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To: Members of the Executive Board

From: The Secretary

Subject: The Role of the SDR

The attached paper on the role of the SDR has been prepared for a forthcoming meeting of the G-10 Deputies. It is now being circulated for the information of the Executive Directors before being transmitted to the G-10 Secretariat.

If Executive Directors have technical or factual questions relating to this paper, they should contact Mr. Hood (ext. (5)8977).

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INTERNATIONAL MONETARY FUND

The Role of the SDR

Prepared by the Staff

October 31, 1984

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The Role of the SDR

The staff of the Fund presented a sizable document on "The Evolving Role of the SDR in the International Monetary System" to the Fund's Executive Board in June 1982. 1/ What follows is an abridged and revised version of that document. The material is presented here in two parts. The first deals with concepts of the role of the SDR that have been stressed during the period of its establishment and use to date. The second part deals with possible directions for the future evolution of the SDR.

I. The Concept of the SDR From Its Inception to the Present

The theme of this part is that the SDR was created to meet a perceived need in the international monetary system and has been adapted as that perception has evolved. Reference is also made to two roles for the SDR that have been prominently advocated but not adopted, namely, the use of the SDR on a large scale as a substitute for currencies in official reserves and the use of the SDR in financing economic development.

1. The changing perception of the SDR's role since its establishment

a. The initial conception

The SDR originated in the late 1960s, during the period of fixed exchange rates and the gold exchange standard. As a matter of practice, countries held their official reserves, with which they financed the official support given to their currencies in exchange markets, mainly in the form of gold and U.S. dollars. The formal link between U.S. dollar reserves and gold reserves consisted in the willingness of the U.S. authorities to exchange gold and dollars at a fixed rate. The U.S. dollar was a good reserve asset because it well satisfied the principal requirements of a good money: it served as a unit of account, as a store of value, and as a medium of exchange. As a unit of account it was a useful measure of value because it was widely used in the world, both in official and in commercial transactions. As a store of value it was thought to be a good asset because of its link to gold and because it had a continuing prospect of being convertible into a wide range of goods within a narrow range of variation of goods prices. As a medium of exchange it was outstanding because (1) it was generally acceptable by other monetary authorities; (2) it was usable in dealings

1/ SM/82/107. The document was later published by the Fund in 1983 in the volume, International Money and Credit: The Policy Roles.

with commercial banks in the foreign exchange markets; and (3) the large capital market of the United States was available to serve the credit needs of official entities seeking to borrow reserves.

But problems arose with the gold exchange standard. In a growing world economy, there is a growing demand for reserves. However, two contradictions or asymmetries within the system spurred an interest in alternative means of generating reserves. First, even if the supply of dollars could be expanded, the gold backing for the U.S. dollar could not be expanded, or at least not smoothly. So, as more dollars were backed by the same gold stock, or even a smaller gold stock, in the United States, the convertibility of the dollar became doubtful, and the U.S. dollar itself became less acceptable. Second, the asymmetry of the system whereby one country in particular could draw resources from the rest of the world through a current account deficit and pay for them by issuing reserves seemed inequitable and to warrant change. The SDR was conceived as at least a partial response to these difficulties.

Robert Triffin was one of the first to articulate the dilemma inherent in the gold exchange standard:

> The elimination of [the] overall balance of payments deficits [of the United States] would, by definition, put an end to the constant deterioration of [U.S.] monetary reserves and deprive thereby the rest of the world of the major source by far--two thirds to three fourths--from which the international liquidity requirements of an expanding world economy have been met in recent years, in the face of a totally inadequate supply of monetary gold. 1/

The decade leading up to the adoption of the SDR scheme was one of considerable turmoil in the international monetary system. This was the period in which the United States built its ring of defenses for the U.S. dollar--weakened in part by the domestic inflation associated with the Viet Nam war--by attempting to stem capital and gold outflows with instruments such as the interest equalization tax, with operations designed to affect the term structure of interest rates, and with Roosa bonds and gold market arrangements such as the gold pool. It was also the period of recurring exchange market crises affecting the pound sterling and other currencies, with exchange markets closed for an entire week on one occasion (November 1968).

1/ Robert Triffin, Gold and the Dollar Crisis, rev. ed. (New Haven: Yale University Press, 1961), p. 9.

As these signs of stress in the international financial system multiplied in the 1960s, creation of a new international reserve asset began to be considered a matter of urgency. Discussions took place in many quarters, academic and official, and many varied schemes were studied. The culmination of all of these discussions and negotiations 1/ was embodied in the First Amendment to the Articles of Agreement, which took effect in 1969. This amendment authorized the Fund to allocate SDRs "to meet the need, as and when it arises, for a supplement to existing reserve assets." 2/ The amendment further provided that SDRs should be allocated to all members of the Fund who chose to participate, at a rate, in relation to quotas, common to all participants. Thus was the SDR conceived to be responsive to the two main difficulties with the existing system noted earlier.

