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SM/84/24

January 19, 1984

To: Members of the Executive Board
From: The Secretary
Subject: Review of the Level of the Fund's SDR Holdings

Attached for consideration by the Executive Directors is a paper on the level of the Fund's SDR holdings. A draft decision appears on page 6.

This subject has been tentatively scheduled for Executive Board discussion on Monday, February 13, 1984.

Att: (1)

Other Distribution:
Department Heads



INTERNATIONAL MONETARY FUND

Review of the Level of the Fund's SDR Holdings

Prepared by the Treasurer's Department

(In consultation with the Legal Department)

Approved by W. O. Habermeier

January 19, 1984

1. Introduction

Following the inflow of SDRs in connection with quota increases under the Seventh Review, the Executive Board reviewed the policy on sales of SDRs through the operational budgets on three occasions: in March 1981, May 1982, and May 1983. 1/ As a result of these reviews, transfers of SDRs in purchases under the operational budgets were guided by the aim of progressively reducing the Fund's SDR holdings from SDR 5.6 billion--the level in early 1981--to approximately SDR 1.5 billion by the end of 1983. It was agreed on the occasion of the last review that the level of the Fund's SDR holdings would be reviewed again in the light of the progress made in implementing the increases in quotas under the Eighth General Review of Quotas. 2/ The increases in quotas are now in effect for all but a small number of members, and the Fund's SDR holdings totaled about SDR 7.0 billion at January 13, 1984.

This memorandum reviews briefly the factors that might be taken into account by the Executive Board in its consideration of the present level of the Fund's holdings of SDRs, and the amount by which this level may appropriately be reduced. In the light of this review, it is proposed that the Fund would aim to reduce its holdings of SDRs to about SDR 4.0 billion over the period through the end of May 1985; the amount of SDRs proposed for sale by the Fund under the quarterly operational budgets during the intervening period would be determined in the light of this aim. It is also proposed that another review would be conducted by April 30, 1985 to determine whether the Fund's SDR holdings should be further reduced.

1/ The relevant memoranda were "Review of the Policy on Sales of SDRs and Currencies through the Fund's Operational Budgets" (SM/81/37, February 13, 1981); "Review of Policy on Sales of SDRs and Currencies in the General Resources Account" (SM/82/46, March 1, 1982; Correction 1, April 22, 1982; and Supplement 1, May 3, 1982); and "Review of the Sales of SDRs and Proposal on the Level of the Fund's SDR Holdings" (SM/83/63, April 18, 1983). An earlier memorandum dealing with this issue was SM/78/284, "The Role of SDRs in General Resources Account", December 29, 1978.

2/ Executive Board Decision No. 7397-(83/70) S, adopted May 16, 1983.

2. General background

The General Resources Account receives and disburses SDRs in a variety of ways. Some of these receipts and disbursements are made at the initiative of the Fund; some are at the initiative of members. 1/ As a result, the Fund is not in a position to control precisely the level of its SDR holdings. The Board has decided to review the level of the Fund's holdings of SDRs from time to time and "determine an approximate range" within which the Fund will aim to maintain the Fund's SDR holdings. 2/ The main way in which the Fund is able to regulate the level of its SDR holdings on an ongoing basis is by decisions on the amounts of SDRs to be transferred in purchases under the operational budget. The principal purpose of the periodic reviews of the level of SDR holdings is that the amount of SDRs to be transferred in purchases under each operational budget should not be decided on a purely ad hoc basis, but should respond to a longer-term view on an appropriate level of the Fund's SDR holdings.

As noted above, the Executive Board last reviewed the level of the Fund's holdings of SDRs in May 1983, and decided that holdings should be reduced to about SDR 1.5 billion by December 1983. Inflows and outflows

1/ As regards inflows of SDRs to the General Resources Account, a member is required to pay charges in SDRs, while repurchases may be made in SDRs if a member wishes and the Fund is obliged to accept the SDRs. Members are required to pay 25 percent of payments for quota increases in SDRs, unless the Fund decides otherwise. The Fund also receives interest on its SDR holdings in SDRs. On the outflow side, members are not obliged to accept SDRs in any transaction or operation except replenishment. However, the Fund generally offers SDRs to members as an alternative to currencies in all payments it makes to members. Members accept SDRs willingly in purchases, and they are able to convert the SDRs so acquired into currency in a transaction with designation if they wish; significant amounts are accepted in remuneration payments; and SDRs have been accepted in repayment of loans and in payment of interest.

2/ Executive Board Decision No. 6275-(79/158) G/S, adopted September 14, 1979:

"(c) Transfers of SDRs Under Article V, Section 3(f).

