore, to have more perspective on the characteristics of the present flexible exchange rate regime, and in particular to judge how this regime has developed over time.

Although a majority of member countries continue to peg their currencies in some fashion, the countries allowing their currencies to float dominate world trade and financial transactions. The following analysis will therefore focus on developments in the exchange rates for the currencies of these major industrial countries. Chart 1 shows changes in the dollar value of the six major currencies from 1973 through the first several months of 1976.

EXCHANGE RATES AGAINST THE US DOLLAR.



Although all countries have at times intervened in their foreign exchange market, the degrees of intervention have differed greatly among countries depending on the importance they attach to maintaining a particular average value for their rate and to the avoidance of daily and weekly fluctuations. The snake countries, taken as a group, the United States and Canada have intervened relatively little. France, Italy, Japan and the United Kingdom on the other hand, have engaged in relatively more intervention in an attempt to pursue exchange rate objectives in the face of market pressure which has sometimes been sustained.

The sources of strain in foreign exchange markets over the past year have arisen to a large extent from differences, partly cyclical in nature, in the stance of monetary and fiscal policy among countries. These policies have been determined by a continuing effort on the part of industrial countries to reflate their economies without provoking renewed inflationary pressure.

Because of the importance of exchange rate developments for the efficient working of the adjustment process, the behavior of governments with respect to exchange policies remains a matter for consultation and surveillance in the Fund. Although the proposed new Article IV is not yet formally in effect, it is noteworthy that it contains general obligations relating to the overall economic policies members are expected to pursue, and gives the Fund duties to oversee the compliance of each member, regardless of the particular exchange arrangement it follows, with these obligations. In particular, the Fund is to exercise firm surveillance over the exchange rate policies of members, and to adopt specific principles for the guidance of all members with respect to those policies. These principles have yet to be worked out, and in the meantime, the Fund's surveillance is

based, for members with fixed exchange rates, on the Central Rate decision of December 1971, and for members with floating rates, on the "Guidelines for the Management of Floating Exchange Rates" adopted by Executive Board decision in June 1974. These guidelines focus on three types of exchange rate developments that may be cause for official concern and action:

(1) Erratic short run movements (i.e. day-to-day and week-to-week)

(2) Unduly rapid changes brought about by market pressures over periods of several months or quarters.

(3) Movements that cause exchange rates to deviate substantially from a level considered conducive to medium term equilibrium in the balance of payments.

In basing surveillance on these guidelines, the Fund is expected also to have regard for the effect of intervention on members' reserve positions and for the interest issuing countries have in intervention conducted in their currencies by other countries. Furthermore, the guidelines reassert that all countries, whether or not they are floating, should avoid introducing restrictions on current account transactions for balance of payments purposes.

Day-to-Day and Week-to-Week Fluctuations

A tendency towards smaller day-to-day and week-to-week exchange rate fluctuations has characterized the pattern of floating over the past year, by comparison with the previous two years.

The largest daily and weekly fluctuations tended to occur during periods when longer run pressures were also influencing exchange developments. In July 1975, for example, when the snake was experiencing a depreciation

against the dollar, daily changes in the dollar value of the deutschemark were as great as 1.3 per cent, with weekly declines of up to 2.5 per cent. Both of these maximum changes were, however, less than those observed during comparable periods of overall exchange rate adjustment in mid-1973 and mid-1974.

In addition, the pattern of daily changes over the past year has differed somewhat from that of previous periods of substantial exchange rate movement. Daily fluctuations have usually occurred in the same direction as the longer run movement, and therefore could be considered to reflect less disorderly market conditions than a rapid adjustment to changes in the market's appraisal of basic economic conditions. By contrast, during the strong appreciation of the snake currencies against the U.S. dollar in late 1974 and early 1975, the direction of daily exchange rate movements was more erratic, and therefore more suggestive of disorderly market conditions. An exception to this pattern is to be found in the experience of those currencies, particularly the lira and the pound sterling, for which the exchange rate was maintained relatively stable for a substantial period of time, despite unfavorable domestic price developments. For these currencies, when market developments eventually forced an adjustment in the exchange rate, early in 1976, the size of daily movements in the rate was quite substantial, (though in the case of the Italian lira developments also owed something to political uncertainties.)

An analysis of daily and weekly changes in the dollar value of currencies concentrates attention on a single (albeit important) exchange rate for each currency, and thus does not reflect the impact of fluctuations in other currency relationships. To derive a more general measure of exchange rate variability, it is necessary to compile an exchange rate

measure which expresses the value of a currency in terms of a suitably weighted average of a variety of currencies. Average weekly changes in such "effective" exchange rates for seven major industrial countries are shown in Table 1.[1/]

The table indicates that week-to-week changes have been fairly large over the entire floating period for most currencies, but that there has been some tendency for their size to diminish over the three year period taken as a whole. It can also be seen that average fluctuations have tended to be larger for countries that have suffered chronic balance of payments problems, and which have therefore had to accept substantial realignments in their exchange rate over time. In a number of cases where weekly movements are indicated to be large, this reflects simply a process of readjustment of the rate concerned to a new and more appropriate level.

In principle, the uncertainty introduced into the process of international payments by daily and weekly volatility of spot exchange rates should give rise to a sufficiently large forward market to finance those trade and financial transactions that would otherwise be inhibited by this uncertainty. Although evidence on the efficiency with which forward markets are operating is notoriously difficult to obtain, some indication of the cost of forward cover can be gained from an inspection of the spread between buying and selling rates that banks quote for forward currency. Over the past year, the size of forward bid-ask spreads has decreased somewhat, although there have tended to be sharp widenings of the spread during periods of relatively greater exchange rate uncertainty. In March 1976, for example, the spread

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1/ The weights used in calculating the effective exchange rates used in Table 1 are from the Fund's multilateral exchange rate model, as described below. For short term movements in exchange rates, alternative weighting schemes show a very similar pattern.

Table 1.

Average Weekly Changes in Selected Effective Exchange Rates
1973-First Quarter 1976

(In per cent)

Country	1973		1974				1975				1976
	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter
Canada	0.23	0.24	0.42	0.23	0.39	0.23	0.30	0.32	0.29	0.26	0.31
France	0.93	0.58	0.93	0.67	0.66	0.53	0.39	0.46	0.60	0.29	0.46
Germany, Fed. Rep. of	1.32	0.47	0.71	1.10	0.46	0.67	0.56	0.34	0.51	0.35	0.70
Italy	0.82	0.48	0.72	0.67	0.22	0.35	0.22	0.16	0.19	0.11	2.31
Japan	0.55	0.46	1.02	0.52	0.75	0.37	0.47	0.39	0.37	0.21	0.35
United Kingdom	0.82	0.57	1.06	0.38	0.34	0.43	0.31	0.59	0.61	0.24	0.67
United States	0.69	0.55	1.03	0.44	0.50	0.34	0.55	0.22	0.59	0.26	0.26

on both the forward franc and lira with respect to sterling doubled. In comparison with earlier periods of disturbance in foreign exchange markets (for example, late 1973) recent increases in forward spreads have been of smaller magnitude.

Short-term Swings

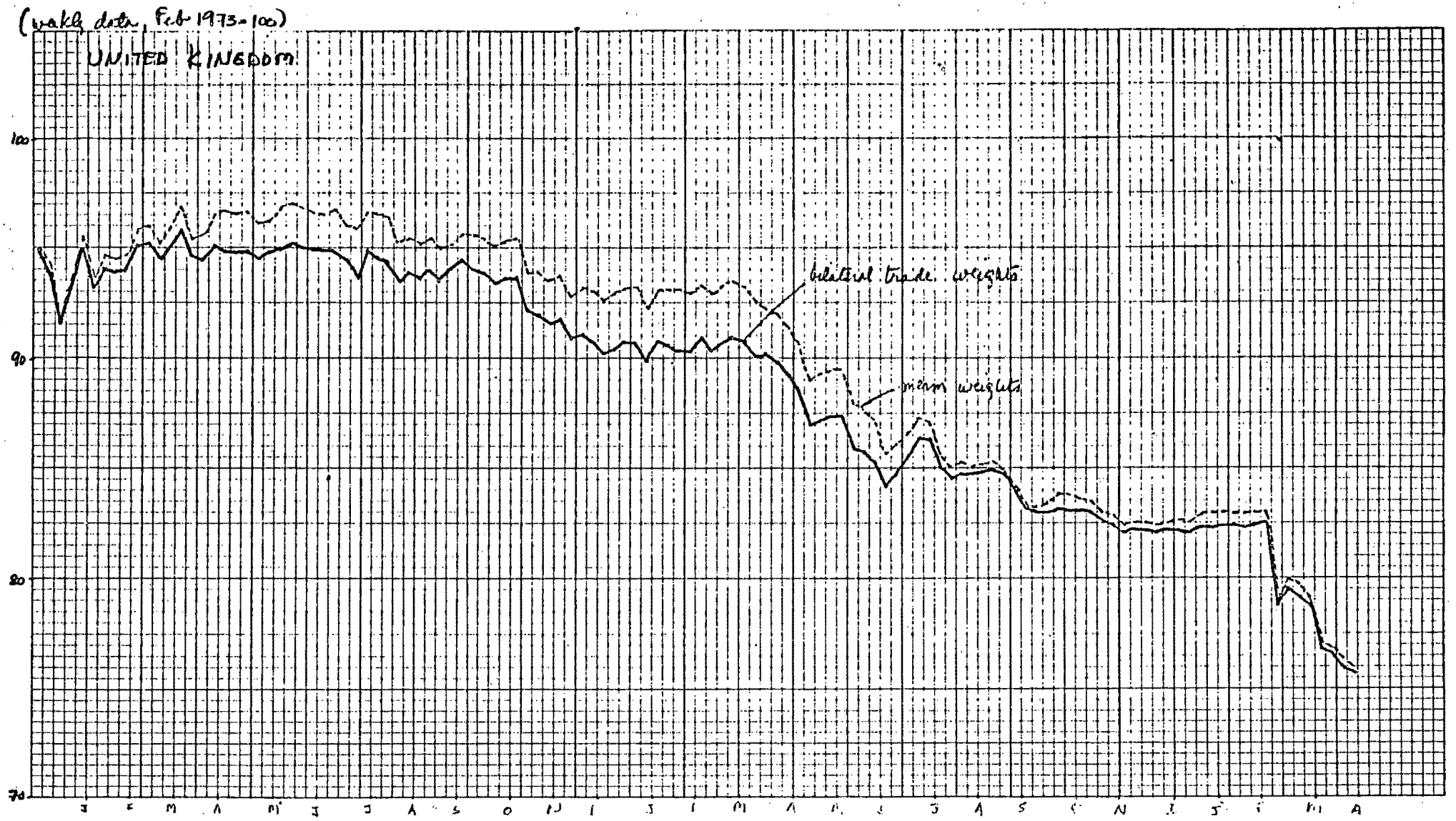
Although the exchange value of currencies of major industrial countries continued to exhibit noticeable swings lasting over a period of a few months or even quarters, the magnitude of these swings tended to be somewhat less over the past year than in the previous two years of floating. Furthermore, the oscillatory character of movements in the dollar/snake rate, which had been a feature of earlier experience with exchange rate flexibility, became less pronounced. Although the reasons for these exchange rate movements have differed from one period to another, some basic kinds of behavior can be identified as the proximate causes for their initiation and duration.

Changes in interest rate differentials between countries and expected returns from exchange rate movements are commonly held to be important influences on capital flows. These factors respond both to underlying economic conditions and to changes in official policies taken in response to such conditions. If there are a sufficient number of transactors willing to invest funds on the basis of their expectations, the effect of changes in policy and interest rate differentials on capital flows and exchange rates should reflect expectations as to the duration and magnitude of the policy change concerned. Whether the policy is expected to be a short-run response to cyclical developments or a more permanent reorientation should determine the extent of exchange rate movement needed to preserve equilibrium in the foreign exchange market.

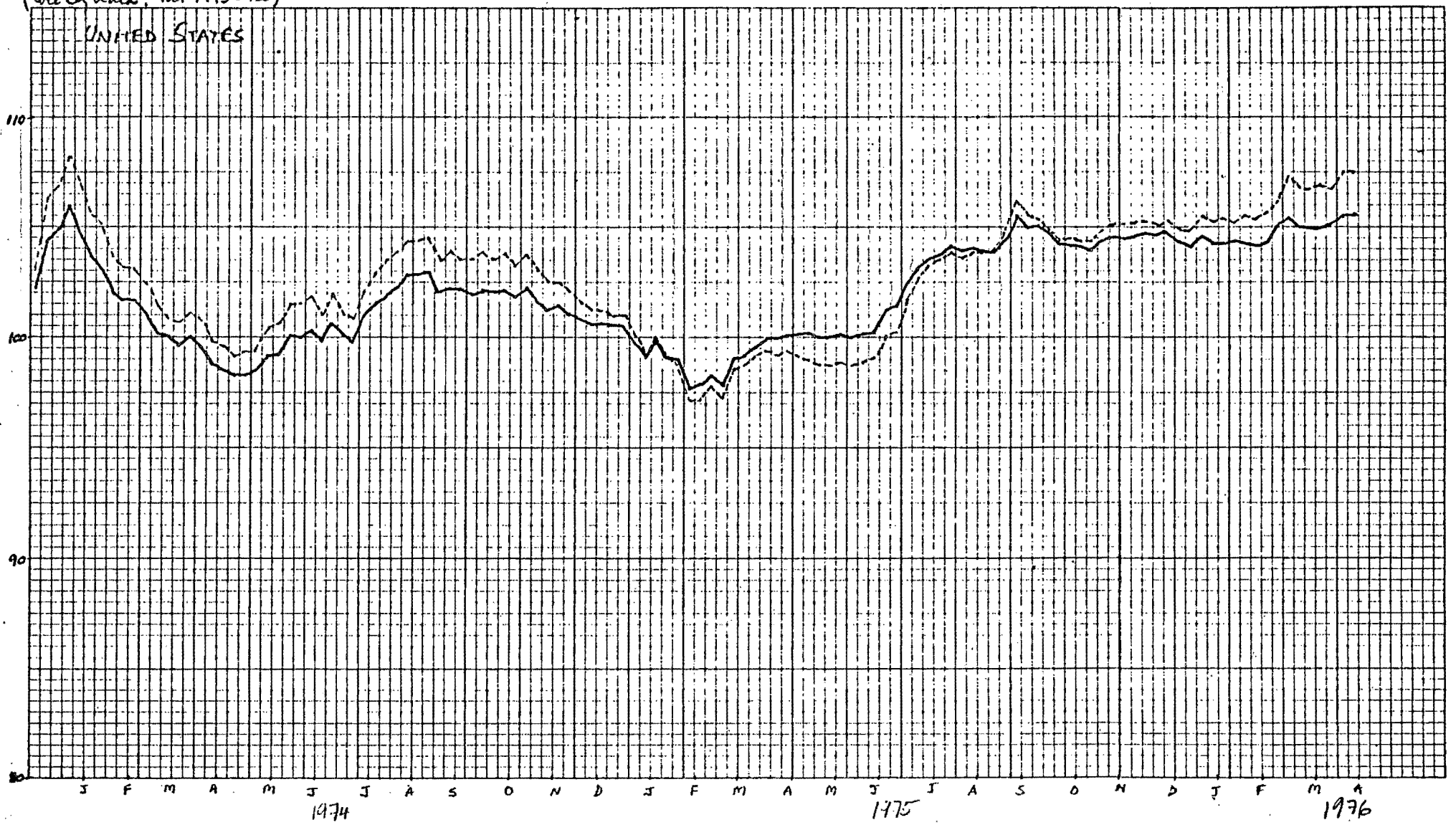
Exchange rates are also affected by a far less concrete group of factors, including the degree of political stability, longer term balance of payments prospects, and each individual country's cyclical outlook. The effect of pressures from such sources is likely to be quite strong in comparison to the effect of interest rate developments as discussed above.

As already pointed out, changes in the market rate for individual currencies against the U.S. dollar are not necessarily the best guide to the overall exchange value of the currencies concerned. Since for most purposes of analysis interest focuses on the implications of exchange rate movements for a country's overall competitive position, the following discussion of movements in individual currencies will be conducted in terms of the effective exchange value of each currency. The indices resulting from two methods of assigning weights to various currencies for the purpose of deriving effective exchange rates are shown in Chart 2. The first (in blue) is from the Fund staff's multilateral exchange rate model which embodies assumptions that attempt to take into account in the calculation of a country's effective exchange rate the commodity composition of its trade, and the relative importance of other countries as trading partners and as competitors in third markets. The second (in black) reflects a weighting scheme based on the relative importance of 27 countries in the bilateral trade of each of the countries for which the index is computed.