b. The first allocation

The first allocations of SDRs, provided for in 1969, were justified as supplements, in the sense of net additions, to existing reserve assets. The arguments for the first allocation of SDRs are set forth in the report to the Board of Governors, dated September 12, which contains the Managing Director's proposal. The Managing Director first provided broad historical perspectives. He noted that reserves had declined by over 50 percent relative to world trade since the early 1950s. 3/ Over most of the period, any effect of declining reserve ratios in impairing reserve ease of most countries had been offset, if not outweighed, by a marked improvement in the distribution of reserves, in the sense of a shift from countries (notably the United States) where in the early 1950s reserves had been very high to other countries where they had been inadequate. Possibly, also, there had been some decline in the magnitude of payments imbalances relative to international transactions. Since about 1964, however, there had been a change in the situation: growth of reserves had flattened markedly, the ratio of reserves to trade had declined more rapidly, the transfer of reserves from deficit to surplus countries had ceased to act as a force tending to equalize reserve ratios, and there had been increasing resort to international credit as a means of relieving the tightness of reserves.

1/ For details see Margaret G. de Vries, The International Monetary Fund, 1966-1971, The System Under Stress, Volume I: Narrative, *(Washington, D.C.: IMF, 1976), Chapter 9, especially pp. 193-95.*

2/ See Article XV, Section 1 of the present Articles.

3/ For this and subsequent attributions see the Fund's Summary Proceedings of the Twenty-Fourth Annual Meeting of the Board of Governors, Washington, D.C., September 29 - October 3, 1969, pp. 276-95.

The Managing Director then noted that the main indications of reserve inadequacy in those years lay in the increased reliance on restrictions in international transactions and the increased recourse to international financial assistance, bilateral and multilateral, for the purpose of meeting payments deficits and sustaining reserves. After due consideration, evidence such as high levels of domestic demand, rising rates of inflation, and the absence of competitive or excessive devaluations, which could have suggested that reserve levels were adequate or even excessive, was given less weight. On balance, the Managing Director concluded, some supplement to reserves was required. Otherwise, he argued, the balance of payments adjustment policies adopted by deficit countries could well be frustrated by the attempts of others to increase their reserves. He therefore proposed that the prospective growth in the supply of reserves of SDR 1 billion to SDR 1.5 billion per annum, which was assumed to be produced by U.S. payments deficits on the official settlements basis, be supplemented by allocations of SDR 3 billion to SDR 3.5 billion per annum to meet annual increases in the need for reserves estimated to range from SDR 4 billion to SDR 5 billion per annum under noninflationary conditions. The decision subsequently adopted led to an allocation of SDR 3.4 billion on January 1, 1970 and SDR 3.0 billion at the start of each of the following two years.

c. The changing conditions of the 1970s

If the events of the 1960s raised questions about the international monetary system that led to instituting the SDR, the 1970s brought profound changes in the system that induced changes in the SDR itself and raised doubts about its role, which have not been resolved.

The first of these changes was the suspension of the convertibility of the dollar into gold for official holders in August 1971. This was followed, in the period to February 1973, by the abandonment of the commitment to maintain dollar exchange rates within fixed margins of parity by major industrial countries (Canada in fact acted in May 1970). The resort to floating dollar rates raised questions as to the demand for reserves (currency reserves as well as SDRs) in the system of floating exchange rates. In fact, the ratio of non-gold reserves to imports has been significantly lower in the 1980s than they were in the early 1970s.

A second major development was the severe inflation that gripped the world for much of the decade. One reaction to inflation was to limit (though not preclude) the creation of SDRs through allocation. This effect arose not only from apprehension by some authorities that the creation of SDRs in an inflationary period might signal an official lack of concern with inflation and thereby intensify inflationary expectations. It arose also from the fact that in the period of inflation, with the structural changes in economies that are called for, it has been desired to place the emphasis in Fund activity on conditional lending rather than on the provision of unconditional resources through SDR allocation.

A third development was that currency reserves increased substantially. During the first basic period, 1970-72, the U.S. deficit on official settlements had averaged SDR 17 billion per annum rather than SDR 1 billion to SDR 1.5 billion as projected by the Fund at the start of that period. Currency reserves in general trebled from the end of 1969 to the end of 1972, and trebled again by the end of 1980. A feature of this growth of currency reserves was the growing importance of reserves held in non-dollar currencies, particularly the mark and, to a lesser extent, the yen. 1/

A fourth development, closely related to the emergence of the practice of diversifying exchange reserves among currencies, has been the almost uninterrupted expansion of integrated international capital markets over the past two decades. One effect of the growing maturity of international capital markets has been to improve possibilities for national monetary authorities, to use these markets as channels for the investment of their reserves, thereby facilitating the diversification of reserves mentioned earlier. At the same time, opportunities for countries to borrow in the international capital markets for the purpose of increasing or sustaining their reserves, as well as for other purposes, have improved also. These developments raise questions relating to the use of the Fund's resources generally, as well as to the need for SDR allocations.

A further aspect of the evolution of international capital markets is that private holding of foreign currencies is now very much more widespread. As private foreign reserves have become important adjuncts to domestic monetary and banking systems and as credit markets have become more open to foreign and non-resident borrowers, movements of funds have the potential to tie these systems more closely together. The state of global liquidity thus relates more than ever to the financial policies of the major countries and requires to be appraised in terms of those policies.