Pursuant to Article V, Section 3(f), the Fund shall provide SDRs instead of the currencies of other members to a participant making a purchase in accordance with decisions on the operational budgets taken under Rule 0-10. For this purpose, the Executive Board shall keep under review the amount of the Fund's holdings of SDRs in the General Resources Account in the light of all relevant considerations, including the relationship of SDR holdings to its other assets, and will determine from time to time the approximate range within which the Fund will aim to maintain these holdings."

of SDRs in the period since March 31, 1983 are shown in Table 1. Largely because of the reserve asset payments made in connection with the quota increase under the Eighth Review, the Fund's SDR holdings have risen from about SDR 1.5 billion in early December to approximately SDR 7.0 billion. In the light of expected inflows and outflows of SDRs, including transfers of SDRs in purchases under the existing operational budget, the Fund's SDR holdings are expected to fall to approximately SDR 6.4 billion by early March 1984, when the operational budget for the March-May period will be discussed by the Executive Board.

3. Considerations bearing on the future level
of the Fund's SDR holdings

In earlier reviews, the following factors were considered in determining the target range of the Fund's holdings of SDRs: (i) the Fund's liquidity; (ii) the Fund's actual and prospective holdings of SDRs in relation to total allocations of SDRs; (iii) the Fund's operational need to hold SDRs; and (iv) the Fund's financial position.

(i) The Fund's SDRs are highly liquid assets because they can be readily used to finance members' purchases and for replenishment of needed currencies. As most SDRs transferred in purchases are channelled into the designation system, these transfers are subject to the capacity of members in 'sufficiently strong' balance of payments and reserve positions to absorb SDRs within their legal acceptance limits. This scope is normally very large. ^{1/} The Fund can also, subject to the SDR acceptance limit of the member concerned, replenish its holdings of a needed currency by requiring the member concerned to sell its currency to the Fund against SDRs. The Fund's liquid liabilities are already very large, and are expected to increase over the next year; in early January 1984, reserve tranche positions totaled approximately SDR 27 billion, (compared with close to SDR 22 billion immediately prior to the inflow of SDRs from quota payments) and loan claims amounted to a further SDR 13.5 billion.

(ii) A second consideration is whether the Fund's SDR holdings represent an unduly large proportion of the total of SDR allocations. At the level of SDR 6.4 billion expected by early March, the Fund's holdings would represent close to 30 percent of total allocations of SDR 21.4 billion, which is a higher proportion than has been reached in the past. In early 1981, after the quota increase under the Seventh Review, when the Fund's holdings of SDRs amounted to SDR 5.6 billion, they represented 26 percent of total SDR allocations.

^{1/} At the end of September 1983, for example, the legal obligations of members judged 'sufficiently strong' to accept SDRs within their acceptance limits was SDR 23.7 billion, compared with Fund SDR holdings of SDR 2.7 billion.

Table 1. Transfers of SDRs to and from the
General Resources Account
March 31, 1983 - January 13, 1984

(In millions of SDRs)

| | | |
|---------------------------------------|----------------|----------|
| Fund's SDR holdings: March 31, 1983 | | 3,930.5 |
| A. <u>Inflows of SDRs</u> | | |
| Repurchases | 242.0 | |
| Charges | 1,248.8 | |
| Interest | 506.2 | |
| Assessment | 2.5 | |
| Quota payments | <u>6,036.8</u> | |
| | | +8,036.3 |
| B. <u>Outflows of SDRs</u> | | |
| Purchases | 2,596.5 | |
| Remuneration | 1,246.4 | |
| Repayment of Fund borrowing | 785.1 | |
| Interest on Fund borrowing | 115.1 | |
| Refunds of service charges | 19.1 | |
| Acquisitions to pay charges | <u>232.3</u> | |
| | | -4,994.5 |
| Fund's SDR holdings: January 13, 1984 | | 6,972.3 |

(iii) As regards operational requirements, the Fund needs working balances to be able to provide SDRs to members that need them to meet obligations payable in SDRs. These obligations are (i) charges on the use of Fund resources, and (ii) quarterly payments of net charges in the SDR Department. In addition, the Fund also offers to pay remuneration in SDRs, and for this purpose its SDR holdings should not be less than the quarterly total of remuneration payments. In view of the magnitudes of the regular inflows and outflows of SDRs in charges, the inflows from interest on the Fund's SDR holdings, and the amounts needed for remuneration, the operational needs of the Fund to hold SDRs can, in the view of the staff, be more than adequately covered by working balances of the order of SDR 1.0 billion.