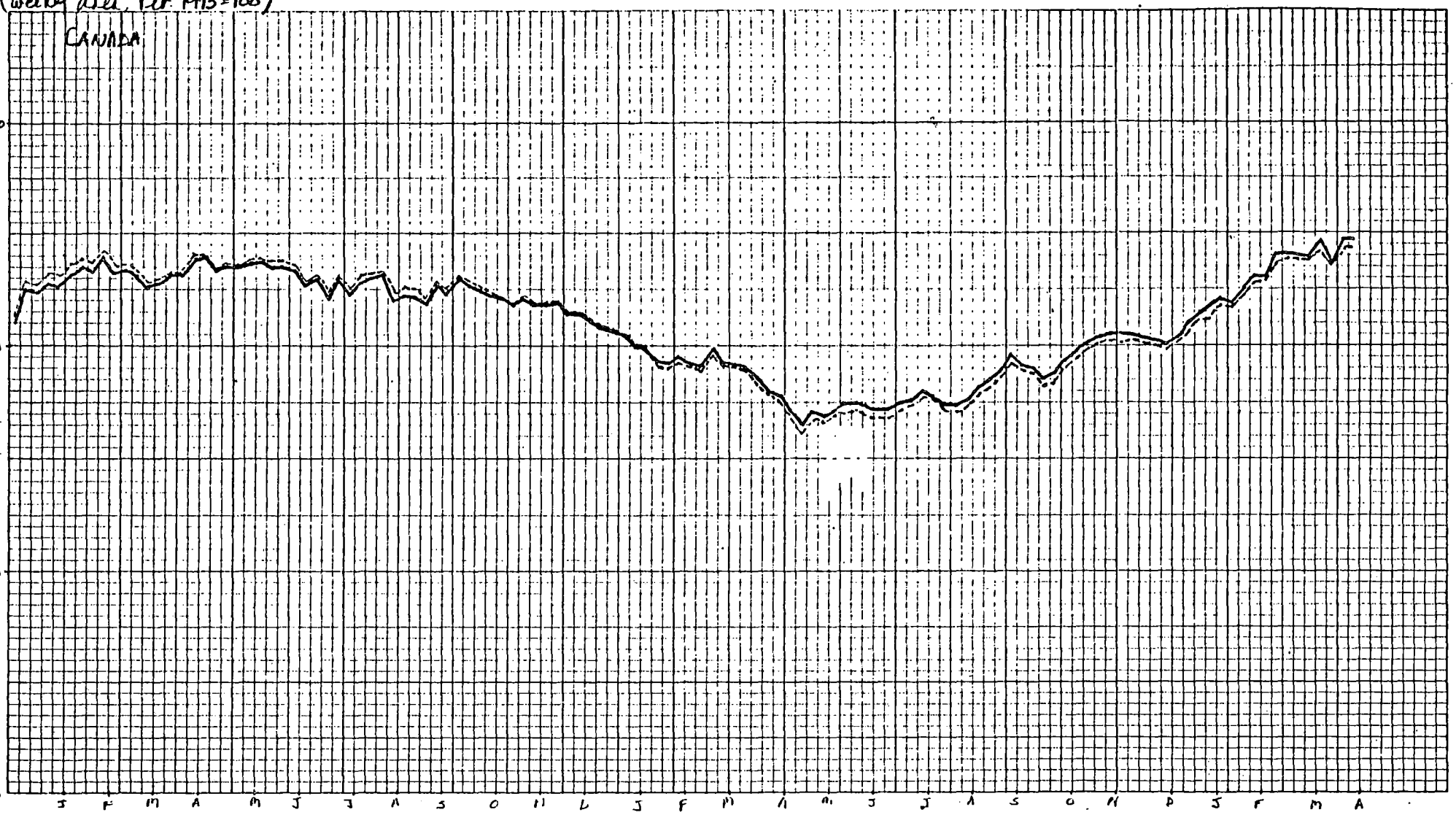
The past year saw a considerable increase in the effective exchange value of the U.S. dollar, with movements in the effective rate being broadly similar under both weighting systems. Since, as noted above, changes in interest rate differentials are generally assumed to be an



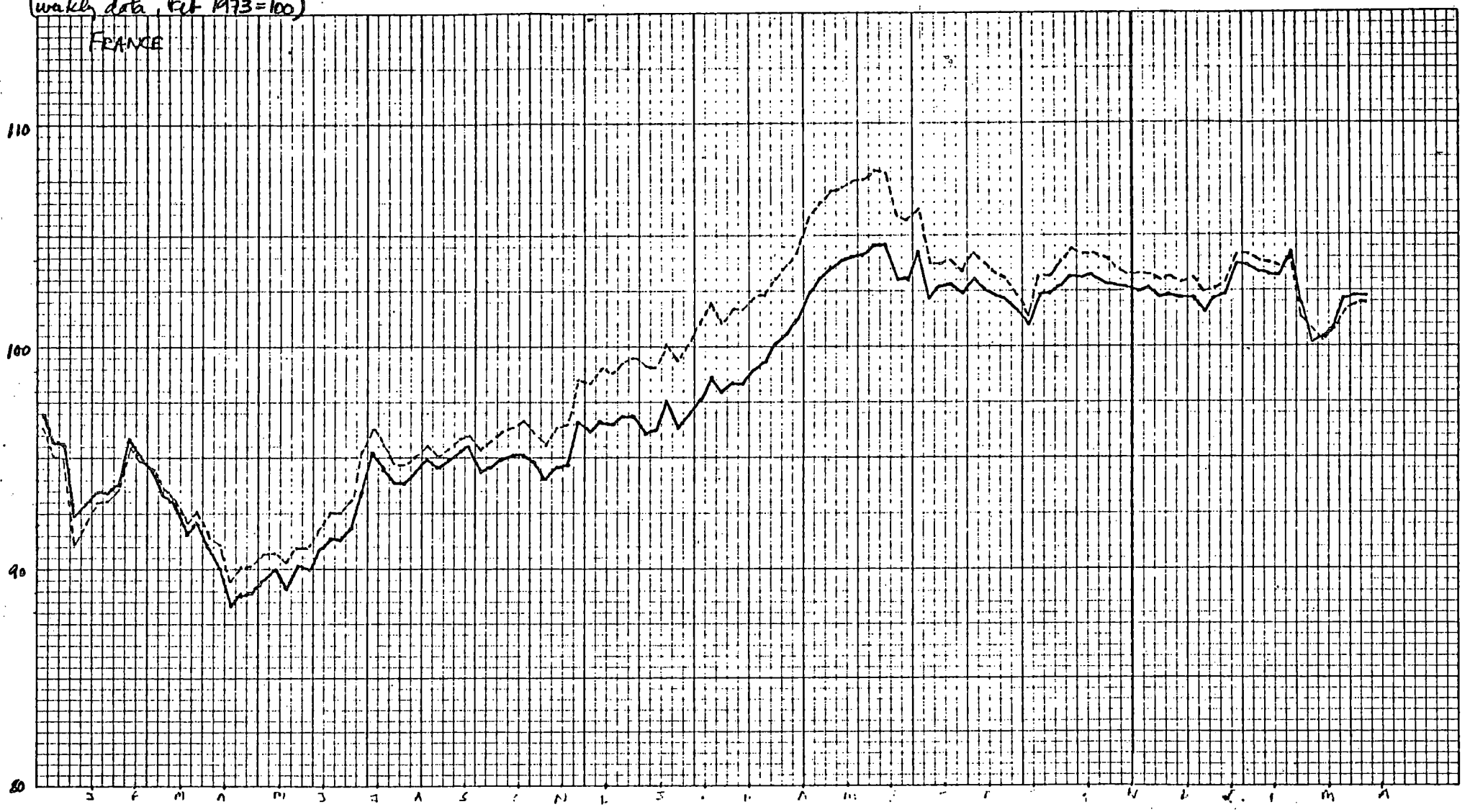
(weekly data, Jul 1973 = 100)



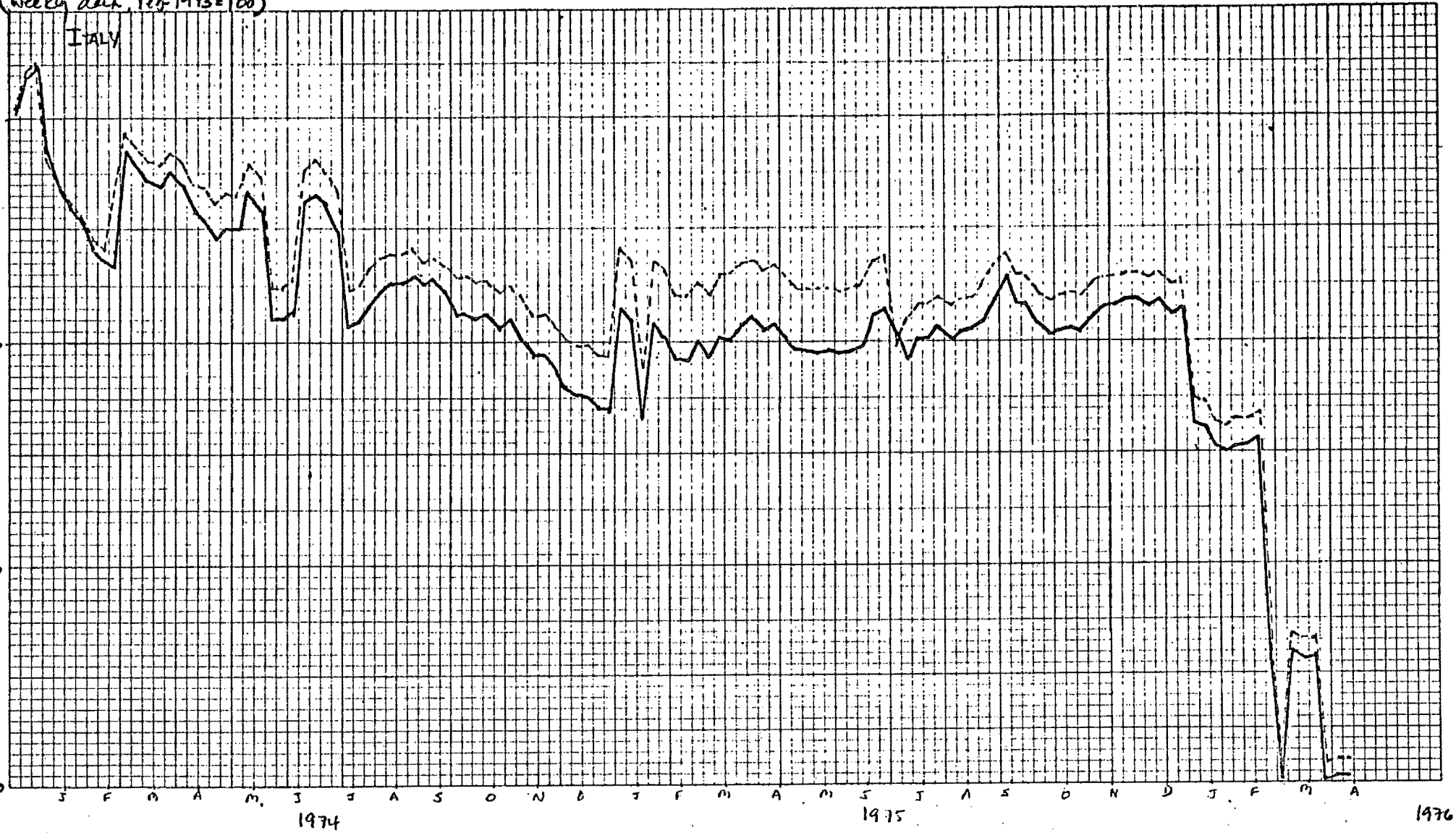
(weekly data, Feb 1973 = 100)



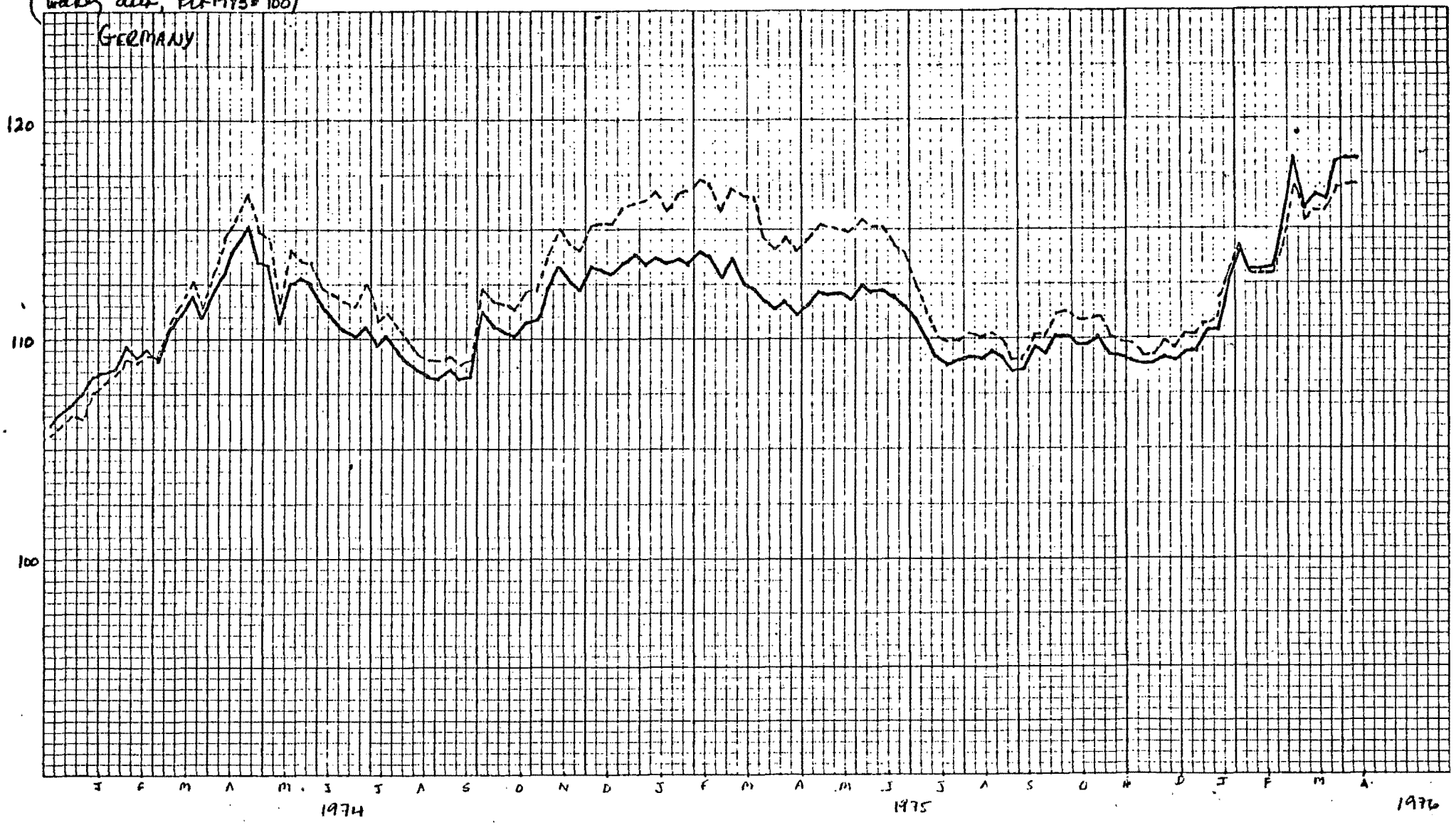
(weekly data, Feb 1973=100)



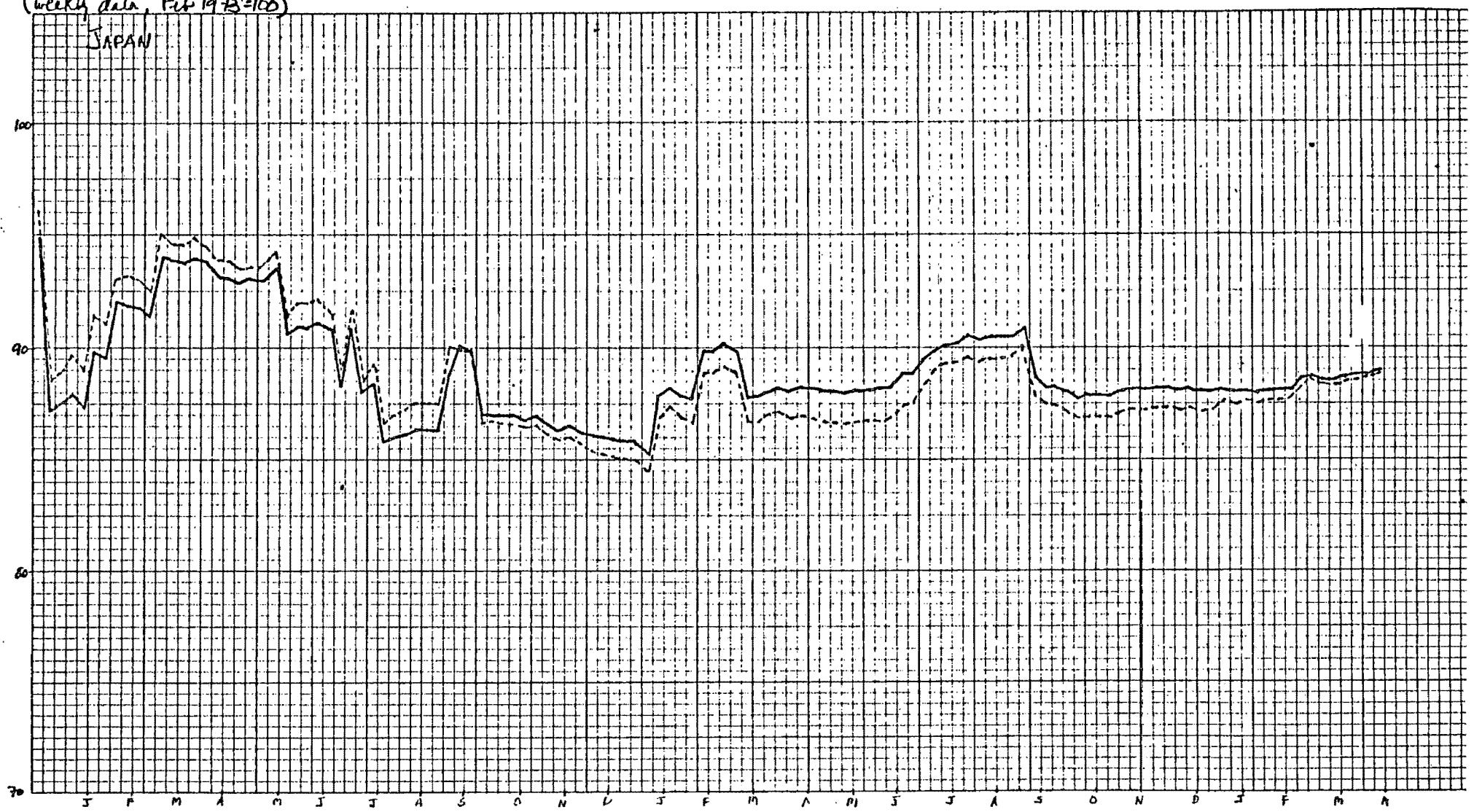
(weekly data, Feb 1973=100)



(weekly data, Feb 1973 = 100)



(weekly data, Feb 1973=100)

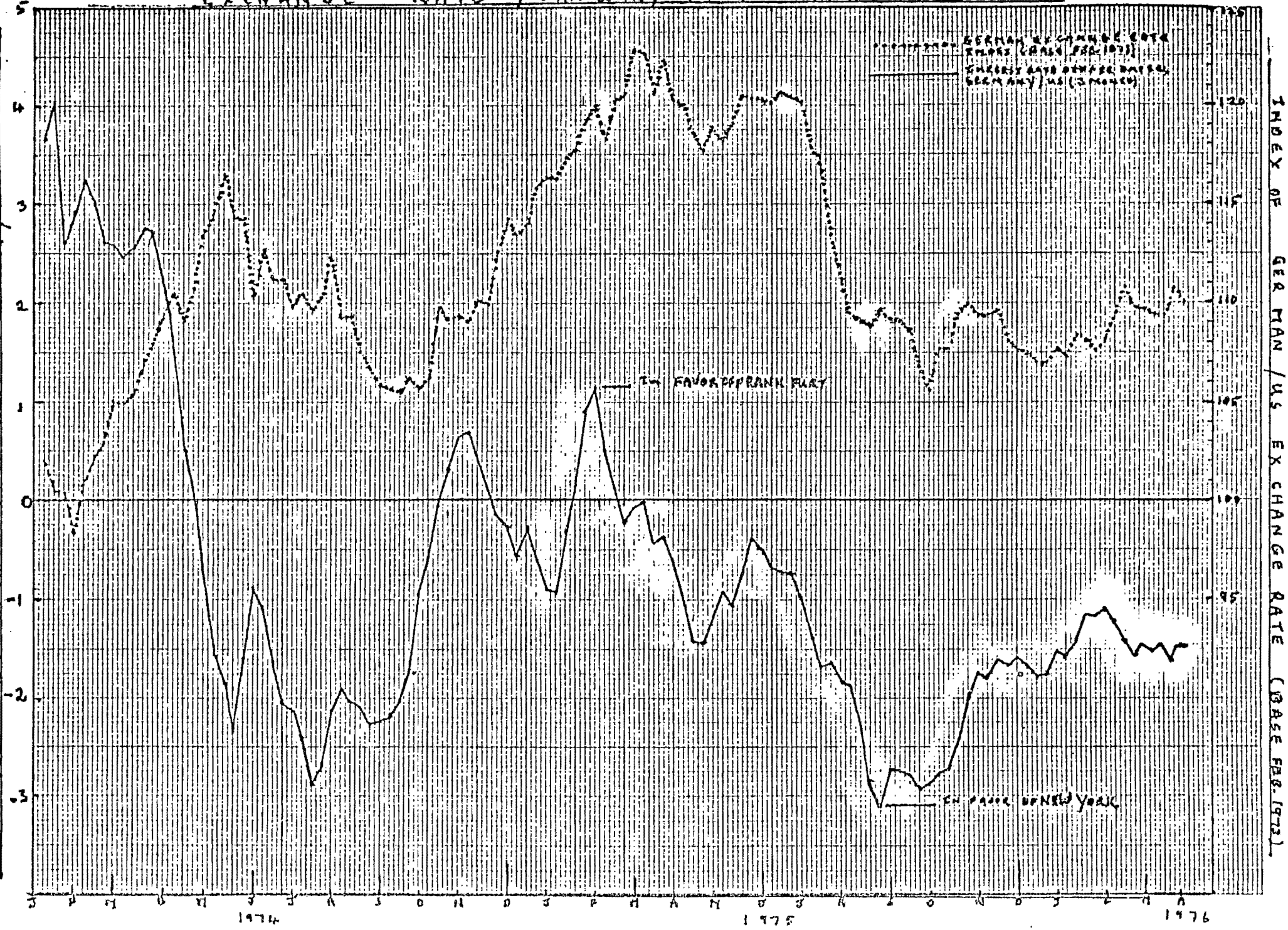


important determinant of exchange rate changes, Chart 3 illustrates the relationship between interest rate differentials and exchange rates for the United States and the Federal Republic of Germany. (The German exchange rate and interest rate are here taken as broadly representative of conditions in the money and exchange markets in the snake countries taken as a group). During 1975 and 1976, the correlation between interest differentials and exchange rates tended to be tighter than in previous periods, when factors other than interest rate change (in particular, reactions to the oil price increase) tended to have greater relative importance. Exchange rate movements from peak to trough and vice-versa have generally been greater than the comparable interest movements.