These developments have had a number of consequences for the SDR. One is the effect on the SDR itself. With the growth in reserves and

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1/ A tabulation of the changing shares of national currencies in the SDR value of total official holdings of foreign exchange is given for various dates from 1976 to 1983 in the Fund's Annual Report 1984, p. 61.

in liquidity as reflected in the enhanced opportunities to borrow foreign currencies, a strong effort has been made to change features of the SDR so as to make it more competitive in terms of rate of return and usability with currency reserves.

The developments of the 1970s also affected both the willingness of members of the Fund to support allocations and the justification that was used for allocations. Mention has been made of the general effect of inflation in tempering the willingness to create reserves through allocation. The growth of currency reserves and the extension of international capital markets have also contributed to this attitude. Indeed, because of the unexpectedly large growth of reserves, and rising inflation during the early 1970s, no allocations were proposed for the second basic period 1973-77. The Fund's 1973 Annual Report records that the symptoms of reserve ease were now acknowledged to predominate over those of stringency.

d. The allocation of the third basic period

The Managing Director's 1978 proposal for allocation of SDRs in the third basic period acknowledged the changes in the reserve creation process that had taken place in the 1970s by noting that most countries have a means for satisfying their need for reserves when international capital markets are as free as they were at that time. 1/ As a result, SDR allocations were no longer justified by finding that the long-term global need for reserves cannot be met except by allocation. Rather, the Managing Director pointed to qualitative improvements by noting that some of the difficulties associated with a system in which countries add to their international indebtedness as their gross reserves increase can be overcome through allocation. In particular, if developing countries substituted a substantial part of any allocation for increases in official holdings of foreign exchange that would otherwise have taken place, so that total borrowing would fall, any expansionary effects of allocation would be limited. 2/ The desire to change the composition of additions to gross reserves toward SDRs and thereby to improve the terms and conditions on which such additions are supplied, rather than the need to provide adequate growth of total non-gold reserves, now furnished the main rationale for renewing SDR allocation. In addition, the international symmetry and exchange neutrality of reserve creation through

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1/ See the Fund's Annual Report 1979, pp. 123-28.

2/ If non-oil developing countries borrowed less but also held smaller deposits in the Eurocurrency market, as here assumed, the supply of loans to other groups of countries in that market would not rise directly but only in response to a favorable change in the risk composition of the bank's remaining assets.

SDR allocation could make such allocation substitute for reserve creation by less efficient and potentially more inflationary means. 1/

Possible effects on expectations with respect to inflation of a decision to allocate SDRs were cited for keeping allocations modest. The total of SDR 4 billion allocated each year over the period 1979-81 was estimated to amount to only a small fraction of the average annual growth of non-gold reserves, conservatively estimated as SDR 20 billion per year. While the actual growth of non-gold reserves from the end of 1978 to the end of 1981 turned out to be almost twice as high as projected, this fact alone would no longer automatically have diminished the size of the SDR allocations that would have been indicated under the criteria emphasized in 1978 as opposed to those applied in 1968-69 to determine the appropriate size of allocations.

2. Ideas for extending the SDR's role though substitution accounts

Concern at the lack of international control over the total of international liquidity, the surprising increase in it, the potential for instability involved in the emergence of the new reserve centers and the apparent inequity implied in the creation of reserves through the issue of liabilities by reserve centers, led to extensive examination of variations of an SDR substitution account in the Fund on two occasions in the 1970s.

The first such occasion was in connection with the study of International Monetary Reform by the Committee of Twenty in the period from mid-1972 to mid-1974. Among the features of the international reform that were studied by the Committee were "better management of global liquidity, with the SDR becoming the principal reserve asset and the role of gold and reserve currencies being reduced" and "consistency between arrangements for adjustment, convertibility and global liquidity." 2/ In seeking ways to approach these and other objectives, the idea of providing a substitution account in the Fund was extensively explored.

1/ Thus, reserve creation through intervention often has undesirable consequences for money supply growth and inflation in industrial countries, and continued liability settlement by reserve center countries usually implies an exchange rate structure with other countries that is inefficient for trade and the appropriate transfer of resources toward their internationally most profitable uses.

2/ Outline of Reform, June 14, 1974 in International Monetary Reform, Documents of the Committee of Twenty, IMF, Washington, D.C., 1974, p. 8. This compendium of the Committee's documents will be referred to hereafter simply as "C-20".

Substitution was defined as the replacement of short-term currency assets by liquid claims on the international community in the form of SDRs. 1/ Many features of the substitution account were left unclarified at the end of the Committee's deliberations. Among these were the extent to which the account would provide for the exchange into SDRs of the outstanding balances of currency reserves at the inception of the scheme, the extent to which newly accruing balances would be exchangeable for SDRs, the degree to which substitution would be mandatory for some or all countries, the relation of the operations of the substitution account to the practice of asset settlement by reserve currency countries, the role for such an account in a system in which the nature of the exchange rate regime was still unclear and in which international adjustment policies might be triggered, under Fund surveillance, by a system of "objective indicators," and the use of the account along with ancillary measures to provide effective control by the Fund over the total of members' reserves. All of these considerations were of course intertwined and the Committee was not able to reduce them to an integrated and agreed system.