(iv) As long as the SDR interest rate is higher than the rate of remuneration, a higher (lower) level of SDR holdings results in a somewhat higher (lower) level of net income. For example, using the present SDR interest rate, and taking into account the increase in the remuneration coefficient on May 1, 1984 (i.e., to 88.3 percent of the SDR interest rate) a difference of SDR 1 billion in the Fund's average holdings of SDRs would affect net income for FY 1985 by about SDR 10 million. ^{1/}

4. Proposal on the future level of the Fund's SDR holdings

Since early 1981, when the Fund's SDR holdings were at SDR 5.6 billion, the Executive Board decided as a result of successive reviews to reduce the level of SDR holdings to about SDR 1.5 billion by the end of 1983. In the light of this past approach, the question arises whether the level of the Fund's SDR holdings should again be reduced to approximately the same level over a similar period, that is, about 2 1/2 to 3 years.

In the staff's view, the appropriate level, and the speed with which it is achieved, are largely matters of judgment. Of the considerations mentioned above, the relatively high proportion of the total SDR allocation now held by the Fund would suggest an early and substantial reduction in its holdings. Such a reduction would not run counter to the Fund's need for working balances of SDRs. However, in view of the high and rising levels of the Fund's liquid liabilities, the liquidity advantages of the Fund's SDR holdings suggest the avoidance of too substantial and rapid a reduction in these holdings. In addition, although the Fund's income has generally been a subsidiary factor in decisions on the Fund's SDR holdings, so long as a differential remains between the SDR interest rate and the rate of remuneration a fast pace of reduction would tend to increase the pressure on the Fund's net income that will arise--other things being equal--from the increases in the rate of remuneration resulting from the recent decision to bring the rate closer to the SDR interest rate.

^{1/} The SDR interest rate in the week beginning January 16, 1984 was 8.51 percent per annum. With a remuneration coefficient of 88.3 percent, the rate of remuneration would be 7.51 percent--i.e., about 1 percent per annum below the SDR interest rate.

In the light of the foregoing considerations it is proposed that the Fund's holdings be reduced to about SDR 4.0 billion over the next five operational budgets, that is, in period through the end of May 1985. It is also proposed that prior to April 30, 1985, another review be conducted to determine whether the Fund's SDR holdings should be further reduced.

It is estimated that total (gross) transfers (i.e., mainly in purchases) under the operational budgets for the next five quarterly periods could average about SDR 2.5 billion per quarter, or broadly in line with the size of recent budgets. Taking account of likely net inflows (see Table 2), a reduction in the Fund's SDR holdings to about SDR 4.0 billion over the period would imply total transfers of SDRs in purchases under the five operational budgets of about SDR 3.9 billion, or on average about SDR 800 million in each budget. This would mean that the proportions of currencies and SDRs included on the transfer side of the budgets are likely to be broadly in line with recent budgets. 1/

5. Recommended decision

In the light of the above, and in accordance with Executive Board Decision No. 6275-(79/158) G/S, it is proposed that the Executive Board adopt the following decision:

"In determining the amounts of SDRs to be transferred in purchases under the operational budgets, the Fund will be guided by the aim of reducing the Fund's SDR holdings to a level of approximately SDR 4.0 billion by May 31, 1985. Prior to April 30, 1985, the Fund will review the level of its SDR holdings to determine whether and to what extent they should be further reduced."

1/ Over the last nine operational budgets, SDRs proposed for use in purchases have ranged from SDR 1.5 billion to (untypically) SDR 100 million. On average, the proposed transfers of SDRs in purchases have been about one third of the maximum gross amounts of transfers under the proposed budgets. Over the same period, the proposed amounts of the designation plans have averaged SDR 1.1 billion.

Table 2. Estimates of Receipts and Transfers of SDRs by the
General Resources Account, February 1984 - May 1985

(In billions of SDRs)

| | | |
|--|------------|---------------|
| Projected Fund SDR holdings: February 29, 1984 | | 6.4 |
| A. <u>Inflows of SDRs</u> | | |
| Repurchases | 0.8 | |
| Charges | 3.7 | |
| Interest | <u>0.5</u> | |
| | | +5.0 |
| B. <u>Outflows of SDRs</u> | | |
| Payment of interest to lenders | 0.6 | |
| Repayment to lenders | 0.1 | |
| Remuneration | 2.5 | |
| Acquisition for charges | <u>0.3</u> | |
| | | -3.5 |
| C. <u>Transfers of SDRs in Purchases</u> | | 3.9 <u>1/</u> |
| Projected Fund SDR holdings: May 31, 1985 | | 4.0 |

1/ The amount of SDR 3.9 billion represents transfers in purchases that would be necessary in the light of the present estimates of other inflows and outflows of SDRs in order for the Fund's holdings to be reduced to about SDR 4.0 billion by May 31, 1985.