The strengthening of the U.S. dollar in the middle part of 1975 tan be attributed largely to a change in interest differentials favoring the dollar. Uncertainties connected with the financial situation of the City of New York checked the rise in the dollar in October, and subsequently a narrowing of interest differentials kept its effective exchange rate within a narrow band until early in 1976. Then, the exchange crises which led to substantial declines in the rates for the lira and pound sterling, and which forced the French franc to leave the European snake, caused some further upward movement in the rate for the U.S. dollar. By the end of April 1976, the effective exchange rate for the dollar stood some 7-9 per cent above a year earlier (depending on the index of measurement employed).

In the early part of the year under review, the strength in the effective exchange rate for the dollar was mirrored by a weakness in the effective exchange rate for the deutschemark. The same basic causes can be adduced to explain the changes that occurred, since the exchange rates

SHORT TERM MONEY MARKET RATE DIFFERENTIAL PLOTTED AGAINST EXCHANGE RATE, JANUARY 1974 - MARCH 1976



for the currencies of Germany's other main trading partners were moving in a relatively narrow range. In 1976, however, the sharp falls in the exchange value of the lira and sterling and, to a lesser extent, the French franc, caused a strong upward movement in the effective exchange rate for the deutschemark. This upward movement was considerably stronger than that for the dollar, less because of a change in the dollar/DM rate than because the three European currencies just mentioned have a greater relative importance for the competitive position of Germany. Thus, after falling by about 6 per cent from June to September 1975, the DM remained relatively stable until year-end, and then appreciated by about 7 per cent in the first four months of 1976.

For the smaller members of the European snake arrangement (not shown in Chart 2), effective exchange rates moved narrowly over the year. This is because their effective exchange rates are influenced to a relatively greater extent by movements in the rates of their partner currencies in the snake. However, they too shared in the appreciation resulting from the decline of the lira and pound sterling, and the departure of the French franc from the snake.

The effective value of the pound sterling declined gradually during the early and middle part of 1975--maintaining a fairly constant rate against other European currencies, while these currencies as a group were depreciating relative to the North American currencies and the Japanese yen. When this depreciation ceased, around October 1975, the pound's effective value fluctuated in a fairly narrow range until early March 1976, when a sharp decline began, amounting to about 10 per cent over the following three months. This decline occurred despite heavy intervention to moderate movements in the rate.

The Italian lira, in 1975, followed a middle course between the U.S. dollar and the major European currencies, and hence sustained, on balance, no net depreciation in its effective exchange rate. This stability was achieved despite a relatively high domestic inflation rate, and probably owed much to a better-than-expected current account performance. In early 1976, however, market sentiment turned sharply against the lira, largely due to political uncertainties, and there was a sharp fall in the lira's effective value. The decline was as much as 15 per cent in January, and had reached 25 per cent by the end of April. ...

Movements in the effective rate for the French franc during 1975 and 1976 were dictated by French policy in relation to the franc's membership of the European snake. In the first half of 1975, when the franc was moving towards a return to the snake, there was quite a strong appreciation, amounting to about 9 per cent. Following its return, it declined somewhat over the following three months, along with the other European currencies, and then stabilized until March 1976, when speculative pressure forced its departure again. By end-April 1976, the franc was about 2 per cent below its level two months earlier and was some 5 per cent below its high point the previous June. ...

The Japanese yen fluctuated within a rather narrow range for the entire period under review. Having a market value broadly stabilized in terms of the U.S. dollar, it shared to some extent in the effective appreciation of the dollar in the middle part of 1975, and in response to this the Japanese authorities permitted the exchange rate to adjust downwards by about 3 per cent in mid-September. Thereafter the effective rate remained fairly stable in the rest of the period. ...

The Canadian dollar showed a weakening trend against the U.S. dollar in the early part of 1975, but thereafter strengthened continuously, despite a weak current account, under pressure of strong capital inflows. Since the U.S. dollar dominates the overall effective rate for the Canadian dollar, a similar trend is discernible in movements of the effective rate. By the end-April 1976, this rate was some 7 per cent higher than its low point of August 1975. ...

Exchange Trends and Competitiveness

In the longer run, conditions determining long-term capital flows and the underlying competitiveness of an economy are likely to be the principal factors affecting the trend of exchange rate movements. The extent to which a country attracts long-run capital flows will depend on such factors as location, relative factor costs, and the general orientation of monetary and fiscal policies. The underlying competitiveness of an economy may be altered by exogenous elements such as shifts in demand following taste changes or the development of substitute commodities and the availability of factors of production. For periods in which countries are experiencing inflation at sharply different rates, however, one of the strongest and most systematic influences on exchange rates is likely to come from developments in relative costs of production.

The usefulness of changes in relative costs of production in explaining exchange rate changes depends on the nature of the disturbances that tend to affect economies. If disturbances are of a structural nature, such an approach will not be adequate to explain resulting exchange rate movements. If, however, disturbances tend to be of a monetary nature and affect the balance of payments through the general level of prices, then

movements in relative costs and prices will be a better indication of changes in the equilibrium exchange rate. Of course, the usefulness of such an approach may also be hampered during short periods when persistent capital flows, whether from speculation or government intervention, dominate other factors in determination of the exchange rate.

Chart 4 shows the relationship between the changes in relative rates of inflation and the effective exchange rates for seven major currencies.[1/] The base period for the chart is the first half of 1973; though this cannot of course be taken to mean that the pattern of exchange rates was necessarily in equilibrium at that time. Rates of inflation as measured by GNP deflators are shown to have differed markedly among the seven industrial countries over the past year. While national inflation rates in France, Canada, and Japan have tended to stabilize relative to the average for their main trading partners, the rates for Italy and the United Kingdom were considerably higher than the average, and those for Germany and the United States well below the average.

While quarter to quarter changes in relative prices are only loosely associated with contemporaneous changes in exchange rates, there is a considerably closer relationship over the three year period taken as a whole. The expected negative correlation between relative price movements and changes in exchange rates appears to be strongest for countries with inflation rates that diverge most sharply from the average rate. For example, both the U.K. and Italy experienced a sharp depreciation of their

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1/ An important consideration in the design of Chart 4 is the price index to be used to compare price levels between countries. If an index too heavily weighted with traded goods is used, differentials in production costs may be underestimated because, in the absence of transport costs and trade restrictions, the prices of traded goods tend not to differ between countries. From this point of view, the GNP deflator, by relating to as general a range of goods and services as possible and being highly comparable across countries, is the best index to use.

CHART 4 PAGE 1

JAPAN

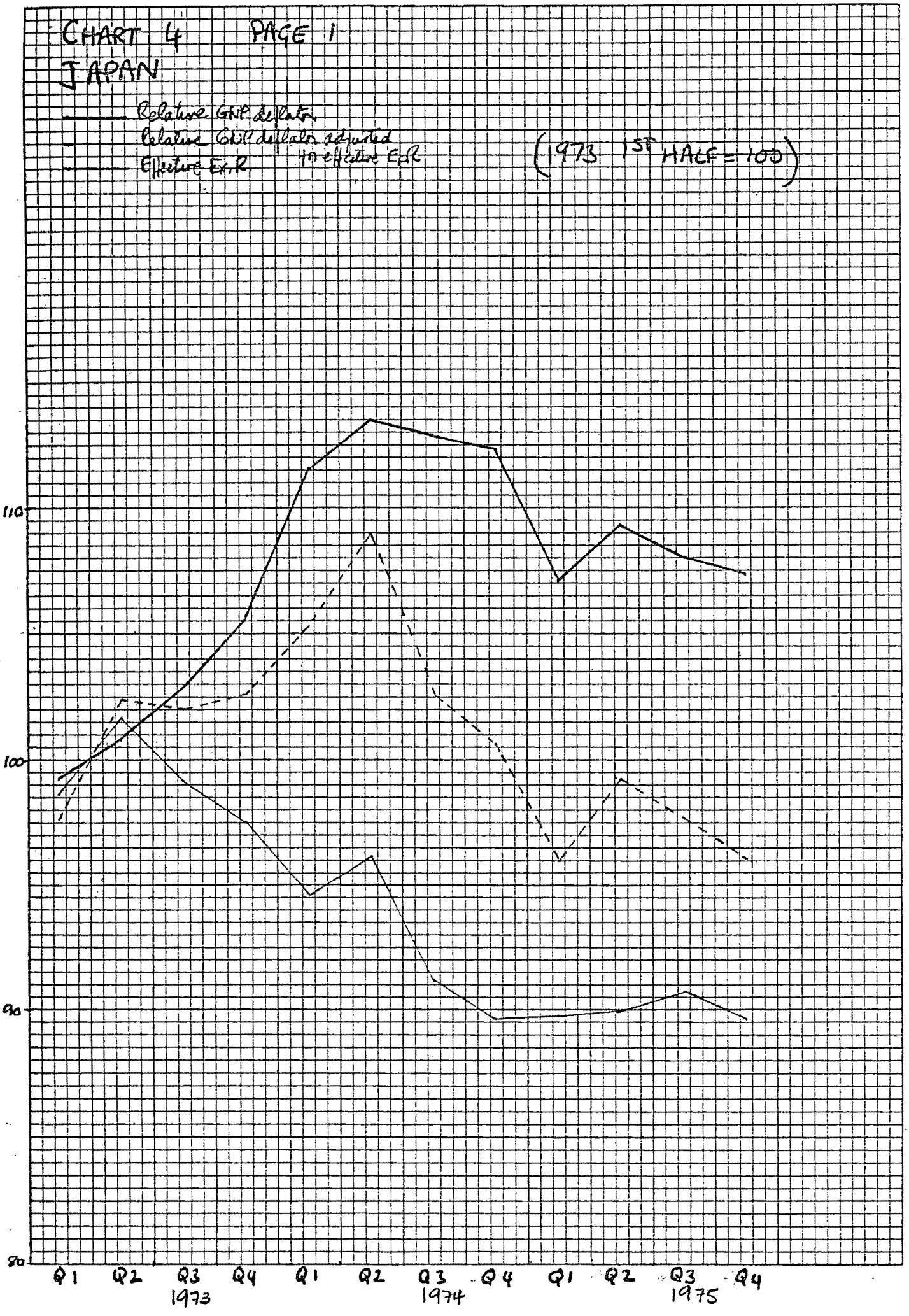


CHART 4 PAGE 2

UNITED KINGDOM

(1973 FIRST HALF = 100)

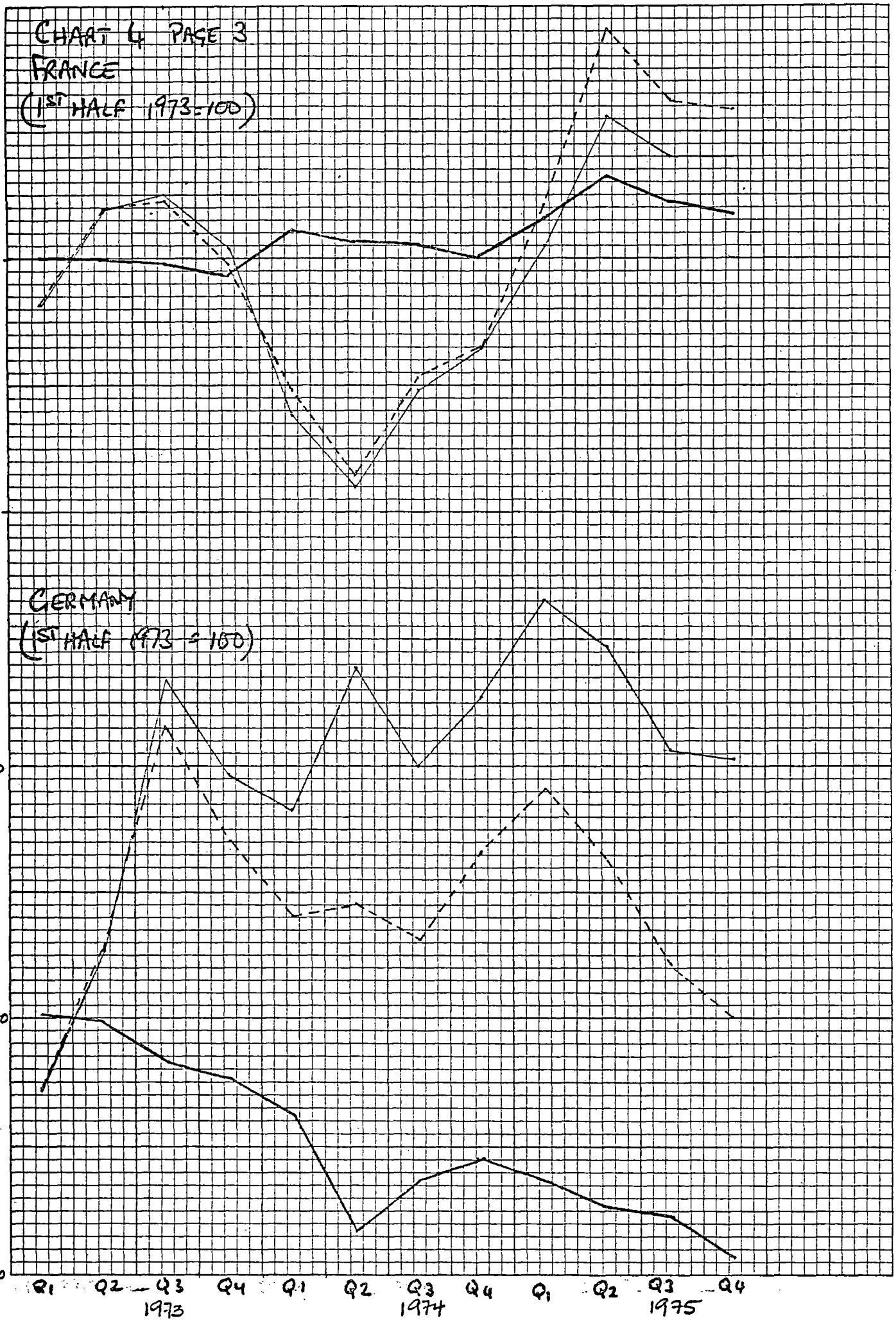


CHART 4 PAGE 3
FRANCE
(1ST HALF 1973=100)
100
90
GERMANY
(1ST HALF 1973 = 100)
110
100
90
Q1
Q2
Q3
Q4
1973
Q1
Q2
Q3
Q4
1974
Q1
Q2
Q3
Q4
1975

CHART 4 PAGE 4.