In the closing years of the 1970s, the international monetary system experienced strains that reminded some observers of the recurring dollar crises and other systemic defects that had been evident when the decision to activate the SDR facility had been taken in 1969. The first round of SDR allocations had done little to modify a reserve system overwhelmingly dependent on the U.S. dollar and on a continuous growth in the stock of dollars held abroad. The increasingly rapid depreciation of the U.S. dollar that occurred before the announcement of stabilizing measures on November 1, 1978 contributed to the growth in the amount of currency reserves held in currencies other than the dollar. But a multiple-currency reserve system was widely considered not to be a desirable alternative because the process of moving toward such a system through reserve diversification could be disruptive of exchange markets and, once achieved, that system could be an ever present source of exchange rate instability. Thus SDR substitution came to be widely regarded as the only feasible means of checking excessive dependence on the U.S. dollar while avoiding the development of a multiple-currency reserve system.

These goals were modest compared with those envisaged in 1974. As noted earlier, SDR substitution had then been proposed as part of an asset settlement system in which balance of payments adjustment and stable growth were to be promoted by controlling the generation and use of international reserves by means of the SDR. The voluntary substitution account proposed in 1979-80, however, would provide directly only

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1/ C-20, pp. 167-78.

for adjustments within the portfolio of international reserves. While it might dampen exchange rate pressures by taking any dollar overhang out of official holdings and enhance the role of the SDR, the immediate impact of such an account on the working of the international monetary system would be quite limited unless accompanied by national measures promising greater price stability and international adjustment. In this regard, the Report of the Executive Board to the Interim Committee on a Substitution Account, dated August 3, 1979, 1/ noted the longer-range potential that "this development could over time bring about conditions more conducive to international influence over the growth of international liquidity, although some have doubts that these results would follow."

The detailed studies that emerged around this time focused on a single substitution of SDR claims for dollars, although it was noted that, in the long-run development of the system, the SDR could be envisaged as a substitute for any reserve currency or group of currencies. 2/ It was generally agreed that, in order to achieve widespread participation on a voluntary basis and on a large scale, the account should contain satisfactory provisions with respect to the liquidity of the claims, their rate of interest, and the preservation of the capital value. Furthermore, the claims should have a yield that would make them sufficiently attractive in comparison with other major reserve components, implying that they should yield a market-oriented return. 3/

The substitution account, as last presented in the beginning months of 1980, 4/ provided that participating countries would be able, on a voluntary basis, to deposit U.S. dollars in the account and receive in exchange obligations denominated in SDRs issued by the account (SDR claims). The dollars deposited in the account would be held in a special account in the U.S. Treasury, with the United States paying interest on the dollar balances in this account, at a floating rate to be determined on the basis of one or more market interest rates for U.S. Government securities. The substitution account would pay interest to the holders of SDR claims at a floating interest rate, equal to the combined market interest rate that is used by the Fund to determine the interest payable on SDRs.

1/ SM/79/199 and Revision 1.

2/ See "Review of the Question of a Substitution Account and Related Issues," SM/79/30.

3/ See "Substitution Account--Calculation of the Interest Rate to be Paid on SDR-Denominated Claims," SM/79/283.

4/ See "Outline of a Substitution Account," SM/80/4; "Report of the Executive Board to the Interim Committee on a Substitution Account," SM/80/65; and "Report of the Executive Board to the Interim Committee and Draft Outline of a Substitution Account," SM/80/89.

Any difference between the interest rates on the SDR and on dollar claims 1/ and in the exchange value between them would have to be compensated and capital value would have to be maintained by mechanisms on which no agreement was reached. The United States continued to argue, as it has since 1974, 2/ that if a substitution account provided important advantages for the international community, its benefits and risks should be shared, possibly among the membership in proportion to quotas, or in relation to the amounts of currency that individual members substituted for SDRs, or in relation to countries' shares in total currency holdings, or, more recently, by pledging some of the Fund's gold to provide a reserve equity for the account. 3/ The possibility of providing such a backup through issuing SDRs to the substitution account was also considered. 4/

3. Ideas for extending the SDR's role through a link with development finance

A potential feature of the role of the SDR that has been emphasized thoughout the period since the idea of a new reserve asset for the system was first conceived, has been the linking of SDR creation to the financing of development.

Representatives of developing countries have repeatedly argued that the principle of establishing a link between the allocation of SDRs and development finance would best be served by an increase in their share of SDRs by means of direct country allocations by the Fund, to be used for development purposes. 5/ Thus, it was stated in 1973 that, whereas reserve creation had in the past involved resource transfers to gold producers and reserve centers, it would be appropriate in a reformed

1/ See, "Substitution Account: Balance Between Interest Received and Interest Paid," SM/79/279.

2/ C-20, p. 175.

3/ Calculations of the backing required by the account under a number of different assumptions are contained in Peter B. Kenen, "The Analytics of a Substitution Account," Banca Nazionale del Lavoro Quarterly Review, No. 139, December 1981, pp. 403-26.

4/ While this most recent attempt to construct a substitution account envisaged an account administered by the Fund, it has since been proposed to consider the establishment of such an account in the Fund so as to avoid the complications of committing specific Fund resources to back up such an account. See J. J. Polak, "Hope for Substitution May Lie in Simpler Scheme, Embodied in IMF," IMF Survey, October 27, 1980, pp. 337-39.

5/ See the Report of Technical Group on the SDR/Aid Link and Related Proposals, in Committee of Twenty (C-20), International Monetary Reform: Documents of the Committee of Twenty, (Washington, D.C.: IMF, 1974), pp. 95-109.

system that a greater part of the benefit derived from the switch to reserve creation in the form of SDRs should be channeled on an agreed basis to developing countries. 1/ Essentially the same conclusion was repeated in 1980 when the Brandt Commission recommended that SDRs should be allocated to those countries most likely to experience balance of payments deficits and high domestic costs of adjustment, and least likely to be able to finance them from alternative sources. 2/

Using the SDR for the additional objective of resource transfer to the developing countries in a more concentrated fashion than is possible through allocations in proportion to quota may take several different forms. 3/ Direct allocations to developing countries, the scheme preferred by such countries, would involve the adoption of a new formula for the allocation of SDRs among participants that would channel to the developing countries a larger share of total allocations than corresponds to their share in Fund quotas. Direct allocations to development finance institutions (or, alternatively, to the General Department of the Fund) would involve making available to development finance institutions (or to the Fund) a portion of the SDRs created, determined either as a percentage of the total SDR allocation or as an absolute amount. Indirect allocations to development finance institutions (or to the Fund) would leave unaltered the principle of SDR allocations to participants on a basis strictly proportional to Fund quotas, but would be complemented by agreement among developed countries to transfer to development finance institutions (or to the Fund) either part of the SDRs allocated to them or the equivalent in currencies. 4/

1/ C-20, p. 96.

2/ Willy Brandt, North-South: A Programme for Survival, (Cambridge: MIT Press, 1980), p. 212; and United Nations, General Assembly, Towards the New International Economic Order: Analytical Report on Developments in the Field of International Economic Co-Operation Since the Sixth Special Session of the General Assembly, Report of the Secretary-General, A/S - 11/15, dated August 7, 1980, p. 48.

3/ For extensive discussions of these and additional proposals, see "Considerations Relating to a Link Between SDR Allocation and Finance for Developing Countries," SM/80/188; and "Further Issues Relating to a Link Between SDR Allocations and Finance for Developing Countries," SM/80/266.

4/ A version of the approach of indirect allocation to the Fund has recently been described in a paper by the Belgian Deputies prepared for the Deputies of the Group of Ten (X/DEP/29, March 7, 1984). In this version, stress is placed upon the fact that any financing of developing countries through the use of SDRs allocated indirectly to the Fund would be subject to the Fund's conditionality. A further feature of this version is that SDRs originally allocated to members under the present Articles would in effect be lent to the Fund and would subsequently be repaid when the drawings they support are reversed.

None of the various schemes for linking SDRs to financing of development has yet been adopted, and accordingly this potential role of the SDR has not become a feature of the SDR in practice.

II. Possible Future Developments in the Role of the SDR

This part is concerned with opportunities to broaden the role of the SDR in the immediate and more remote future. First, however, there is a statement on the SDR today.

1. The SDR today

Since the first allocation of SDRs was made at the beginning of 1970, the SDR is now nearly 15 years old. It has evolved during this period, in terms of its relationship to gold, its definition in relation to currencies, its valuation, its rate of return and its permitted uses by member countries participating in the SDR account and by "other holders."

At the end of June 1984, a total of SDR 21.44 billion had been allocated, of which SDR 15.56 billion were in the hands of participants, SDR 5.85 bilion were held in the General Resources Account of the Fund and SDR 0.03 billion were with prescribed holders. On that same date, the foreign exchange component of official reserves was SDR 317 billion. Accordingly, the SDR's current role realistically would have to be described as marginal or limited.

The SDR has not acquired the characteristics of money to the extent that its near competitors possess these qualities. The SDR as a standard of value is defined under the Articles in decisions of the Executive Board. The standard was most recently defined, with effect on January 1, 1981, in terms of the currencies of five member countries of the Fund. The weight of each such currency was determined in relation to the country's value of exports and the value of the holdings of its currency in the reserves of other members. The amount of each currency in the SDR was determined in accordance with these weights and on the basis of the average exchange rates for the five currencies over the three months ending December 31, 1980. It is provided that the definition of the standard shall be reviewed quinquennially unless the Board should decide otherwise.

The performance of the SDR as a store of value rests upon the performance of its constituent currencies. Its market value is not determined directly in the market place but only indirectly through the market performance of its constituent currencies. As a weighted average of such currencies, its performance will of course not match that of the currency with the best performance in the package during the period, nor will it be as poor as that of the currency with the poorest performance. The record of the SDR as a store of value will be affected by revisions that may take place from time to time in its definition, although care has been taken and will be taken to avoid discontinuities in the value of the SDR on the date of revision of its definition.