ITALY

(1ST HALF 1973 = 100)

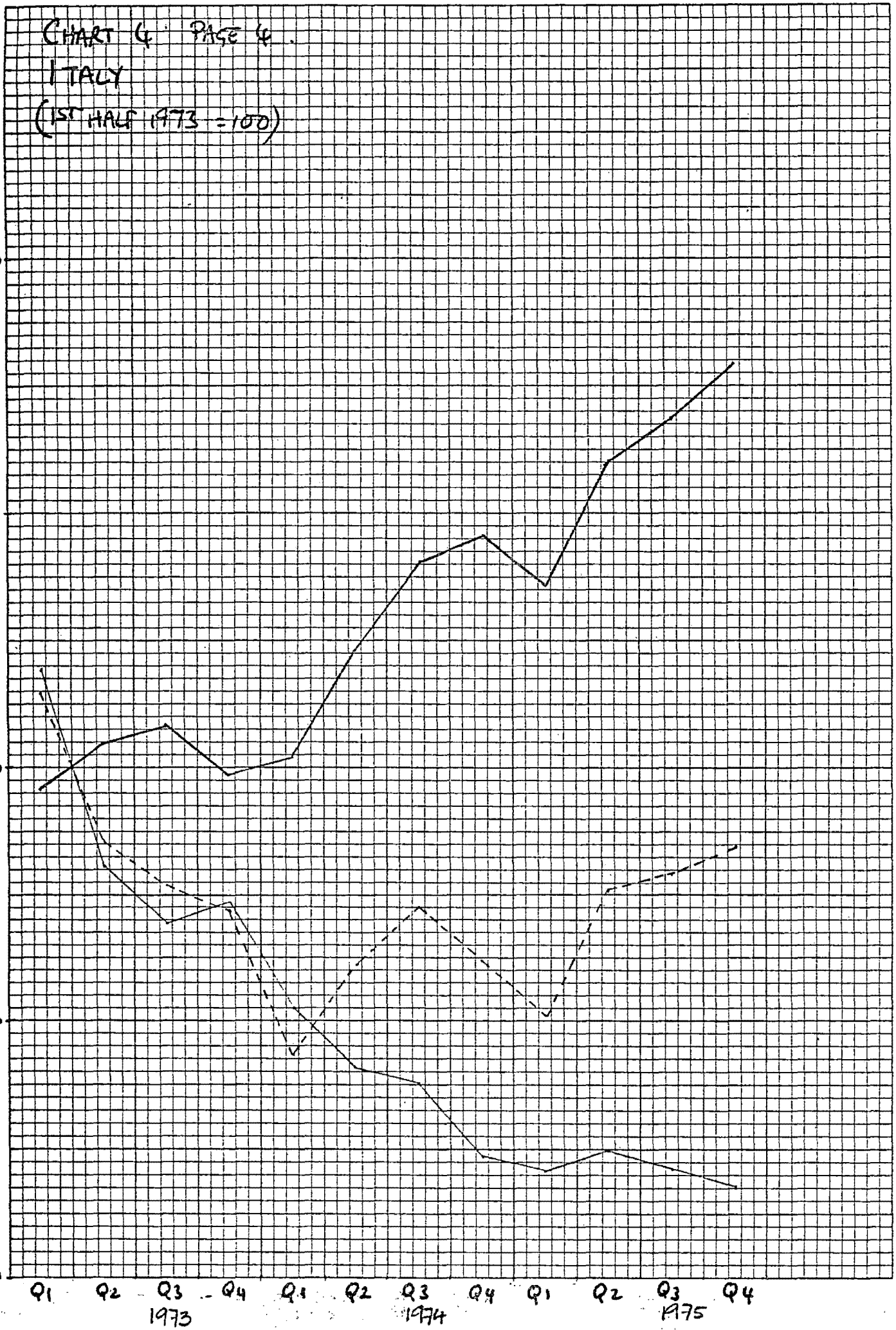
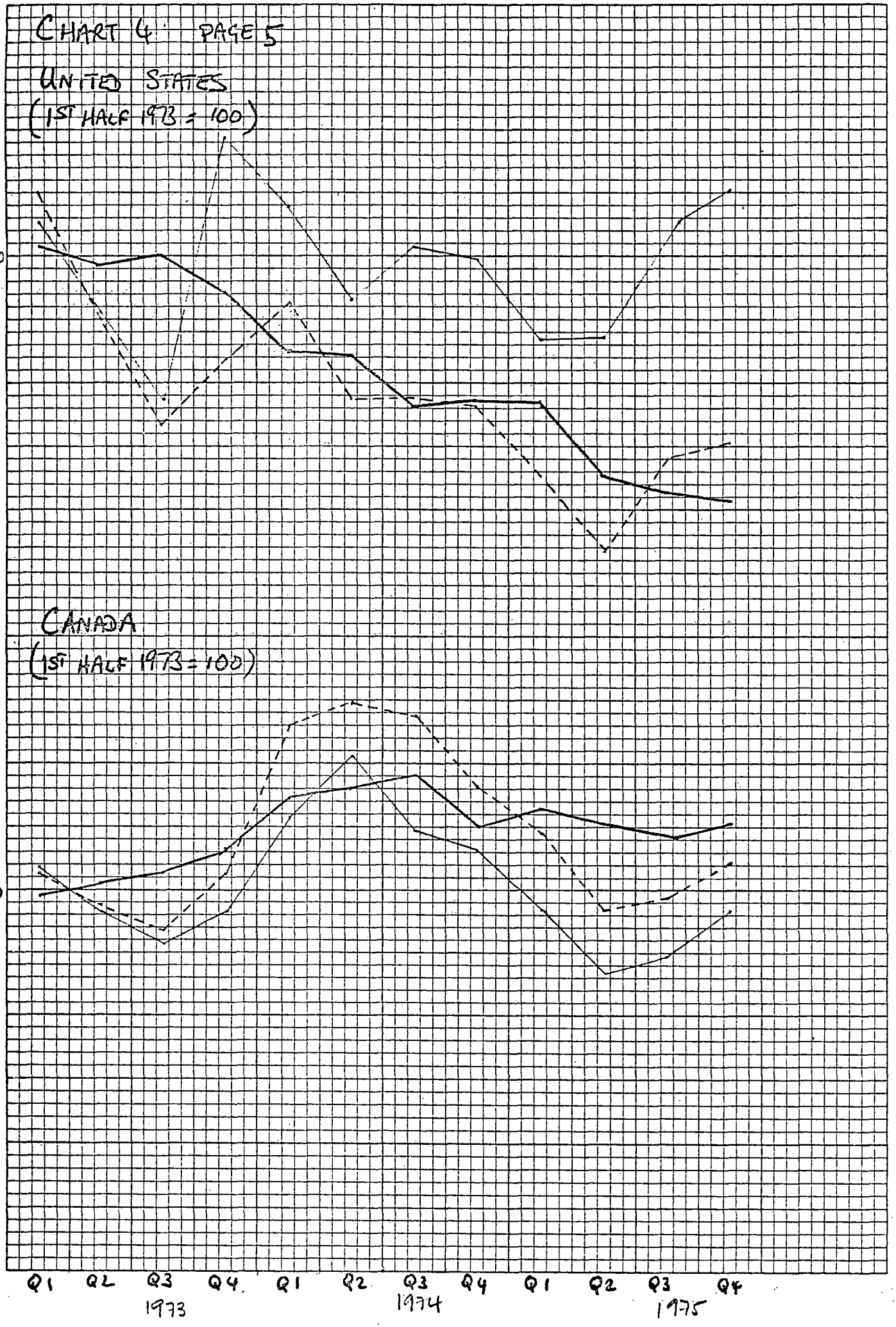


CHART 4 PAGE 5



effective exchange rates that offset their relatively rapid price increases.

For the other countries, it can be observed that both prices and exchange rates tended to adjust when a country's relative competitiveness deteriorated or improved significantly relative to the average. In Germany, for example, the positive correlation between relative price movements and effective exchange rate changes during most of 1975 can be seen as a reaction to the deterioration of Germany's relative competitiveness during 1974, when exchange rate adjustments more than offset the improvement in relative price performance. Similar patterns of adjustment are observed for France and Japan when their competitive positions became quite far out of line with the norm in early 1975 and early 1974, respectively.

Canada, having experienced price movements very similar to the norm, has also had a very stable effective exchange rate. The U.S. is the only country that registers a significant improvement in competitiveness over the floating period as a result of favorable relative price developments without an offsetting exchange rate appreciation.

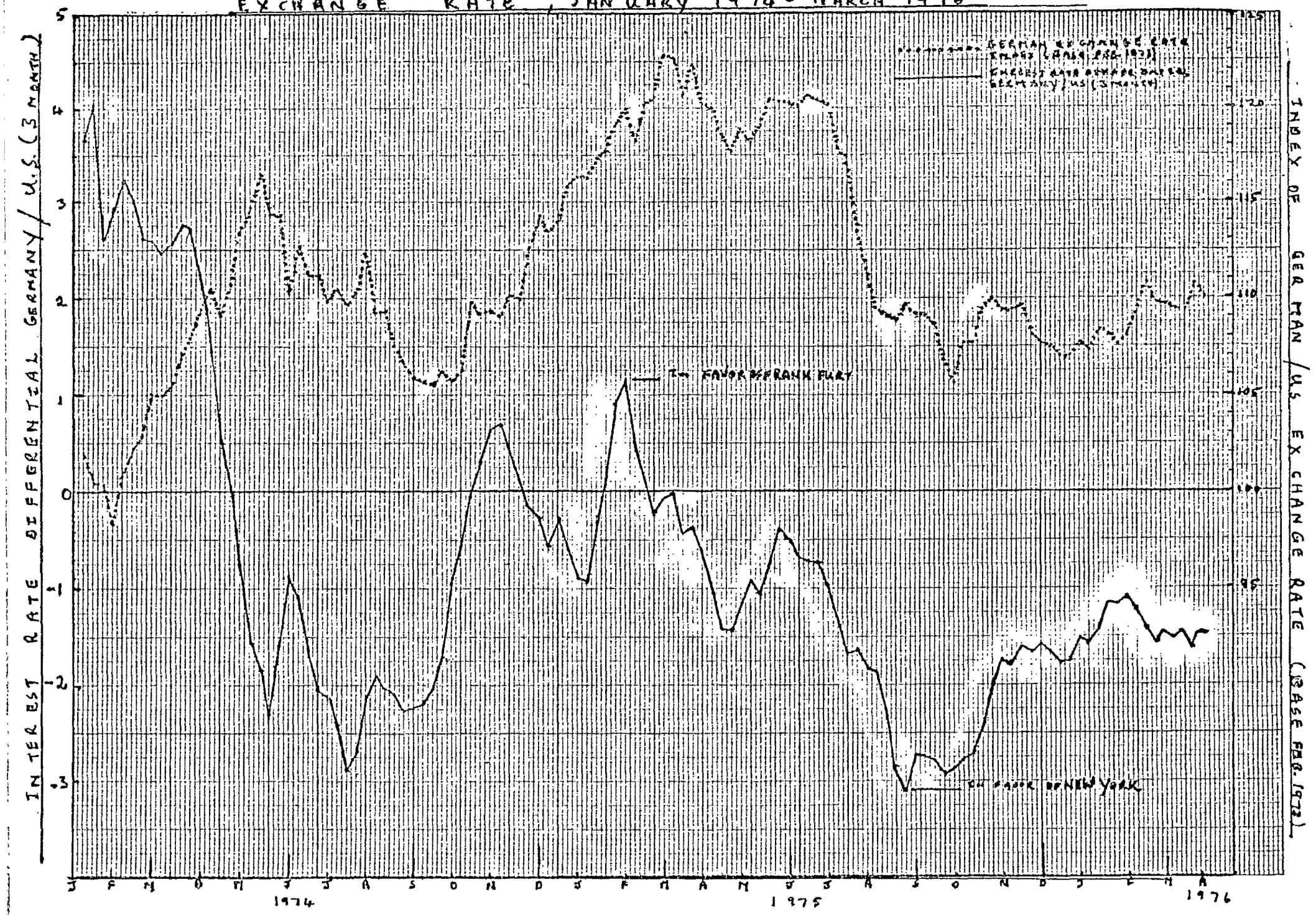
* * * * * *

The year under review has witnessed a further adaptation on the part of the world economy to a monetary system in which countries have greater freedom of choice in exchange arrangements. There has been, in the proposed new Article IV, a recognition of the fact that responsible policies on the part of individual countries are necessary to ensure a stable international monetary system; and the principles to be adopted by the Fund for the guidance of members' exchange rate policies should provide a framework of collaboration and surveillance that will help this objective to be met.

At the same time, the floating system among major countries has been operating, on the whole, more effectively than before. Daily and weekly fluctuations in effective rates have tended to decline for most countries, and so also has the amplitude of short-term swings in exchange rates. Partly, these encouraging developments reflect the fact that disturbances in the global pattern of payments have been less severe than during the early period of floating rates; in part, however, they may also represent an improvement in the ability of market mechanisms and official policies to cope with the realities of a more flexible exchange rate system. In a longer-term perspective, the trend of most major countries' effective exchange rates, while not precisely reflecting relative price movements, has been in the appropriate direction to offset inflation differentials, over the floating period taken as a whole.

Further progress, however, needs to be made before the objective of a stable monetary system without erratic fluctuations is achieved. While high and differential rates of inflation continue, and while relatively high rates of underutilization of resources persist, there will continue to be uncertainty concerning the development of official policies and their implications for the balance of payments. As has been apparent during the past year, these uncertainties can at times generate adjustments in exchange rates that are larger than the concomitant changes in international competitiveness.

SHORT TERM MONEY MARKET RATE DIFFERENTIAL PLOTTED AGAINST EXCHANGE RATE, JANUARY 1974 - MARCH 1976



The Managing Director

June 28, 1976

L. A. Whittome

Adequacy of Global Reserves

The new draft is an improvement in that it gives a much needed greater emphasis to conditional liquidity, but it still causes me concern. We need to be aware that its theme runs counter to the present trend of thinking in many industrial countries and its arguments are those widely disputed in the mid-1960s and at that time compromised out but never resolved.

What really disturbs me is that arguments for more liquidity are always certain to be supported by most developing and debtor countries but if they are to be put into practice they have to find favor with the creditor countries, many of whom have more conservative views. I doubt whether this draft will persuade the creditor countries that an increase in international liquidity is now required.

Let me try and argue the conservative case. The point of departure would be a conviction that international liquidity was excessive in the period 1971 through 1973 and contributed in no small measure to the widespread inflationary surge of 1974. The first lesson to be drawn would be that excess international liquidity should not again be tolerated.

The second point would be that the strong growth in international liquidity in the early 1970s was not foreseen. Indeed, it had been preceded by a brief period when for a variety of reasons (including direct U.S. pressure) the world had agreed upon the creation of SDRs. In the event the world almost drowned in liquidity largely resulting from a growth in reserve currency holdings in a period of benign (or otherwise) neglect of the U.S. balance of payments. A similar tendency may now be occurring as again the U.S. balance of payments is not subject to an external constraint.

From the point of view of a conservative industrial country (and I am certainly not only talking of Germany but perhaps even of a majority of the Group-of-Ten countries) changes in international liquidity in today's world reflect the sum of the monetary and exchange rate policies of a few major countries. The present draft, indeed, seems to half recognize this point when it states (on page 20) that for countries with good international credit standing the level of reserves is now demand-determined. I suspect that this is a fair statement and, if so, it highlights the previous point that increases in liquidity due to increases in holdings of reserve countries are unpredictable but can occur very rapidly. Indeed, if the level of reserves of creditworthy countries is demand-determined, then the point at issue is the distribution of reserves, and, if as the paper does, one excludes for one reason or another, both the oil exporters

and many of the industrial countries, then the argument that is left is one that, if the author had the courage of his convictions, would seem to lead him to advocate the issue of SDRs to non-oil LDCs, in other words, the link.

Moreover, in arguing that present liquidity was fully adequate the conservatives would surely draw attention to the following points:

(a) The present undervaluation of gold, which might seriously affect the figures of total liquidity (briefly mentioned on page 3 of the draft but never picked up later).

(b) It is wrong to speak of the reserve accumulation by the oil countries as the putting of reserves into a "sink." A substantial part of these reserves is placed in Euro-currency markets and though reserves cannot be earned through this market, they can most certainly be borrowed.

(c) The limited use still being made of conditional credit from the Fund.

(d) The present revival in activity which has already led to a considerable strengthening of raw material prices and a shift of the terms of trade in favor of the developing countries. Part of the resulting benefit should be used to build up reserve holdings.1/ If, as the draft argues (page 11), countries such as "the United Kingdom, France, Italy, and Japan feel a shortage of reserves," then this is positively to be welcomed. Only an external constraint can persuade such countries (or anyway the first three of the four) to adopt appropriate policies that will reduce their inflation rates and help create conditions for sustained growth.

(e) Finally, a conservative would surely argue that with an upturn under way (and obviously not being impeded by reserve stringency) the emphasis must be on combating inflation for it is a revival of inflation that will threaten the continuance of growth. Indeed in a period when the main industrial countries are resolved to moderate their rates of growth and intend, toward this end, to tighten monetary policies it would be absurd to increase unconditional liquidity.

Moreover, some of the arguments now used to support a plea for unconditional together with (or in lieu of ?) conditional liquidity strike me as curious. For instance, it is alleged on page 15 that countries need to have a reasonably strong gross reserve position to feel willing and able to make proper use of conditional liquidity through the Fund. I have never noticed such an attitude. Then I would not agree (page 12) that in recent years the Fund has concentrated on conditional facilities. In all truth, there was precious little conditionality in the oil facility (Argentina, Pakistan, Turkey to mention but three; one could well add

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1/ On an associated point, we have on other occasions, e.g., the speech to UNCTAD, downplayed the debt problems of the LDCs in general.

Italy and the United Kingdom) and really none at all in the compensatory financing facility unless the fact that Fund lending is to be repaid is to be the definition of conditionality.

I confess that I would find several of the arguments put in the mouth of a "conservative country" to be very persuasive. As of now I do not believe that there is much strength in the argument for an increase in unconditional liquidity and I suspect that it would be impossible to come to such a conclusion unless one could document the argument a lot more persuasively. On the other hand, I would part company with the true conservative in that I can see arguments in favor of an increase in conditional liquidity and I would personally like to see the paper explicitly come to such a conclusion.

It is alarming that for a number of countries the potential political cost of approaching the Fund is not compensated by the amounts that can be drawn because of the small size of quotas. If quotas were very substantially higher, a greater use would be made of them, and, as a result, the political risks would perhaps be reduced by a kind of "demonstration effect." Moreover, the adjustment process could at present be helped by an increase in conditional liquidity.

Over and beyond these arguments are those associated with the perhaps temporary demise of the Safety Net. It has always seemed to me that this project would affect the Fund most adversely. There may now be an opportunity to obtain agreement that conditional liquidity should be concentrated in the Fund, through a further large increase in Fund quotas. In this way, a divisiveness could be avoided taunts that the Fund is becoming an aid-oriented agency would be more easily answered, and yet the LDCs would benefit to the same degree as the developed countries.

cc: The Deputy Managing Director
Mr. Gold
Mr. Polak
Mr. Del Canto
Mr. Gunter
Mr. Habermeier
Mr. Sturc
Mr. Touré
Mr. Tun Thin
Mr. Green

June 15, 1976

The Adequacy of Global Reserves

A discussion paper

The purpose of this paper is to analyze reserve growth over the past ten years; to assess the present distribution and adequacy of world reserves, and to consider what Fund policies should be on the provision of conditional and unconditional liquidity over the medium term. At the outset, it must be recognized that developments in recent years have profoundly affected both the need countries feel to hold reserves, and the mechanisms by which liquidity needs can be met through credit operations. The significance of these developments is briefly touched on later; here it may simply be noted that they make assessing reserve needs and availability even more difficult than it was before.

Although any analysis of reserve adequacy must rest on a global assessment of reserve needs and availability, in present circumstances it is unusually difficult to aggregate the positions of individual countries into a single measure of reserve ease or stringency. This paper therefore begins by considering in turn recent developments for the three main country groups: industrialized, oil exporting, and non-oil primary producing countries. The assessment of global reserve adequacy is dealt with in the subsequent section; and the extent to which conditional and unconditional liquidity can be viewed as alternatives in meeting countries' overall liquidity needs is then considered. The concluding section presents some quantitative implications of the preceding analysis.