As a unit of account the SDR has scored some success. It is the unit of account for Fund transactions and operations. It is also used as a unit of account (or as the basis for a unit of account) by a number of international and regional organizations. A number of international conventions use the SDR to express monetary magnitudes, notably those expressing liability limits in the international transport of goods and persons. There has been some use of the SDR as a denominator of financial instruments. As of June 30, 1984, 11 countries had currencies pegged to the SDR.

The SDR has not yet matured in its role as a medium of exchange. This is not because the number of parties that may hold SDR accounts with the Fund is small. It is normal, indeed even in a national monetary system, for the number of parties holding accounts with the monetary authorities to be limited. The role of the SDR as a medium of exchange is limited because of constraints placed by the Fund upon the use of the SDR accounts and because of the fact that the use of SDR-denominated assets and liabilities by institutions other than the Fund and the monetary authorities that deal with the Fund has not yet developed more than to a limited extent.

The SDR, allocated by the Fund, may be used in certain transactions with the Fund, for example, the payment of charges. The Articles provide that SDRs may be used by one "participant" to obtain currency from another "participant"--either one that has been designated by the Fund or one with which the user has made an agreement. In the former case the user must demonstrate a balance of payments need to obtain currency and, in that case, there is a limited obligation on the designated participant to accept SDRs in exchange for currency. The Articles authorize the Fund to prescribe the terms and conditions on which participants and the Fund may enter into operations and transactions in SDRs with prescribed holders. Prescribed operations in SDRs currently include the use of SDRs in loans, swaps, forward transactions, settlement of financial obligations, donations, and as security for the performance of financial obligations. It may be observed that a market, of the style of a federal funds market, has not developed among participants in the SDR Department and other holders. The reasons for this are to be found not only in the remaining restrictions on the use of the SDR but also in more general factors which govern the attitude of monetary authorities to the holdings of SDRs as an investment or as an asset to be liquidated as a prelude to exchange market intervention.

The issue of SDRs or SDR-denominated claims is less intimately connected with the other functions of the Fund than is the normal situation in money-creating institutions--central banks and commercial banks. In most money-creating institutions, the creation of money in the form of a liability of that institution is a direct counterpart of the act of extending credit. In the Fund, the SDR is created by a deliberate act of allocation, which may be described as an exchange of rights and obligations between the Fund and each of its participating members, with the member receiving a credit in the Fund that may be transferred to other participants and other holders in accordance with prescribed procedures. In normal lending by the Fund, the process is an exchange, in the Fund, of the currency of the borrower for another currency held by the Fund. The use of a member's currency in extending a Fund loan to another member enhances the creditor position of the country whose currency is so used (except when the effect is to reverse a previous debtor position) and such creditor positions--now denominated in SDRs--are deemed to be reserve assets usable by the member country in the case of a demonstrable balance of payments need.

The role of the SDR as a medium of exchange remains moderate not only because of constraints upon its use that derive from present Fund prescriptions, practices, and procedures, but also, and indeed probably to a greater degree, because the use of SDR-denominated assets outside the Fund has evolved only to a limited extent. The effective performance of a monetary unit depends not only upon the adequate financing of the official institution that creates it, but equally upon other institutions being prepared to issue their own liabilities denominated in it. These other institutions include central banks, commercial banks, brokers, dealers--indeed all those whose readiness to transact business in the unit contributes to its general acceptability as well as ease of transfer and clearance.

2. Possibilities for developments of the SDR in the near term 1/

One possibility for developing the use of the SDR in a variety of official transactions is to make further technical improvements in the nature of the asset and the returns it yields to its holders. This matter is not explored in this paper. In this section, attention is directed to changes in the functioning of the Fund itself and in the institutions and practices of the private markets that could contribute to the positive evolution of the SDR.

1/ In this section, and the next, no attempt is made to distinguish evolutionary steps that are consistent with the present Articles from those that are not.

a. Enlargement of the functions of the SDR in the Fund

This section focuses on the role of the SDR in the Fund. For the Fund, using a currency-basket unit of its own design facilitates the conduct of its programs and dealings with members in a pluralistic world. Compared with dealings, allocations, or loans denominated in a single national currency or its equivalent, 1/ use of a basket unit lowers the risk of conflict with national authorities and of interference with their exchange rates, money supply control, and borrowing. Denominating Fund transactions and operations in SDRs also eliminates exposure of the Fund to exchange and interest rate risks.

The Fund could make adjustments in the manner in which it performs its functions so as to accord a larger role to the SDR and a smaller role to currencies in its activities. This could be accomplished without altering the priorities accorded to the key functions performed by the Fund or to the services now provided. The immediate advantage that might be sought in making these adjustments would lie in promoting wider use of the SDR as an international monetary asset.

One route by which the Fund could proceed to accord a larger role to the SDR in its operations is the following. The Articles now provide that, unless the Board of Governors prescribes otherwise, members should pay 25 percent of any increase in quota subscriptions in SDRs. It could be provided that members should pay more than 25 percent of a quota increase in SDRs and that, if necessary, SDRs be specifically allocated for the purpose. Such a change would give the Fund more SDRs to use in its lending operations.

It may be observed that to assure the liquidity of the Fund more reliance would need to be placed on acceptance obligations of members and less on usable currencies, the greater is the extent to which a quota increase is paid in SDRs allocated on that occasion.

There is one evident disadvantage to the procedure of linking the allocation of SDRs and payment of quota increases. The increase in members' reserves that is involved may very well be deemed to be inappropriate--if not on every occasion of a quota increase, then at least on some such occasions.

1/ For instance, prior to the First Amendment that took effect in 1969, the accounting unit of the Fund was the U.S. dollar, and during the period February 1973 to June 1974 the SDR could again be viewed as equivalent to (1.21) U.S. dollars in its exchange characteristics, as it was no longer effectively related to gold and not yet related to other currencies.

To meet that objection, but still to meet the objective of exposing the system to more experience with the SDR through greater use of it and less use of currencies in the Fund's transactions, another possibility could be considered. This possibility would be to require no payment of SDRs or currencies to the Fund upon the occasion of further quota increases. Quota increases, selective and proportional, would take place as at present to determine the limits of access to Fund resources, the voting rights of members, and their shares of SDR allocations but not to determine a member's obligations to provide resources to the Fund in the form of currency or SDR subscriptions. The member's obligations to assist the Fund in extending credit to other members would still be based upon quotas, but the additional resources required by the Fund following an increase in quotas would be generated by the issue of SDRs (as opposed to allocation of SDRs) on the occasion of, and to the extent of, the extension of credit. Thus a drawing by a member would be a drawing of SDRs expressly created for that purpose. (Similarly, a repurchase by a member would be effected in SDRs that would then be canceled.) In this respect the Fund would function like many other financial institutions in creating money through the extension of credit.

The obligation of members to assist in this process would emerge as an acceptance obligation, which would have to be raised on the occasion of a quota increase. The quota limits on access to Fund resources under the various facilities would remain the basic control on the expansion of Fund credit and on the associated SDR creation by the Fund, with the acceptance obligation, linked to quota, setting the upper bound on the general resources that can be created to support Fund lending. 1/

Use of the technique of financing Fund lending by the issue of SDRs would not preclude borrowing by the Fund as an alternative form of the issue of SDR-denominated liabilities. Nor would it imply abandoning the existing allocation system, which, as now, could be used to effect

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1/ To the extent allocated SDRs are retained in the system, the acceptance limit on any country would be equal to its quota (or to increases in its quota, if the new system is applied only to the quota increments decided after its adoption) plus three times the net cumulative amount of allocations it had received. However, there need be no difference in the reserve-asset characteristics of the SDRs created by allocation and those created in the process of Fund lending under the new system; a single acceptance limit could apply without distinction between them.

a general increase in members' reserves. 1/ Adoption of the technique would not require merging the SDR Department and the General Department of the Fund. But such a simplification of the Fund's structure might be regarded a natural consequence. 2/

These are examples of change in Fund practices that, while not altering the basic priorities in the Fund's operations, could assist in the further development of the SDR in the Fund's dealing with its members and thereby help broaden the use of SDR claims in official finance. However, as the next section attempts to explain, the evolution of the SDR depends as much on developments in private markets and on the practices of institutions other than the Fund as it does on developments in the SDR claims issued by the Fund and in the operations of the Fund.

b. *Development of the SDR outside the Fund*

The major national currency denominations in the international monetary system are used in a network of relationships built by central banks, and to some extent between them, which extends to commercial banks and thence to other financial and commercial entities down to individual transactors. However, there is no comparable infrastructure supporting the Fund's SDRs or linking them to SDR-denominated claims in the private sector. Unlike the national moneys that are widely used in international trade and finance, the SDR is neither a medium of exchange nor a standard unit of account in any country. Rather, private dealings in SDR-denominated assets are a minor adjunct to foreign

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1/ The question might even be raised as to whether SDR allocations need be used once SDRs may be created through Fund lending to meet particular needs subject to global constraints. If SDR allocations to member countries are viewed as equivalent to the establishment of guaranteed lines of credit for them, there would be little change in substance if those lines were replaced by unconditional drawing rights on the Fund up to a specified percentage of quotas. Like net users of SDRs under the present system, the drawers would incur an obligation to pay interest when the line of credit is actually used. Furthermore, members that wish to hold on to some of the SDRs obtained by borrowing from the Fund would be free to do so and would incur little or no net interest cost in the process (the precise balance would depend on the difference, if any, between the interest rate on the SDR and the rate of charge on unconditional borrowing from the Fund). However, it is unlikely that members that have no intention of increasing reserves on hand for possible use would have recourse to their unconditional right to borrow SDRs. It may be noted, however, that these unconditional borrowing rights could be treated as reserves, as is currently the case with reserve positions in the Fund.

2/ See J. J. Polak, Thoughts on an International Monetary Fund Based Fully on the SDR, International Monetary Fund Pamphlet No. 28 (1979).

exchange dealings, for which only limited transfer and clearance facilities have been provided, and, as a unit of account, the SDR has remained a comparatively rarely used convenience in international banking and commerce as payments, terms, and obligations are as yet seldom specified in SDR units.