1. Reserve growth 1966-1976

The last few years of fixed rates witnessed an explosive growth in world reserves, a growth which considerably exceeded the expansion of world trade, and almost certainly resulted in a situation of excessive global reserve ease, in which most countries shared. Since the advent of generalized floating in early 1973, reserves have grown more slowly, and reserves to imports ratios have fallen back to, and then below, the levels that obtained prior to the first allocation of SDRs.[1/]

The industrial countries experienced extremely rapid reserve growth between the end of 1969 and the breakdown of the central rate system in March 1973 (see Table 1). After having remained more or less unchanged in the three years up to end-1969, their reserves more than doubled in dollar terms (in SDR terms, the increase was about 80 per cent) in the next 3 1/4 years. As a result, their reserves to imports ratio, which had declined from 40 per cent to 28 per cent between 1966 and 1970, rose back to over 36 per cent in 1972.

Since that time, there has been relatively little movement in the combined reserves of the industrial countries, with as much of the changes that have occurred being attributable to valuation adjustments[2/] as to accumulations or losses of reserves. With the very rapid growth in the value of world trade in 1973 and 1974, the reserves to imports ratio of the industrial countires fell sharply to 21.4 per cent in 1974. During 1975, indus-

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1/ The reserve to import ratio is defined as average reserves held during the year over the value of imports in the same year. (For a brief discussion of the usefulness of reserves to import ratios as an indicator of reserve adequacy, see page 7 below.)

2/ Due to fluctuations in the U.S. dollar value of the component of reserves consisting of gold and SDR-denominated assets, and fluctuations in the SDR value of the dollar component.

Table 1

International Reserves 1966-75
(5 quarter average)

	Industrial Countries			Oil Exporting Countries			Other Developed Countries			Less Developed Countries		
	Reserves (billions)		Reserves/ Imports Ratio	Reserves (billions)		Reserves/ Imports Ratio	Reserves (billions)		Reserves/ Imports Ratio	Reserves (billions)		Reserves/ Imports Ratio
	SDR	US$		SDR	US$		SDR	US$		SDR	US$	
1966	53.6		(40.1)	3.1		(43.7)	6.0		(30.6)	8.7		(26.6)
1967	54.0		(38.2)	3.5		(45.9)	5.9		(27.8)	9.5		(28.1)
1968	54.4		(34.0)	3.8		(44.6)	6.6		(30.4)	10.2		(28.0)
1969	55.3		(30.1)	4.2		(43.4)	7.4		(30.4)	11.2		(28.0)
1970	59.4		(28.1)	4.8		(44.1)	8.1		(27.9)	13.3		(29.2)
1971	77.7	79.2	(33.6)	6.6	6.8	(53.4)	10.4	10.6	(33.5)	14.3	14.5	(28.3)
1972	94.5	102.6	(36.5)	9.1	9.8	(63.5)	15.7	17.0	(48.1)	16.6	18.0	(32.0)
1973:1	99.2	115.0	(32.6)	10.4	12.1	(61.0)	18.9	22.0	(49.4)	20.6	24.0	(34.9)
1973	98.9	116.9	(30.3)	11.0	13.0	(59.1)	19.4	23.0	(46.2)	22.0	26.0	(33.6)
1974	96.5	116.4	(21.4)	25.2	30.4	(80.3)	18.6	22.4	(29.2)	25.8	31.2	(25.1)
1975	100.8	121.7	(22.4)	44.6	53.8	(88.3)	16.4	19.8	(24.9)	25.5	30.8	(24.0)

trial countries' imports stagnated, so that there was little change in their reserves to imports ratio in that year.

A general problem in measuring the reserve holdings of industrial countries lies in the valuation that should be attached to their substantial holdings of gold. If the true value of gold holdings is to be considered at or close to the market price, then the industrial countries' reserve ratios are much stronger than they would appear from Table 1. However, there is a real question for the larger gold holders whether substantial sums can be realized in the short-term by transactions in gold, or through credit operations based on gold collateral. Thus, while the value of gold as an investment and longer-term reserve has clearly increased compared with a few years ago, its value as short-term liquidity may well have been diminished, at least for the larger countries. These developments with respect to gold have further complicated calculations of reserve adequacy, and some industrial countries may have difficulty themselves in appraising their degree of reserve ease.

Oil-exporting countries had steady growth in their reserves during the late 1960s, but with concurrent expansion in their imports, their ratio of reserves to imports held steady at 40-50 per cent. Their reserves grew more rapidly in the 1970s, and most dramatically in 1974, when they more than tripled. Although the oil-exporting countries imports grew rapidly in both 1974 and 1975, reserves grew faster, and in 1975 averaged almost 90 per cent of annual imports. This overall figure of course conceals a diversity of experience within the group, as some oil-exporting countries did not share proportionately in reserve expansion. For others a part of their reserves increase is more appropriately classified as longer term investment rather than short-term liquidity.

Primary Producing Countries (other than oil-exporters) experienced a steady growth in their reserves in the period 1966-70, which was sufficient to keep their combined reserves to imports ratio steady at slightly under 30 per cent. With the boom in industrial countries which began in 1971 and reached its peak in 1973, most primary product prices rose rapidly and permitted these countries to add substantially to their reserves. Reserves of the "other developed countries" reached a peak in 1973, though their reserves to imports ratio was highest in 1972, when it was nearly 50 per cent. The reserves of the developing primary producing countries also grew, though somewhat less rapidly, and pushed their reserves to imports ratio to about 33 per cent in 1973.

In 1974 and 1975, the terms of trade turned firmly against the nonindustrial, non-oil exporting countries, and their weak balance of payments position necessitated some drawing down of their combined reserves. In 1974, this reduction was entirely accounted for by a fall in the reserves of the more developed group, with reserves of the less developed countries continuing to rise slightly. In 1975, however, both groups experienced a reduction in their reserves, particularly when valued in U.S. dollars.

This reduction in nominal reserves translates into an even more significant fall in reserves to imports ratios. The combined reserves to imports ratio of non-oil non-industrial countries fell from about 39 per cent in 1973 to 27 per cent in 1974, and to 24 per cent in 1975.

2. Assessing Current Reserve Adequacy

Although reserves to import ratios for all groups of countries except oil exporters are now at historically low levels, it is hard to interpret the implications of this for current reserve adequacy. This is not just because the distribution of reserves is unequal; it is in the nature of reserves held

to finance fluctuations in payments and receipts that their distribution should normally be out of equilibrium. So long as a mechanism exists which permits reserve transfers between countries to take place freely as part of a smoothly functioning adjustment mechanism, excess reserves held by one group of countries will sooner or later flow back to the rest of the world as balance of payments positions change. At the present time, however, some large reserve holders--in particular the oil countries--hold substantial sums which are not likely to be run down in the foreseeable future, through balance of payments deficits. Furthermore, because a large proportion of these funds have been used, through the euro-currency market and other channels, to help finance payments disequilibria, any decline in the holdings of oil countries may not result in a transfer of reserves to other countries, but simply in a reduction in the volume of credit extended through financial markets.

Beyond the countries with chronic structural surpluses, there are a number of industrial countries which are floating fairly freely, and, apart from minor smoothing intervention, are neither gaining nor losing reserves from the rest of the world. Although a freely floating country may feel that its holdings of liquidity are in excess of its needs, such excess cannot make a contribution to global liquidity ease unless the country concerned is prepared to run it down through exchange market intervention.

It follows from the foregoing that the group of countries for which it is analytically useful to talk of a global, or aggregate degree of reserve ease is something less than the total Fund membership. There would probably be little doubt that the major oil countries should be omitted from the analysis, at least for the next few years. Coming to the industrial countries, the remaining members of the snake, taken as a group, appear to float with relatively little intervention against the rest of the world; and the U.S. and Canada may also be regarded for these purposes as fairly free floaters. It may therefore be more appropriate to exclude these countries from any calculation

of global reserve ease. It must, of course, be recognized that there is no clear dividing line between those industrial countries whose exchange rate arrangements place them outside the "world" supply and demand for reserves, and those which, in principle, will be competing with other countries for access to a limited (though not necessarily strictly limited) quantity of gross reserves. Table 2 supplies several alternative "world" definitions for which a measurement of reserve trends may be helpful.

An assessment of reserve adequacy is perhaps clearest for the non-oil primary producing countries. These countries, which although they represent only 30 per cent of Fund quotas, constitute nearly 80 per cent of Fund members, have for the most part not resorted to floating, although they are making greater use of the exchange rate as a policy instrument than they used to. Furthermore, exchange rate flexibility offers them only limited prospects of additional relief from balance of payments pressures. Exchange rate changes often have less impact on the international prices of the goods in which they trade, and the relevant demand and supply elasticities are typically lower in the short run. Borrowing in private capital markets to protect reserves is not a policy that is open to many of them, and even those that have used it in the past may not be able to continue to use it to the same extent in the future.

Not being, for the most part, large gold holders, these countries have, moreover, not benefited much from any contribution to reserve ease made by the higher price at which gold transactions may be undertaken. For the primary-producing group of countries, therefore, the reduction in reserves to import ratios that has occurred in the past two years probably reflects a genuine increase increase in reserve stringency.

Table 2

International Reserves
(5 quarter average)

	World			World excl. Oil Exporting Countries			World excl. Oil Exporting Countries, Snake, Canada, & USA			World excl. Oil Exporting Countries and all Industrial Countries		
	Reserves		Reserves/ Imports	Reserves		Reserves/ Imports	Reserves		Reserves/ Imports	Reserves		Reserves/ Imports
	SDR	US$		SDR	US$		SDR	US$		SDR	US$	
1966	71.5		(36.9)	68.4		(36.7)	36.2		(34.3)	14.8		(28.1)
1967	73.0		(35.9)	69.4		(35.5)	37.2		(33.1)	15.4		(28.5)
1968	75.0		(33.1)	71.2		(32.7)	37.8		(31.2)	16.7		(28.9)
1969	78.2		(30.3)	74.0		(29.8)	38.9		(28.3)	18.7		(28.9)
1970	85.5		(28.8)	80.7		(28.3)	43.6		(27.4)	21.4		(28.7)
1971	109.0	111.1	(33.5)	102.3	104.3	(32.7)	59.0	60.2	(34.4)	24.7	25.1	(30.3)
1972	135.8	147.5	(38.0)	126.8	137.6	(36.9)	78.1	84.8	(41.8)	32.2	35.0	(38.2)
1973:1	141.0	156.7	(38.2)	131.5	146.1	(37.2)	80.3	89.1	(41.7)	34.7	38.6	(40.2)
1973	151.2	178.9	(33.4)	140.3	165.9	(32.3)	83.9	99.2	(34.4)	41.4	49.0	(38.6)
1974	166.1	200.4	(25.6)	140.9	170.0	(22.8)	82.8	99.8	(23.0)	44.4	53.6	(26.7)
1975	187.2	226.2	(27.8)	142.6	172.3	(24.1)	83.0	100.3	(25.2)	41.9	50.6	(24.4)

Changes in reserve adequacy may be inferred, not only from changes in the level of reserves relative to some index of reserve need, but also from the evidence of countries' actual policy actions. Increased reliance on the use of restrictions may be taken as prima facie evidence of a need to conserve reserves. In this connection, the draft Annual Report on Exchange Restrictions for 1975 states that there has been a clearly discernible trend toward the greater use of import controls and other restraints on current transactions by countries which as a group account for a significant share of world trade. The Report notes that the adoption of more restrictive import policies has occurred in both developed and developing countries but that it has been mainly in some developing countries that new or intensified restrictions have been applied as a major instrument of balance of payments management.1/

It may also be significant that in the past year primary producing countries have chosen to finance their substantial collective deficit almost entirely through the use of conditional liquidity, and only to a very limited extent through the drawing down of owned reserves. Recent purchases under the compensatory financing and oil facilities have not envisaged, for the most part, very significant declines in gross reserves.

Although the indications now are that the reserves of primary producing countries are below an adequate level, it is a very difficult matter to say what should be considered an appropriate level for this group of countries. Neither theoretical reasoning nor actual experience suggest that reserve needs grow precisely in step with the level of trade, and certainly not in a period where important changes have taken place in the working of the adjustment mechanism. However, the level of imports is a useful shorthand index of the scale factor affecting the need for reserves, and no comparably simple

1/ 27th Annual Report on Exchange Restrictions, SM/76/71, Revision 1 (5/10/76).

indicator is likely to give an obviously superior result. And since primary producing countries have for the most part retained their preference for fixed rates and have only limited access to international capital markets, their need for owned reserves should not have been greatly affected by recent developments in the mechanism for financing and adjustment of payments deficits. It may not be unduly misleading, therefore, to base a first assessment of reserve needs on an extrapolation of reserves to imports ratios in the recent past. In this connection, a central assumption, which is necessarily subjective, is the selection of a period in which reserve levels are judged to be as compressed as they can be without leading to adverse consequences.

Over the later 1960s, as already noted, the average level of the reserves to imports ratio for the primary producing countries was some 30 per cent, (though it may be noted that this was a period when a number of official sources concluded that global reserve ease had become less than adequate--see, for example, IMF *Annual Report 1969*). In 1972 and 1973, reserves to imports ratios were considerably higher than this and could be considered comfortable. During 1974 and 1975, however, the ratio fell back to an average of about 25 per cent. This reduction from earlier levels might be considered reasonable, taking into account a greater willingness to change currency pegs (as compared with the later 1960s) and greater use by some countries of international capital markets. But the evidence from these countries' policies in 1974 and 1975 would not in any way suggest that a ratio of the order of 25 per cent contained any significant leeway for further reduction.

If it were accepted that a reserves to imports ratio of 25 per cent represented a prudent minimum for primary producing countries, this would have the following consequences. First, a small addition to reserves would be

desirable immediately, to restore the 25 per cent ratio. Secondly, reserves would henceforth have to grow roughly in step with imports.

The fact that one group of countries has a need for additional reserves does not, of course, mean that the world as a whole is suffering from reserve inadequacy. In order for a reserve shortage in one group of countries to make a case for a general SDR allocation, it needs to be demonstrated that there does not exist a pool of excess liquidity elsewhere in the world economy that can readily be transferred to liquidity-short countries when the latter earn a surplus in their overall balance of payments. It has been argued above that the oil-countries constitute a reserve "sink," and that there is no real prospect of a transfer in their holdings of liquidity to other countries in the near future.

Coming to the industrial countries, the situation of individual countries within the group is more diverse. Countries which are floating with relatively little intervention--the U.S., Canada, and the "snake" currencies (taken as a group though not necessarily individually)--have reserves that are more than adequate to finance prospective imbalances in payments with the rest of the world. But so long as these countries retain a policy of undertaking only smoothing intervention, any reserves they feel are excess to their needs cannot be tapped by the rest of the world.

The United States, as a reserve currency country, is something of a special case in this regard, since countries <u>can</u> accumulate reserves from it by acquiring U.S. liabilities. But recourse to such a technique for reserve expansion would mean that other countries would have to earn or borrow reserves through running a surplus in their overall balance of payments. Neither of these options is wholly satisfactory. Earning reserves through a strengthening of the current

account would require the primary producing countries to set their exchange rates at a level that permitted a transfer of real resources. This would not only seriously hamper their development plans, but might also run the risk of encouraging competitive exchange rate policies. Borrowing to bolster reserves is not possible for many primary producing countries, and anyway would add further to their already serious debt burden (since the cost of borrowing would almost certainly be higher than the return on reserve assets). Furthermore, increasing the role of reserve currencies (and possibly proliferating the number of currencies used for this purpose) would worsen the composition of reserves, and complicate the long-term task of improving control over the quantity of liquidity.

If it is accepted that such excess reserves as are held by oil producing countries and those industrial countries that are floating relatively freely are effectively unavailable to the rest of the world, this leaves only the group of industrial countries that have evidenced a willingness to intervene on a substantial scale. For these countries (which include the U.K., France, Italy, and Japan), the advent of generalized floating has probably reduced the need to hold reserves to finance short-term fluctuations in their balance of payments positions.[1/] At the same time, most of them have shown increased willingness to use borrowing in international capital markets to finance exchange market intervention without drawing down (or without drawing down very much) their reserves. So long as they are willing to take adverse balance of payments developments on the exchange rate, or else have easy access to capital markets, there would not be grounds for concluding that present reserve levels have any undesirably constraining effect on policy. Indeed the ability to borrow readily has probably in some instances allowed countries to postpone adjustment measures unduly.

1/ Though even this statement cannot be made unequivocally, see DM/74/85.

For the four countries mentioned above, however, there is now more evidence of reserve shortage than reserve ease. Each of them, with the exception of Japan, has had to accept exchange rate movements that were not planned or desired as part of an overall adjustment strategy. Although the need for reserves cannot be derived from a desire to offset any short-term speculative capital movements that may occur, it seems unlikely that these countries have much scope for further compression in their reserve holdings.

The primary producing countries, and the industrial countries which have adopted a managed floating policy together account for 55 per cent of the total membership in the Special Drawing Account. For these countries, there is considerable doubt that reserves to import ratios could be further compressed without adverse consequences. Indeed, even at present reserve levels, some adverse consequences are already apparent. The remainder of the Fund's membership generally has either high reserves, or relies on floating to reduce the need to hold reserves. It may be the case that some of the smaller participants in the European narrow margins agreement (who need reserves for settlement of intra-snake transactions) feel that their present reserve levels are low; but, in principle, it should be possible for them to earn or borrow additional reserves from their snake partners who find themselves in a more comfortable position.

3. Conditional and Unconditional Liquidity

The need to make additional liquidity available has been recognized for some time. In January 1974, the Rome communique of the Committee of 20 noted that "The International Monetary Fund . . . and other international organizations are concerned to find orderly means by

which the changes in current account positions may be financed, and they (the Committee) urged that these organizations should cooperate in finding an early solution to these questions."[1/] Later in 1974, the Annual Report for that year observed that..."it is...a widely held view that the [reserve] situation has been changing in the direction of reserve stringency."[2/]

Although these official assessments of reserve adequacy would probably have been different if reserve levels had been higher, in none of them was the conclusion drawn that there should be a deliberate expansion of unconditional liquidity. The reason for this is to be found most clearly in the 1975 Annual Report, which stated, "In the present situation of considerable uncertainty as to the future development of many of the factors affecting reserve adequacy, the contribution that the Fund could most suitably make to its continued maintenance probably lies in the provision of conditional liquidity."[3/] This philosophy has underlain many of the developments in the Fund's financial activities in recent years, including the oil facility, the extended Fund facility, the revision of the compensatory financing facility, and the expansion of regular drawing rights, both under the Jamaica decision to temporarily expand tranche sizes, and under the quota review. However, the Fund has a clear responsibility to review the overall development of sources of liquidity, and in particular to try and achieve an appropriate balance, given all the circumstances, between conditional and unconditional liquidity.

The question of the appropriate balance between reserve creation and the provision of conditional liquidity has been addressed previously by the

three paragraphs discussing disadvantages of conditional liquidity, from pp. 12-13 of old paper transferred to p. 14/15 of this draft

1/ Paragraph 2.
2/ Page 46.
3/ Though it should be noted that the use of borrowing facilities in the Fund, insofar as it creates creditor positions, contributes to an expansion of unconditional liquidity also.

Fund, most notably in the several discussions leading up to the establishment and activation of the Special Drawing Rights facility. The problem of substitutability between conditional and unconditional liquidity was put in the following way in the 1965 Annual Report.1/

"Ideally, countries' needs for additional liquidity could be met by appropriate increases in conditional liquidity. In practice, however, countries do not appear to treat conditional and unconditional liquidity as interchangeable. For various reasons, countries which have adequate real resources like to have the major portion of their external liquidity at their free disposal. Even if conditional liquidity were expanded on a substantial scale, some countries might attempt--in preference to relying on these facilities--to increase their own reserves by adopting balance of payments policies which, from a broad international point of view, would have to be regarded as undesirable."

A similar argument was put in a staff memorandum in 1967:

"...Countries which, out of dislike of accepting international advice in policy matters, or for [other] reasons, have a strong preference for reserves over conditional liquidity, would take steps to maintain or increase their individual reserves despite the scarcity in world reserves, and to avoid recourse to conditional facilities, despite their increased availability. The willingness of such countries to make sacrifices to acquire or retain reserves is likely to produce the same kind of undesirable consequences that are characteristic of an insufficiency of international liquidity in general.

1/ Page 15.

Thus such countries when in payments deficit may adopt unduly restrictive trade and financial policies. And when in payments surplus, in their anxiety to build up a stock of reserves sufficient to ensure them against having to accept the views of the international community when they do encounter payments difficulties, they may respond less expansively than they ought to their surplus positions and thus to contribute less than they ought to the process of international adjustment." 1/

taken from p.13

Although the knowledge that conditional liquidity was readily available could, in principle, exercise an influence on countries' economic policy decisions similar to the actual possession of owned reserves; the similarity of the two types of liquidity is in practice less close. This is partly because access to certain types of borrowing depends on the circumstances which have given rise to the balance of payments need. The availability of borrowing rights which are either linked to specific types of balance of payments need--as in the case of the oil facility, compensatory financing facility and extended Fund facility--or else limited in time--as in the case of the oil facility, and the widening of credit tranches--cannot be expected to have the same influence on members' policy formation as access to resources that is permanent and unrestricted as to type of balance of payments need.

taken from p.13

Conditional liquidity that is permanently available, and not linked to a particular type of balance of payments need has a wider usefulness; but since countries cannot know in advance how easily they will be able to accept the conditions attached to borrowing, there will be circumstances in which unconditional liquidity is more likely to result in desirable economic policies than an equivalent amount of access to borrowing facilities. It should also

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1/ SM/67/34 "Conditional and Unconditional Liquidity", page 4.

be noted that the function of liquidity is not simply to finance deficits after they have arisen, but to enable countries to pursue appropriate policies, from a global point of view, even at times when the balance of payments is not an immediate constraint.

An additional argument for not overlooking the role of unconditional liquidity has also become important in recent years. It is the fact that countries increasingly wish to hold a reserve of owned liquid assets against the expansion of their short-term international indebtedness. Partly this reflects natural prudence and a desire to be covered against a period when repayment or roll-over of existing debt might prove difficult; partly such a policy has become necessary to preserve creditworthiness in private markets. As the Annual Report for 1974 noted: "adequate reserves are often a prerequisite to international borrowing."[1/] Whatever the reason, the consequence is that countries need to have a reasonably strong gross reserves position to feel willing and able to make proper use of conditional liquidity through the Fund, and of borrowing opportunities in international capital markets. This has become even more important at the present time when, as a result of past borrowing, many countries have a much higher outstanding level of short-term debt than was traditional in the past. Thus the existence of an adequate supply of unconditional liquidity may be part and parcel of an appropriate expansion in the use of conditional borrowing facilities. As such, it could contribute to an improvement in the working of the adjustment process, since an increased willingness to use conditional liquidity would help ensure that countries in deficit followed policies that were appropriate from an international standpoint.

1/ Page 40.

The foregoing suggests that, even if conditional liquidity and private market borrowing were to be available on a sufficient scale to cover prospective needs, there would still be a case for a balanced expansion of unconditional liquidity. But there is in practice considerable doubt whether the present availability of conditional liquidity is adequate to cover the increase in the potential need for it. Drawing rights in the Fund under ordinary tranche policies will expand by about one third when the new quotas go into effect sometime in 1977--but this is to be compared with a doubling in the SDR value of world trade between the implementation of the last quota increase in 1970, and 1975. Of course a further source of balance of payments finance has acquired additional importance in recent years--namely, the capacity of countries to tap private markets to cover deficits and bolster reserves. This source of liquidity, however, suffers from an inherent uncertainty of access, since it tends to dry up when a country faces serious difficulties, and in any event depends partly on credit conditions in the major capital markets. Furthermore, as noted above, experience suggests that access to such liquidity depends centrally on the existence of a strong owned reserve position by potential borrowers.

A further consideration arguing in present circumstances for provision of additional liquidity from unconditional rather than conditional sources is that unconditional liquidity is non-repayable--a factor of some importance for countries whose debt-service capacity is already stretched. In the long-run, it is to be expected that reserves used to finance deficits will be reconstituted when the balance of payments improves. But there is considerably greater flexibility in the reconstitution of a stock of owned reserves than there is in the repayment of borrowing according to some fixed schedule.

In the last analysis, the proper balance between conditional liqudity and owned reserves remains difficult to determine. Furthermore, it will depend to some extent on prevailing conditions in the world economy. If the primary risk is perceived to be unduly expansionary policies, there is a strong case for guarding against this danger by financing prospective disequilibria with resources which are conditional on the pursuit of adequate stabilization measures by deficit countries. If, on the other hand, the risk is rather that adequate expansion will be inhibited by external weakness, or that trade and payments controls will be introduced to protect the balance of payments, then conditional liquidity by itself may not be sufficient to ensure the adoption of appropriate policies.

In present circumstances, there may well be a case for the balanced expansion of both conditional and unconditional liquidity. Drawing rights under tranche policies have, as noted above, grown more slowly than world trade, and even allowing for greater flexibility in exchange arrangements, must now be considerably smaller in relation to potential payments imbalances than they were a few years ago. At the same time, there is probably also a need for expansion in unconditional liquidity, to provide a sufficient "cushion" of reserves to give countries the necessary confidence to use the conditional liquidity that is or may become available.

4. Liquidity Needs - Quantitative Aspects

In considering the question of combining a certain amount of unconditional liquidity with the long term expansion of conditional liquidity, it needs to be asked at what pace reserve needs are likely to grow. Table 3 shows that the world trade has expanded at a rate of somewhat over 6 per cent in real terms

over the period 1957-74, and nearly 8 per cent over the last decade. For the purpose of the following calculation the medium-term trend rate of growth of the value of world trade has been taken at 8 per cent; this figure may be considered as perhaps including a very small allowance for the trend rate of price increase of traded goods.

Table 3. Rate of Growth of World Imports

	(Per Cent Per Annum)		
	Import Volume	Import Unit Value (in terms of U.S. dollars)	Total U.S. Dollar Value
1957-74	6.2	4.4	10.9
1960-70	6.2	0.9	7.2
1965-74	7.9	8.8	17.4

Those countries, representing 55 per cent of Fund quotas, identified above as having a prospective shortage of reserves, held gross reserves of approximately SDR 85 billion, on average, during 1975. From this, it follows that reserves of these countries would have to grow over time by some SDR 7 billion a year to maintain a constant reserves to imports ratio. The increase in reserves resulting from gold restitution, and the expansion of reserve positions in the Fund is not likely to have much effect on this calculation, since it would in practice do no more than raise current reserves to import ratios to 25 per cent. For this reason, it seems permissible to disregard it in the context of medium-term reserve needs.

The size of SDR allocation needed to provide "liquidity-short" countries with the reserves they need would depend on the extent to which SDRs allocated to countries with comfortable reserves were allowed to leak out into world supplies. If countries with ample liquidity act as reserve "sinks", then allocations of some SDR 12 billion per year would be needed so that countries facing reserve shortages would receive directly the reserves they require to keep reserves to import ratios constant.

If SDR allocations were to be restricted to only 7 billion, however, liquidity short countries would receive directly less than their calculated need, and would still have to earn or borrow reserves from the rest of the world. Thus countries with excess reserves and with floating currencies would have to adopt policies which enabled their surplus liquidity to "spill out" to liquidity-short countries.

As far as the effects of SDR allocations to countries which do not feel a need for additional reserves is concerned, there is no reason for it to have much direct inflationary impact. For the most part, the countries which presently hold comfortable reserves have not yielded, nor are they now yielding, to the temptation to pursue excessively expansionary policies. And the inflationary implications of reserve increases due to SDR allocations, are somewhat different from those of increases resulting from payments surpluses.

Also, it may be noted that not all high reserve countries need participate in SDR allocations. Many oil exporting countries are not participants in the SDR scheme,[1/] and so long as they remain outside it, would not receive

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

reserve increments from this source. And countries which are participants in the Special Drawing Account can opt out of SDR allocation, though this would not be desirable if it also meant that these countries were unwilling to see their acceptance obligations increased. In any event, opting out would be limited to participants commanding not more than 15 per cent of votes, since opting out by a greater proportion of the voting power would automatically defeat a proposal to allocate.

The foregoing analysis has not considered the possibility of reserve growth through an expansion in reserve currency holdings. This source of reserve growth has in fact contributed very little to aggregate world reserves in recent years, if the large increase in holdings of the oil countries is left out of account. In principle, however, an expansion of reserve currency holdings could occur quite easily, since countries with good credit standing can borrow in international capital markets for the purpose of adding to their owned reserves. If such transactions are performed through the euro-currency market, or in the capital market of a country with a floating exchange rate, there need be no corresponding offset in a reduction in the reserves of other countries. To this extent, reserve-holding, at least among the countries with good international credit standing, is demand-determined. This fact, however, implies that for some countries, an increase in reserves as a result of an SDR allocation would be offset at least in part by a reduced accumulation of reserve currencies, and would therefore not result in an equivalent net increase in global reserves.

new paragraph

Such a tendency to substitute SDR's for reserve currencies would help to improve the composition of world liquidity, since the concentration of liquidity growth in reserve currencies has certain well-known disadvantages (see page 9 above). Furthermore, SDRs would be available on equal terms to all members of the Fund, whereas borrowing to bolster reserves is an option that is in practice closed to a large number of the Fund's members.

Office Memorandum

TO : Mr. Whittome

DATE: June 28, 1976

FROM : A. C. Woodward

SUBJECT : Adequacy of Global Reserves

I very much agree with your draft memorandum to the Managing Director. It seems to me that the only cases that can be made for an allocation of SDRs at the present time are (1) that unless an allocation were made soon the claim that the SDR would become a major reserve asset would begin to have a hollow ring and (2) that an SDR allocation biased in favor of the underdeveloped countries is needed because of their particular reserve stringency. The second case is not explicitly argued in the draft paper, and to make an SDR allocation because of the need to validate our claim that the SDR should be a principal reserve asset is likely to be highly dangerous in the present world conditions. Since the advent of generalized floating in March 1973, foreign exchange holdings have increased by 35 per cent or at an annual rate of about SDR 13 billion. To justify an annual allocation of SDRs of between SDR 7 billion and SDR 12 billion must rest on the assumption that this rate of increase would in some way replace the increase in foreign exchange reserves. Clearly, this case cannot be made.

Some minor points with regard to your draft memorandum and the draft paper are as follows:

In the first full paragraph on page 2 you should add that "international liquidity in today's world reflects the sum of the monetary and exchange rate policies of the major countries."

On page 3 it seems to me that point c. is inconsistent with the view that reserves are adequate and I should be inclined to drop this point.

In the paper it seems to me that in the third line of the first paragraph on page 12 the word should be "conditional" and not "unconditional."

My only question with regard to your memorandum is whether it is too mild in tone. It seems to me that the case against an SDR allocation at the present time is so very strong that I wonder whether it is necessary to hide behind a so-called conservative creditor. This is a point, however, of tactics which I readily leave to others.

cc: Mr. Mohammed
Mr. Brehmer
Mr. Vittas

M. Whittome

Office Memorandum

TO : Mr. Whittome

FROM : Ekhard Brehmer

DATE: June 28, 1976

SUBJECT : Adequacy of Global Reserves

I find that your criticism of the second draft paper on the adequacy of global reserves is very well argued and it does not overlook any important point that could be made against the creation of additional liquidity. What I find alarming is that the new draft paper by RES hardly takes into account any of the major points that could be made by the more conservative countries in Europe as had been set out in Mr. Ungerer's memo of June 8. This shows that (pending management approval) RES is determined to issue the paper as it is even though it remains unconvincing. I think it would then be prudent if we could make sure that the paper is not issued as one prepared in "consultation with the European Department" or by "the staff". In that case the conservative European countries could easily associate the European Department with the expansionist views taken in the paper and that would certainly not make our work in these countries easier.

On p.2. of your draft memo you could broaden your criticism by replacing the last two sentences of the first (incomplete) paragraph by a text along the following lines: "Moreover, it is wrong to speak of the reserve accumulation by the oil countries as the putting of reserves into a "sink" (p.9) and to view any "excess" reserves of the countries floating relatively freely as reserves that cannot be "tapped" by the rest of the world (pp. 5 and 9). A substantial part of these reserves is placed in Euro-currency markets and though reserves are not earned through this market they can most certainly be borrowed. In addition, by permitting their currency to rise to a more appreciated level than in the case of intervention the "snake" countries (plus the United States and Canada) permit other countries, including the non-oil LDCs a greater scope for adjustment and to the extent the latter take advantage of this scope this should help reduce these countries' reserve stringency. Taking these arguments into account and also the facts that gold holdings (concentrated particularly in the hands of the more developed countries) are undervalued and the reserves of countries with good international credit standing are demand-determined (p.20), then the paper fails to prove convincingly that the reserve inadequacy in the non-oil LDCs is not confronted with excess reserves elsewhere in the world economy. Thus with the failure to prove that a global reserve need exists, an important precondition for advocating a general SDR allocation is not fulfilled."

At the end of the second full paragraph of p.2. of your draft memo one could add a sentence along the following lines: "In this connection the paper should have examined the question as to whether the provision of nonrepayable liquidity would be more appropriate in light of the difficult adjustment problems facing the non-oil LDCs than provision of conditional liquidity including liquidity provided through channels that are tailor-made to the special adjustment problems of the LDCs (e.g., the Extended Fund Facility)."

The catalogue of the "curious" arguments used to support the provision of unconditional together with (or instead of) conditional liquidity could be extended on p.4 of your draft memo. For example, one could add there that the logic of the first sentence of the second paragraph on p.16 is not clear, namely that unconditional liquidity should be provided in present circumstances because it is unrepayable--a factor of importance for countries with an already high debt service burden.

Is there any reason not to repeat in your memo to the Managing Director the point you made in your memo of June 8 to Mr. Polak, namely that it might not be tactically prudent to give any quantification in a paper on reserve adequacy? I consider this to be an important point at least as long as there is no agreement on the need for a new allocation of SDRs.

On p.3., last paragraph, line 4 the words "the resumption of" could be omitted.

The paper by RES has included in the group of countries floating relatively freely only the "snake" countries, the United States, and Canada. I think it would be more appropriate to expand the number of countries in this group by those which follow the snake relatively closely (e.g., Austria, Switzerland, and others).

cc: Mr. Mohammed
Mr. Woodward
Mr. Vittas

Office Memorandum

TO : Mr. Whittome

FROM : H. Vittas

DATE: June 28, 1976

SUBJECT : Adequacy of Global Reserves

My main criticism of your draft memorandum is that while you seem to challenge the view that global liquidity is now inadequate you then go on to contradict yourself by expressing yourself in favor of a large increase in quotas. I take it that any increase in quotas beyond the one recently agreed is out of the question for the next several years. If that is the case then we should make our mind whether we consider that the present level of world liquidity--and its prospective growth until a further increase in quotas can be contemplated--is adequate or not. On this I would agree with you that paper falls far short of demonstrating that global reserves are insufficient. There is hardly any evidence that countries are forced to pursue unduly restrictive policies because of a reserve constraint.

cc: Mr. Mohammed
Mr. Woodward
Mr. Karlstroem
Mr. Brehmer

INTERNATIONAL MONETARY FUND

6/25

TO : Mr. Mohammed

FROM: H. Ungerer

I just had a short look at LAW's draft and I have 2 suggestions:

1) Perhaps, Messrs. Woodward and Vittas should have a look at my comments of 6/8 to see things in context.

2) The MD may not be aware of the discussion of the

INTERNATIONAL MONETARY FUND

TO : Dirks. To illustrate

FROM: a "conservative country's"
view in more detail,
my comments of 6/8
could be used as
an annex to her.
Whittome's note.

Please, find attached my
copy in case you need
it for further copying.

June 8, 1976

Some Comments on "The Adequacy of Global Reserves"

The paper brings back to mind the debates on the adequacy of reserves of the mid-1960s, prior to the establishment of the Special Drawing Account. Many of the issues discussed at that time are raised and the answers remain controversial as before. Some of the issues are: Can the need for reserves be related to imports? How to combine conditional and unconditional liquidity? Are reserves to be held or spent? At what stage does availability of financing through reserve creation impede or support adjustment? What are the effects of global liquidity injections on inflation? There are new issues, to be sure, such as the evaluation of the situation of the oil countries for the assessment of reserve needs, the importance of private markets for balance of payments financing and the onset of generalized floating. The old questions persist, however, and require more careful treatment.

Among the arguments of the past, we will undoubtedly be reminded that we had rejected the idea of reserve needs of individual countries or groups of countries in favor of a global approach. The paper points out that the existence of floating rates and the oil price increase have caused varying changes in reserves needs of different groups of countries which have to be taken into account. It argues the oil countries, at least as a group, the United States, and the freely floating countries are not in need of additional reserves while their excess reserves are not available to the rest of the world. Neither assumption is unassailable. A substantial part of the oil surpluses are held

in Euro-currency markets and while reserves are not earned through this market, they can certainly be borrowed. As for the "floating" industrial countries, while they do not supply reserves by intervention, the lack thereof keeps their exchange rates at a more appreciated level than otherwise and allows other countries greater scope for adjustment. These points are implicitly recognized at the top of page 19 when arguing for SDR issues lower than the calculated need of liquidity short countries. Also it is less than obvious that the United States would insist on having balanced external accounts. By maintaining, within certain limits, an attitude of benign neglect, the United States can contribute substantially to the creation of additional liquidity. This might be a less desirable type of liquidity, nevertheless, it is additional liquidity.

While the draft paper notes in passing (top of page 5) that reserves do not have to finance turnover but imbalances, it proceeds thereafter to relate reserves to imports which implies that overall imbalances develop in step with the expansion of imports and that there are no possibilities of offsetting capital movements. But even if one accepts imports as a proxy, there remains the question if the increase in world trade in recent years can be taken as a basis. Average national growth rates may well be lower than in the past. The impact of the oil price increase on trade was, in its magnitude, a once-for-all development which cannot be expected to be repeated. In addition, any simple projection of past trade trends accepts as unavoidable the lack of longer-term structural changes in response to the increased cost of energy. After the emergence of the oil-related difficulties, it was thought that oil

deficits should be financed only temporarily so as to allow for the necessary structural changes which would reflect the redistribution of the power of disposition over real resources. At issue is whether reserve creation is supposed to accommodate the oil imbalances or help to correct them. A look at the list of countries included in the 55 per cent figure reveals that about half of them (the industrialized and the more developed primary producing countries) are countries where a more flexible response to new realities could be expected. The reference in the paper to "appropriate and desirable policies" would, however, seem to endorse a continuation of the policies of nonadjustment. "Appropriate policies" could, of course, be interpreted as allowing for anti-recessionary policies; however, in past discussions, there was agreement that reserve creation should not be used for cyclical purposes. Besides, any actual reserve creation in the years to come might coincide with a world-wide boom.

There remains a group of countries where any further adjustment to higher energy-related prices might simply mean the sacrifice of growth or even worse. These countries account for about one fourth of participants in the Special Drawing Account. For their reserve needs, import developments may indeed be the most reliable indicator, and their policy might be strongly influenced by the import/reserve ratio, not least because they have only limited access to international markets for borrowing. However, what these countries need is not so much liquidity for bridging temporary imbalances but a permanent transfer of real resources. Although the paper seems to implicitly acknowledge this (see sentence at the end of page 9), it stops short of advocating an allocation of SDRs to LDCs only. It rather suggests the creation of SDRs in amounts tuned to the needs of this limited group of countries. In the process, all other countries would be equally provided with liquidity which could slow down desirable and necessary adjustment in a number of countries, and create a sizable potential for inflation.

The paper makes a case for unconditional rather than conditional liquidity. While there was always the notion that not all liquidity needs could be met by the provision of conditional liquidity, there is also the strong feeling that both should go hand in hand and that conditional liquidity has an important role to play. Some of the problems, mentioned above, namely the need to ensure in the longer run a restructuring of economies in line with the higher price for energy-related goods as well as general adjustment needs could be better handled by the availability of conditional liquidity. Some of the needs of the LDCs could be accommodated by the special facililities of the Fund, tailored to the requirements of LDCs, in particular, the Extended Facility. From this point of view the need to allocate SDRs would be substantially smaller.

Besides, it appears a bit curious for a staff paper to be emphasizing the disadvantages of conditional liquidity at a time when a major increase in quotas is on its way. Also, the various doubts about the kind of conditionality used for Fund drawings (see pp. 13, 15, and 16) seem to call rather for a re-examination of the presently applied policy on conditionality than for rejection of conditionality in general.

One of the arguments for unconditional liquidity used in the paper is that access to private markets is only possible for a country in serious difficulties if it has a good reserve base. Obviously, if a country is in serious difficulties, the country will use any additional reserves. In other words, it appears that the paper uses the argument that reserves are there to be held in cases where additional reserves

are rather needed to be spent. More generally, it is not the amount of reserves of a country which inspires confidence but the speed with which they are likely to be spent, in a word, policy. On the other hand, it is a fact that for many countries it is easier to get access to private markets and other sources of financing if they are willing to obtain liquidity with conditions attached (e.g., by stand-by arrangements).

There is one important aspect of reserve creation which is hardly dealt with in the paper, namely, the relationship between the creation of international liquidity and inflation; there is only a short reference to the direct inflationary impact of reserve creation on page 19. Given the general apprehension about inflation in many countries and the experience of worldwide inflation in recent years, one would expect a more thorough discussion of this problem in the paper. After all, Article XXIV (new Art. XVIII) refers to the avoidance of "stagnation and deflation as well as excess demand and inflation."

It is well-known that the creation of SDRs does not have a direct inflationary impact in the recipient country as long as its counterpart in national currency is neutralized. Many countries, are, however, concerned about the indirect impact of reserve creation and how they will be affected by induced expansionary policies in other countries against which they cannot defend themselves completely, even under a regime of floating rates. In a number of potential deficit countries, reserve ease may remove existing constraints with regard to public expenditure or income policy, leading to an increase in imports of consumer and investment goods. The countries which are able to meet

this demand will soon find themselves in a dilemma. Either they let their exchange rate move upward which may hurt export industries or they absorb trade surpluses by accumulation of reserves which may upset their internal stability.

To provide a proper balance, it would help to show awareness of the need for control of liquidity, even in a paper addressed to the creation of liquidity. It does not appear sufficient either to play down the probability of liquidity creation through an expansion in reserve currency holdings or to simply state (on page 20) that this source of liquidity has not been considered.1/

1/ It is interesting to note that the Bundesbank in its Annual Report for 1975 (page 62, German edition) refers to this problem in saying: "A better control of international liquidity remains...in the long run a task, though difficult to solve. /This task/ was also explicitly mentioned in the communique of the monetary conference of Jamaica in January 1976 as one of the aims to be pursued."

Office Memorandum

TO : Mr. L. A. Whittome

DATE: June 24, 1976

FROM : H. Ungerer

SUBJECT : The Adequacy of Global Reserves

I read Mr. Polak's new draft and compared the new text with the old one, paragraph by paragraph. My impression is that the expansionary bias of the old draft remained unchanged. There is still hardly any discussion of the relation between liquidity creation and inflation. Import developments continue to be used as a proxy for reserve need without much qualification. The question, to what extent the quantity and the type of additional liquidity affects the working of the adjustment process does not get much more attention than in the old draft, except for the changes referred to under 1 below. The section on quantitative aspects still contains the figures of SDR 7 and SDR 12 billion (see pp. 18 and 19).

Apart from minor editorial changes, there are two major changes:

1. The section on conditional and unconditional liquidity is restructured and contains at its end (in two new paragraphs on p. 17) a more balanced assessment of the question of unconditional versus conditional liquidity.

2. At the very end of the paper, on pp. 20 and 21, new ideas are introduced. As a consequence, the question of a further increase of reserve currency holdings is discussed with a less laconic attitude. One interesting idea, of course intended to strengthen the case for a SDR issue, is that an allocation of SDRs could "be offset at least in part by a reduced accumulation of reserve currencies, and would therefore not result in an equivalent net increase in global reserves". This would "help to improve the composition of world liquidity....." (on pp. 20/21).

All paragraphs marked with ✓ are virtually unchanged. All changes of some significance are indicated in the margins (see pp. 5, 6, 7, 10, 12, 14, 15, 16, 17, 20, and 21).

cc: Mr. Mohammed

Mr Whittome

2

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

DEPUTY MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

June 22, 1976

MEMORANDUM

To: Mr. Schwartz

From: William B. Dale

Subject: The Adequacy of Global Reserves

I want to make two comments on the revised paper, the first minor and technical and the second of substance.

1. I meant to raise this question on the first draft, but neglected it. I do not understand why table 1 and 2 specify "(5 quarter averages)". This does not seem obviously consistent with footnote 1 on page 2. I should think some technical explanation is called for.

2. I think Section 3 ("Conditional and Unconditional Liquidity") will have to make up its mind. I greatly sympathize with the author, because drawing the arguments is far from easy. But it does not seem to me to come down anywhere, and has a tendency to meander in the process. Perhaps I am wrong, but I have the feeling this section would benefit from an examination of some numerical relationships, such as the ratio of quotas to reserves and/or of quotas to imports over the Fund's history.

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

Have

No. Have we received the revised paper (I don't think so)?

Mr Whittome

Office Memorandum

TO : Mr. Schwartz DATE: June 18, 1976

FROM : Ernest Sturc

SUBJECT : Comments on The Adequacy of Global Reserves

Page 5: Second sentence of first full paragraph

If the country runs down its reserves, it would be appreciating its rate beyond what market forces would justify. It would consequently no longer be a free floater.

Page 6: First complete paragraph, third sentence

This sentence does not seem to accord with the experience of a number of developing countries with crawling pegs and our own recommendations to them to pursue a flexible exchange rate in the short run. More generally, the longer-run effect of exchange rate changes in developing countries is substantial.

Page 7: Second full paragraph

The deficit in the balance of payments of primary producing countries was largely financed by loans from international banks, and to a much smaller extent through the use of Fund conditional facilities.

In fact, at other points in the paper, there are statements--which are not correct--that developing countries have limited access to international banks (p.8), that borrowing to bolster reserves is not possible for them (pp.10,16), etc.

Page 8:

The discussion of Section 3 is in our view somewhat biased in favor of unconditional liquidity. While I accept the argument of page 8, and the need for larger unconditional liquidity, I would not like to argue its case at the expense of increased conditional liquidity. I doubt, for example, whether it is wise to play down the usefulness of conditional liquidity as is done at the bottom of page 14. I find it difficult in any case to understand the point here. Is it meant that because of conditions attached to conditional borrowing (designed though they are to promote desirable policies), countries may be unwilling to resort to such borrowing, and that in the absence of any other finance, they may adopt undesirable measures such as restrictions?

Page 9:

Not all oil countries can be said to constitute a reserve "sink." This description will apply to Saudi Arabia, Kuwait and UAE only.

Page 17 ff:

I would be strongly against giving figures about SDR creation.

cc: Managing Director
Deputy Managing Director
Messrs. Gold, Polak, Del Canto, Gunter, Habermeier, Toure, Tun Thin, Whittome, Green

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

MEMORANDUM June 15, 1976

To: The Managing Director

From: Charles F. Schwartz C.F.S.

Subject: The Adequacy of Global Reserves

Mr. Polak has asked me to send you the attached further version of this paper. Most, though not all, of the changes have been seen by him.

Mr. Whittome, while not having as yet commented in detail on the paper, has suggested as a preliminary thought that it might not be tactically prudent to mention specific figures on a possible SDR allocation. This matter could be considered in the context of a discussion on the paper as a whole.

Attachment

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

Mr. Polak June 8, 1976

L. A. Whittome

Adequacy of Global Reserves

The attached commentary has been prepared by Mr. Ungerer. Deliberately it reflects the thinking and likely response of the more conservative countries in Europe. While we may have to be resigned to being labeled as expansionists there might be some advantage to strengthening our argumentation to take account of some of the objections that will inevitably be raised. We have not yet attempted to reach a Departmental position on the subject, but one preliminary thought is that it might not be tactically prudent to mention any numbers in a paper of this sort.

Attachment

cc: Mr. Green

Mr. Ungerer
Mr. Brehmer

June 8, 1976

Some Comments on "The Adequacy of Global Reserves"

The paper brings back to mind the debates on the adequacy of reserves of the mid-1960s, prior to the establishment of the Special Drawing Account. Many of the issues discussed at that time are raised and the answers remain controversial as before. Some of the issues are: Can the need for reserves be related to imports? How to combine conditional and unconditional liquidity? Are reserves to be held or spent? At what stage does availability of financing through reserve creation impede or support adjustment? What are the effects of global liquidity injections on inflation? There are new issues, to be sure, such as the evaluation of the situation of the oil countries for the assessment of reserve needs, the importance of private markets for balance of payments financing and the onset of generalized floating. The old questions persist, however, and require more careful treatment.

Among the arguments of the past, we will undoubtedly be reminded that we had rejected the idea of reserve needs of individual countries or groups of countries in favor of a global approach. The paper points out that the existence of floating rates and the oil price increase have caused varying changes in reserves needs of different groups of countries which have to be taken into account. It argues the oil countries, at least as a group, the United States, and the freely floating countries are not in need of additional reserves while their excess reserves are not available to the rest of the world. Neither assumption is unassailable. A substantial part of the oil surpluses are held

in Euro-currency markets and while reserves are not earned through this market, they can certainly be borrowed. As for the "floating" industrial countries, while they do not supply reserves by intervention, the lack thereof keeps their exchange rates at a more appreciated level than otherwise and allows other countries greater scope for adjustment. These points are implicitly recognized at the top of page 19 when arguing for SDR issues lower than the calculated need of liquidity short countries. Also it is less than obvious that the United States would insist on having balanced external accounts. By maintaining, within certain limits, an attitude of benign neglect, the United States can contribute substantially to the creation of additional liquidity. This might be a less desirable type of liquidity, nevertheless, it is additional liquidity.

While the draft paper notes in passing (top of page 5) that reserves do not have to finance turnover but imbalances, it proceeds thereafter to relate reserves to imports which implies that overall imbalances develop in step with the expansion of imports and that there are no possibilities of offsetting capital movements. But even if one accepts imports as a proxy, there remains the question if the increase in world trade in recent years can be taken as a basis. Average national growth rates may well be lower than in the past. The impact of the oil price increase on trade was, in its magnitude, a once-for-all development which cannot be expected to be repeated. In addition, any simple projection of past trade trends accepts as unavoidable the lack of longer-term structural changes in response to the increased cost of energy. After the emergence of the oil-related difficulties, it was thought that oil

deficits should be financed only temporarily so as to allow for the necessary structural changes which would reflect the redistribution of the power of disposition over real resources. At issue is whether reserve creation is supposed to accommodate the oil imbalances or help to correct them. A look at the list of countries included in the 55 per cent figure reveals that about half of them (the industrialized and the more developed primary producing countries) are countries where a more flexible response to new realities could be expected. The reference in the paper to "appropriate and desirable policies" would, however, seem to endorse a continuation of the policies of nonadjustment. "Appropriate policies" could, of course, be interpreted as allowing for anti-recessionary policies; however, in past discussions, there was agreement that reserve creation should not be used for cyclical purposes. Besides, any actual reserve creation in the years to come might coincide with a world-wide boom.

There remains a group of countries where any further adjustment to higher energy-related prices might simply mean the sacrifice of growth or even worse. These countries account for about one fourth of participants in the Special Drawing Account. For their reserve needs, import developments may indeed be the most reliable indicator, and their policy might be strongly influenced by the import/reserve ratio, not least because they have only limited access to international markets for borrowing. However, what these countries need is not so much liquidity for bridging temporary imbalances but a permanent transfer of real resources. Although the paper seems to implicitly acknowledge this (see sentence at the end of page 9), it stops short of advocating an allocation of SDRs to LDCs only. It rather suggests the creation of SDRs in amounts tuned to the needs of this limited group of countries. In the process, all other countries would be equally provided with liquidity which could slow down desirable and necessary adjustment in a number of countries, and create a sizable potential for inflation.

The paper makes a case for unconditional rather than conditional liquidity. While there was always the notion that not all liquidity needs could be met by the provision of conditional liquidity, there is also the strong feeling that both should go hand in hand and that conditional liquidity has an important role to play. Some of the problems, mentioned above, namely the need to ensure in the longer run a restructuring of economies in line with the higher price for energy-related goods as well as general adjustment needs could be better handled by the availability of conditional liquidity. Some of the needs of the LDCs could be accommodated by the special facililities of the Fund, tailored to the requirements of LDCs, in particular, the Extended Facility. From this point of view the need to allocate SDRs would be substantially smaller.

Besides, it appears a bit curious for a staff paper to be emphasizing the disadvantages of conditional liquidity at a time when a major increase in quotas is on its way. Also, the various doubts about the kind of conditionality used for Fund drawings (see pp. 13, 15, and 16) seem to call rather for a re-examination of the presently applied policy on conditionality than for rejection of conditionality in general.

One of the arguments for unconditional liquidity used in the paper is that access to private markets is only possible for a country in serious difficulties if it has a good reserve base. Obviously, if a country is in serious difficulties, the country will use any additional reserves. In other words, it appears that the paper uses the argument that reserves are there to be held in cases where additional reserves

are rather needed to be spent. More generally, it is not the amount of reserves of a country which inspires confidence but the speed with which they are likely to be spent, in a word, policy. On the other hand, it is a fact that for many countries it is easier to get access to private markets and other sources of financing if they are willing to obtain liquidity with conditions attached (e.g., by stand-by arrangements).

There is one important aspect of reserve creation which is hardly dealt with in the paper, namely, the relationship between the creation of international liquidity and inflation; there is only a short reference to the direct inflationary impact of reserve creation on page 19. Given the general apprehension about inflation in many countries and the experience of worldwide inflation in recent years, one would expect a more thorough discussion of this problem in the paper. After all, Article XXIV (new Art. XVIII) refers to the avoidance of "stagnation and deflation as well as excess demand and inflation."

It is well-known that the creation of SDRs does not have a direct inflationary impact in the recipient country as long as its counterpart in national currency is neutralized. Many countries, are, however, concerned about the indirect impact of reserve creation and how they will be affected by induced expansionary policies in other countries against which they cannot defend themselves completely, even under a regime of floating rates. In a number of potential deficit countries, reserve ease may remove existing constraints with regard to public expenditure or income policy, leading to an increase in imports of consumer and investment goods. The countries which are able to meet

this demand will soon find themselves in a dilemma. Either they let their exchange rate move upward which may hurt export industries or they absorb trade surpluses by accumulation of reserves which may upset their internal stability.

To provide a proper balance, it would help to show awareness of the need for control of liquidity, even in a paper addressed to the creation of liquidity. It does not appear sufficient either to play down the probability of liquidity creation through an expansion in reserve currency holdings or to simply state (on page 20) that this source of liquidity has not been considered.1/

1/ It is interesting to note that the Bundesbank in its Annual Report for 1975 (page 62, German edition) refers to this problem in saying: "A better control of international liquidity remains...in the long run a task, though difficult to solve. /This task/ was also explicitly mentioned in the communique of the monetary conference of Jamaica in January 1976 as one of the aims to be pursued."

Office Memorandum

TO : Mr. Whittome

FROM : H. Ungerer

DATE: June 7, 1976

SUBJECT : Memorandum on Adequacy of Reserves

Please find attached a new draft of my memorandum. It attempts to give a more coherent reasoning based on the same arguments as in my first draft. This new draft incorporates a number of suggestions by Mr. Mohammed with regard to the structure of the paper, and the way some arguments are presented. I did not take into account, however, those of his observations which seemed to reflect a difference of opinion. I attach, for comparison, the copy of an earlier draft on which Mr. Mohammed has written his comments.

Attachments

cc: Mr. Mohammed

cc: AFM

PL look. What I think would be most useful as I see it is to prepare a reasoned view of the conservatives' arguments & to send it to JJP with perhaps a copy to MD making plain that it is not our views necessarily.

7/6

DRAFT/HU/6/7/76

Some Comments on "The Adequacy of Global Reserves"

There may be good reasons to start now considerations about the adequacy of reserves and to draw attention to the particular situation of various groups of countries in the wake of the international developments of the last five years. In its present form, however, the Research Department's paper is bound to raise suspicion in more conservative quarters of the Fund membership and will inevitably reinforce the staff's image as being "expansionist." In opening the subject, it is important to keep in mind the sensitivities of a number of important countries, and the arguments and discussions of the past, particularly those of the late 1960s in connection with the establishment of the SDR facility. To start with, it might not be tactically prudent to mention in a preliminary paper any figure, no matter how soundly based.

Among the arguments of the past, we will undoubtedly be reminded that we had rejected the idea of reserve needs of individual countries or groups of countries in favor of a global approach. It appears appropriate, however, that the present paper tries to take into account the varying impact of the oil price increase and of floating on reserve needs of different groups of countries. It argues that the oil countries as a whole, the United States, and the countries with freely floating currencies (snake countries and Canada) neither need additional reserves nor are liable to make their excess reserves available to the rest of the world (amounting to about 55 per cent of participants in the Special Drawing Account) which experiences reserve stringency rather than reserve ease.

Is the assumption correct that countries with excess reserves will not make available liquidity by running a deficit? The oil countries are expected to continue to have substantial surpluses—the size of which, however, will depend on adjustment measures by prospective deficit countries. The countries which at present are freely floating should not be expected to forego any sizable intervention; there are a number of reasons (e.g., internal structural problems, influence of capital transactions) which might induce them to influence their exchange rates although such action would perhaps more often tend to depreciate (and thus to absorb reserves) than to appreciate their currenties, On the other hand, it seems less than obvious that the United States would insist on having balanced external accounts. By maintaining, within certain limits, its stature of benign neglect, the United States, might contribute substantially to the creation of additional liquidity by accumulating liabilities toward official holders or private holders (which can be transformed into official liabilities via the Euro-dollar market). This might be a less desirable type of liquidity, nevertheless, it is additional liquidity.

In trying to find a yardstick to assess the adequacy of reserves and future needs, it has to be kept in mind that reserves do not have to finance turnover, as domestic money does, but imbalances. To relate reserves to imports implies that overall imbalances develop in step with the expansion of imports and that they are no offsetting capital movements. But even if one accepts imports as a proxy, there remains

the question if the increase in world trade in recent years can be taken as a basis. Average national growth rates may well be lower than in the past. The impact of the oil price increase on trade was, in its magnitude, a once-for-all development which cannot be expected to be repeated. In addition, any simple projection of past trade trends in the future accepts as unavoidable the lack of longer-term structural changes in response to the increased cost of energy. After the emergence of the oil-related difficulties, it was thought that oil deficits should be financed only temporarily so as to allow for the necessary structural changes which would reflect the redistribution of the power of disposition over real resources. At issue is whether reserve creation is supposed to accommodate the oil imbalances or help to correct them. A look at the list of countries included in the 55 per cent figure reveals that about half (the industrialized and the more developed primary producing countries) of them are countries where a more flexible response to new realities could be expected. The reference in the paper to "appropriate and desirable policies" seems to endorse a continuation of the policies of nonadjustment. "Appropriate policies" could, of course, be interpreted as allowing for anti-recessionary policies; however, in past discussions, there was agreement that reserve creation should not be used for cyclical purposes. Besides, any actual reserve creation in the years to come might coincide with a world-wide boom.

There remains, however, a group of countries where any further adjustment to higher energy-related prices might simply mean the sacrifice

of any growth or even worse. These countries account for about one fourth of participants in the Special Drawing Account. For their reserve needs, import developments may indeed be the most reliable indicator, and their policy might be strongly influenced by the import/reserve ratio, not least because they have only limited access to international markets for borrowing. Leaving aside for the moment the possibility that a number of these countries might benefit from favorable developments in the prices for raw materials and from agreements which might be reached in the context of the on-going North-South dialogue, they appear to need not so much liquidity for temporary imbalances but a permanent transfer of real resources. Although the paper seems to implicitly acknowledge this (see sentence at the end of p. 9), it stops short of outright advocating an allocation of SDRs to LDCs only. It rather suggests the creation of SDRs in amounts tuned to the needs of this limited group of countries. In the process, all other countries would be equally provided with liquidity which at present could slow down the desirable and necessary adjustment in a number of countries, and for the future would create a sizable potential for inflationary policies even by countries which presently, due in part to cyclical reasons, might not be in need of using reserves.

There remains the question of the needed transfer of real resources to LDCs and it appears that the developed countries are not ready to provide the necessary funds. Perhaps, this would be a reason to discuss again a possible role for the Fund in providing liquidity not only for temporary balance of payments financing but also for development financing. However, wouldn't it be better to say so clearly and thus take up anew the issue of the link?

The paper makes a case for satisfying the reserve needs by creating unconditional rather than conditional liquidity. While there was always the notion that not all liquidity needs could be met by the provision of conditional liquidity, there is also the strong feeling that both should go hand in hand and that conditional liquidity has an important role to play. Some of the problems, mentioned above, namely the need to ensure in the longer run a restructuring of economies in line with the higher price for energy-related goods as well as general adjustment needs could be better handled by the availability of conditional liquidity. Some of the needs of the LDCs could be accommodated by the special facililities of the Fund, tailored to the requirements of LDCs, in particular, the Extended Facility. From this point of view the need to allocate SDRs would be substantially smaller.

Besides, it looks a bit curious if a staff paper overemphasizes the disadvantages of conditional liquidity at a time when a major increase in quotas is on its way. Also, the various doubts about the kind of conditionality used for Fund drawings (see pp. 13, 15, and 16) seem to call rather for a re-examination of the presently applied policy on conditionality than for rejection of conditionality in general.

One of the arguments for unconditional liquidity used in the paper is that access to private markets is only possible for a country in serious difficultues if it has a good reserve base. Obviously, if a country is in serious difficultues, the country will use any additional reserves. In other words, it appears that the paper uses the argument that reserves are there to be held in cases where additional reserves

are rather needed to be spent. More generally, it is not the amount of reserves of a country which inspires confidence but the speed with which they are spent; in other words: policy. On the other hand, it is a fact that for many countries it is easier to get access to private markets and other sources of financing if they are willing to obtain liquidity with conditions attached (e.g., by stand-by arrangements).

There is one important aspect of reserve creation which is hardly dealt with in the paper, namely, the relationship between the creation of international liquidity and inflation; there is only a short reference to the direct inflationary impact of reserve creation on page 19. Given the general apprehension about inflation in many countries and the experience of worldwide rampant inflation in recent years, one would expect a more thorough discussion of this problem in the paper. After all, Article XXIV (new Art. XVIII) refers to the avoidance of "stagnation and deflation as well as excess demand and inflation."

It is well-known that the creation of SDRs does not have a direct inflationary impact in the recipient country as long as its counterpart in national currency is properly neutralized. Many countries are, however, concerned about the indirect impact of reserve creation and how they will be affected by induced expansionary policies in other countries against which they cannot defend themselves completely, even under a regime of floating rates. In a number of potential deficit countries, reserve ease may remove existing constraints with regard to public expenditure or income policy, leading to an increase in imports of consumer and investment goods. The countries which are able to meet

this demand will soon find themselves in a dilemma. Either they let their exchange rate move upward in order to keep their balance of payments in equilibrium and to avoid undesired general expansionary impulses. This may hurt either/industries which then would lose their international competitiveness resulting in structural and regional imbalances. Or they absorb trade surpluses by accumulation of reserves which may upset their internal stability.

In this context, it is interesting to note that H. Robert Heller in his article "International Reserves and World-Wide Inflation," IMF Staff Papers, March 1976, refers to the early 1970s as a period of "excessive expansion of global liquidity" which he thinks "laid the foundation for the world-wide inflation of the early 1970s."

To provide a proper balance, it would help to show awareness of the need for control of liquidity, even in a paper addressed to the creation of liquidity. It does not appear sufficient either to play down the probability of liquidity creation through an expansion in reserve currency holdings or to simply state (on p. 20) that this source of liquidity has not been considered.[1/]

1/ It is interesting to note that the Bundesbank in its Annual Report for 1975 (p. 62, German edition) refers to this problem in saying: "A better control of international liquidity remains.....in the long rund a task, though difficult to solve. [This task] was also explicitly mentioned in the communiqué of the monetary conference of Jamaica in January 1976 as one of the aims to be pursued."

DRAFT/HU/6/3/76

Some Comments on "The Adequacy of Global Reserves"

It is not clear what the final intention of the paper is. The mention of some figures for the future creation of SDRs seems to indicate a desire to open discussions on an early allocation of SDRs while the general structure of the paper lends itself more to a consideration of broad issues. At any rate, the subject under discussion is extremely sensitive. Therefore, it is necessary to look critically at the various arguments in favor of a large creation of unconditional liquidity, and to re-examine the line of thinking from the mid-1960s in the light of more recent developments in the field of international monetary relations. My problems with the paper relate to conceptual questions as well as to questions of economic judgment.

In contrast to the past when the idea of reserve needs of individual countries or groups of countries was rejected in favor of a global approach, the paper tries to take into account the varying impact of the oil price increase and the practice of floating on reserve needs of different groups of countries. It argues that the oil countries as a whole, the United States, and the countries with freely floating currencies (snake countries and Canada) neither need additional reserves nor are liable to make their excess reserves available to the rest of the world. This rest, consisting of non-oil LDCs, other primary producing countries, and the industrialized countries, with managed floating, and accounting for about 55 per cent of participants in the Special Drawing Account, is said to experience reserve stringency rather than reserve ease. It was, therefore, their need which should determine reserve creation.

Is the assumption correct that countries with excess reserves will not make available liquidity by running a deficit? The oil countries are expected to continue to have substantial surpluses--the size of which, however, will depend on adjustment measures by prospective deficit countries. The freely floating countries should not be expected to forego any sizable intervention; there are a number of reasons (e.g., internal structural problems, influence of capital transactions) which might induce them to influence their exchange rates although such action would rather tend to depreciate (and thus to absorb reserves) than to appreciate their currencies. On the other hand, it seems less than obvious that the United States would insist on having balanced external accounts. By maintaining, within certain limits, its stature of benign neglect, the United States might contribute substantially to the creation of additional liquidity by accumulating liabilities toward official holders or private holders (which can be transformed into official liabilities via the Euro-dollar market). This might be a less desirable type of liquidity, nevertheless, it is additional liquidity.

In trying to find a yardstick to assess the adequacy of reserves and future needs, it has to be kept in mind that reserves do not have to finance turnover, as domestic money does, but imbalances. To relate reserves to imports implies that overall imbalances develop in step with the expansion of trade and that there are not compensating capital movements. But even if one accepts imports as a proxy, there remains the question if the increase in world trade in recent years can be taken as a basis. Average national growth rates may well be lower than in the past. The impact of the oil price increase on trade was, in this magnitude, a once-for-all development which cannot be expected to be repeated. In

addition, any simple projection of past trade trends in the future accepts as unavoidable the lack of longer-term structural changes in response to the increased cost of energy. After the emergence of the oil-related difficulties, it was thought that oil deficits should be financed only temporarily so as to allow for the necessary structural changes which would reflect the redistribution of the power of disposition over real resources. At issue is whether reserve creation is supposed to accommodate the oil imbalances or help to correct them.

A look at the list of countries included in the 55 per cent figure reveals that about half (the industrialized and the more developed primary producing countries) of them are countries where a more flexible response to new realities could be expected. The reference in the paper to "appropriate and desirable policies" seems to endorse a continuation of the policies of nonadjustment. "Appropriate policies" could, of course, be interpreted as allowing for anti-recessionary policies; however, in past discussions, there was agreement that reserve creation should not be used for cyclical purposes. Besides, any actual reserve creation in the years to come might coincide with a world-wide boom.

There remains, however, a group of countries where any further adjustment to higher energy-related prices might simply mean the sacrifice of any growth or even worse. These countries account for about one fourth of participants in the Special Drawing Account. For their reserve needs, import developments may indeed be in the most reliable indicator, and their policy might be strongly influenced by the import/reserve ratio, not least because they have only limited access to international markets for borrowing. Leaving aside for the moment the possibility that a number of these countries might benefit from favorable developments in the prices for raw materials and from agreements which might be reached in the context of the on-going North-South dialogue, they appear to need not so much liquidity for temporary imbalances but a permanent transfer

If these countries do adjust and the remaining countries don't or can't, the structural surpluses of the OPEC becomes a structural deficit of the LDCs. If they cannot borrow continuously, they have no choice but to adjust by reducing growth and/or applying restrictions. If the structural surpluses of OPEC cannot meet, what do we want & expect the industrialized + more developed primary producing countries to adjust fully? SDR issue would not and rather than such a less-than-full adjustment

of real resources. Although the paper seems to implicitly acknowledge this (see sentence at the end of p. 9), it stops short of outright advocating an allocation of SDRs to LDCs/ only /. It rather suggests the creation of SDRs in amounts tuned to the needs of a limited group of countries. In the process, all other countries would be equally provided with liquidity which at present would slow down the desirable and necessary adjustment in a number of countries, and for the future would create a huge potential for inflationary policies even by countries which at present due in part to cyclical reasons might not be in need of using reserves.

/There remains the question of the needed transfer of real resources to LDCs /and it appears that the developed countries are not ready to provide the necessary funds. Perhaps, this should be a reason for the Fund to provide liquidity not only for temporary balance of payments financing but also for development financing. However, wouldn't it be better to say so clearly and thus revive the issue of the link?/

The paper makes a case for satisfying the reserve needs by creating unconditional rather than conditional liquidity. While there was always the notion that not all liquidity needs could be met by the provision of conditional liquidity, there is also the strong feeling that both should go hand in hand and that conditional liquidity has an important role to play. Some of the problems, mentioned above, namely the need to ensure in the longer run a restructuring of economies in line with the higher price for energy-related goods as well as general adjustment needs could be better handled by the availability of conditional liquidity. Some of the needs of the LDCs could be accommodated by the special facilities of the Fund, tailored to the need of LDCs, in particular, the Extended Facility.

Besides, it looks a bit curious if a staff paper dismisses in an off-hand way the potential of additional conditional liquidity at a time when a major increase in quotas is on its way. Also, the various /attacks on/ /doubts about/ the kind of conditionality used for Fund drawings (see pp. 13, 15, and 16) seem to call rather for a re-examination of the presently applied policy on conditionality than for rejection of conditionality in general.

One of the arguments for unconditional liquidity is that access to private markets is only possible for a country in serious difficulties if it has a good reserve base. Obviously, if a country is in serious difficulties, the country will use any additional reserves. On the other hand, it is a fact that for many countries it is easier to get access to private markets and other sources of financing, such as debt rescheduling, if they are willing to obtain liquidity with conditions attached (e.g., by stand-by arrangements). In other words, it appears that the paper uses the argument that reserves are there to be held in cases where additional reserves are rather needed to be spent. More generally, it is not the amount of reserves of a country which inspires confidence but the speed with which they are spent; in other words: policy.

There is one important aspect of reserve creation which is hardly dealt with in the paper, namely, the relationship between the creation of international liquidity and inflation; there is only a short reference to the direct inflationary impact of reserve creation on page 19. Given the general apprehension about inflation in many countries and the experience of worldwide rampant inflation in recent years, one would expect a more thorough discussion of this problem in the paper. After all, Article XXIV (new Art. XVIII) refers to the avoidance of "stagnation and deflation as well as excess demand and inflation".

It is well-known that the creation of SDRs does not have a direct inflationary impact in the recipient country as long as its counterpart in national currency is properly neutralized. Many countries are, however, concerned about the indirect impact of reserve creation and how they will be affected by induced expansionary policies in other countries against which they cannot defend themselves completely, even under a regime of floating rates. In a number of countries, reserve ease may remove existing constraints with regard to public expenditure or income policy. This may lead to a sharp increase in demand for consumer and investment goods. The countries which are able to meet this demand will soon find themselves in a dilemma. Either they let their exchange rate move upward in order to keep their balance of payments in equilibrium and to avoid undesired general expansionary impulses, which may hurt other industries or certain regions concentrating in economic activities which are in less international demand; or they absorb trade surpluses by accumulation of reserves which may upset their internal stability. Experience shows that it is not only the absolute level of the pace of inflation which creates problems but equally the unavoidable time lags in adjustment and the distortions in economic structure which are related with excess demand and inflation.

In this context, it is interesting to note that H. Robert Heller in his article "International Reserves and World-Wide Inflation", IMF Staff Papers, March 1976, refers to the early 1970s as a period of "excessive expansion of global liquidity" which he thinks "laid the foundation for the world-wide inflation of the early 1970s".

The paper in its present form is bound to raise suspicion in more conservative quarters of the Fund membership and will inevitably reinforce the staff's image as being "expansionist". There may be a good reason to start now considerations about the adequacy of reserves and to draw attention to the particular situation of various groups of countries in the wake of the international developments of the last five years. There should, however, be an unbiased discussion of the pros and cons of the creation of additional liquidity. In doing so, the sensitivities of a number of important countries, and the arguments and discussions in the past, particularly those in the late 1960s in connection with the establishment of the SDR facility, should be taken into account. From this point of view, it certainly does not appear wise to mention already in a paper for general discussion figures of SDRs 7 or 12 billion--no matter how they are arrived at--since this will only stiffen opposition to the idea of reserve creation at the very beginning. In this context a last, very general observation: The paper addresses itself only to the creation of liquidity, and not the control of liquidity. Though it might be impossible to make any progress on the latter subject, it should perhaps be mentioned. It is not enough either to play down the probability of liquidity creation through an expansion in reserve currency holdings or to simply state (on p. 20) that this source of liquidity has not been considered. It is interesting to note that the Bundesbank in its Annual Report for 1975 (p. 62, German edition) refers to this problem in saying: "A better control of international liquidity remains.....in the long run a task, though difficult to solve. /This task/ was also explicitly mentioned in the communiqué of the monetary conference of Jamaica in January 1976 as one of the aims to be pursued."

Mr. Whittome

Mr Ungerer. I'll take a critical look at this paper & let me have comments through Mr Mohammed.

JJP 26/5

MEMORANDUM

TO: Managing Director May 24, 1976

FROM: J. J. Polak

SUBJECT: The Adequacy of Global Reserves

I attach a discussion paper on this subject. I think you might consider sending this to the Board if the covering memorandum made clear that Directors would receive a draft text of a section of Chapter 2 of the Annual Report that, in the opinion of the staff, would meet their obligation to report on the adequacy of international liquidity, but that they might be interested in an informal discussion of a more far ranging nature.

Most of the work in the preparation of this paper has been done by Mr. Crockett.

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

i) difficulty of concept of reserves; gold; credit; swaps etc

2) danger greater (?) from excess than insufficiency especially given qualitative character of reserves

3) doubts re extent to reserve centers

4) accommodating not correcting of imbalances

5) of LDCs — this last