In sum, information and transaction costs associated with active use of SDR claims are still considerable. Private users who transfer such claims by going through the dollar incur exchange costs. 1/ Also, the growth of the private SDR deposit market may have been impeded somewhat by difficulties of generating SDR-denominated assets for banks, as non-bank borrowers, both private and public, appear to have been somewhat reluctant to have their liabilities denominated in that unit. In addition, SDR-denominated obligations of the Fund, which could, in principle, provide an alternative source of supply of SDR-denominated assets, have not been sold in the private market.

If use of the SDR in commercial transactions is to spread, not only will it be necessary for commercial banks to lend and open accounts in SDRs, it will also be necessary for central banks to deal in that denomination with commercial banks within their respective jurisdictions, with Euro-banks, and with other central banks. It would also seem to be desirable for central banks to become the channel through which exchanges of the Fund's SDRs and commercial SDR claims could be effected. Central clearing facilities for SDR claims could be provided by central banks for their domestic banks. International clearings could be effected by central banks through their SDR accounts with the Fund. 2/

1/ Converting SDRs into dollars at the bid rate, transferring dollars, and then converting back into SDRs at the asked rate involves a loss of spread. Even if banks are willing to make the transfer at a central rate, the costs of doing so will still be charged to SDR depositors, for instance, by offering a lower interest rate on SDR deposits.

2/ See Warren L. Coats, Jr., "The SDR as a Means of Payment," Staff Papers, Vol. 29, No. 3, September 1982, pp. 422-36. The paper, "The Evolution of the SDR Outside the Fund," SM/82/93 (also published as Chapter 13 in the Fund's publication International Money and Credit: The Policy Roles, 1983) describes how clearing in SDRs between commercial banks of different countries, each having SDR-denominated deposits with their central bank, could be conducted by transferring official SDRs between these central banks on the books of the SDR Department. Alternatively, central banks could open SDR-denominated accounts with each other for bilateral clearing, or with a single central bank, such as the Federal Reserve Bank (of New York) for multilateral clearing bypassing the Fund. Extension of the SDR clearing mechanism to the private sector is also discussed in UNDP/UNCTAD, Project INY/75/015, Studies on International Monetary and Financial Issues for the Developing Countries, Measures to Strengthen the SDR, Report to the Group of Twenty-Four, UNCTAD/MFD/TA/11, dated March 1981, pp. 12-13.

3. More remote lines of evolution of the SDR

a. Opportunities for the SDR presented by a stable environment

It is recognized in this paper that if SDR-denominated assets are to be widely used in international commerce they will have to compete successfully with major national currencies now used in international trade, finance, and investment. It is contended that a stable environment with low inflation rates, less divergent inflation rates, and less volatile interest and exchange rate movements, while not guaranteeing the success of such competition, is nevertheless a necessary condition for that success.

The contention that more stability is necessary rests upon two lines of argument: one negative and one positive. The negative line of argument is to the effect that if instability promotes resort to currency baskets, there should have been a considerable flowering of such units in the present period. There has been some advance of the private use of the SDR, but it has not been outstanding. The ECU has been born and has survived its infancy in this period, and it has enjoyed increasing employment as a denominator of assets in private hands. These facts may seem surprising, for to resort to the SDR denominator is to resort to an average performance of asset value and yield: neither the worst nor the best performance. The facts, however, appear to be that the need for hedging of positions is generally felt to be greatest when fluctuations of values and returns are expected to be greatest and, beyond that, it is in those circumstances when the need for precise hedges is generally felt most strongly. Denomination in SDRs will only give a precise hedge when the distribution by currency of the risks to be hedged matches the weighting of currencies in the SDR. It must be only rarely in commercial life that this matching occurs even reasonably closely.

This leads to the more positive argument that in stabler conditions the need to hedge is felt less keenly and the need to hedge precisely less keenly still. It is therefore in those circumstances that the prospect of a composite unit competing successfully with any or all of the constituent currencies is maximized. But even in these circumstances it is not assured that the SDR would be more widely used. Many developments would still have to converge to create the conditions of convenience and cost advantage that would permit the SDR to evolve as a more widely used instrument in international transactions--private and public. At best, one would have to expect the evolution to be gradual. Once there is a basis for confidence that the SDR would be as good as the major currencies contained in it, it could become convenient for a much greater number of transactors to transact business, to bank, and to create liquidity and store wealth in that denomination. International transaction and settlement costs could be reduced by avoiding conversion and using the SDR as the uniform denominator of international transactions. An SDR standard could thus evolve on condition that the SDR can be expected to maintain its value as well as all other major national currencies, while being superior in spreading the risks and reducing the information and transactions costs that remain.

If the major countries, and particularly those whose currencies make up the SDR, succeed through appropriate policies in stabilizing their domestic price levels, then exchange rates, which are now disturbed by volatile expectations about prices, interest rates, and policies, would be calmed. In these circumstances, the countries whose currencies are embodied in the SDR (as well as other countries) might choose to establish parities with each other's currency or group of currencies that they would be willing to defend within some range. Pegging to the SDR would put all such countries on a more equal footing regarding their international and domestic policy obligations than pegging to a single currency. 1/ Such a development could be an important factor contributing to the willingness to use the SDR in international transactions, but it is not contended here that it is essential. What is contended is that a history of stability is required that would reduce the need for constant reappraisals of exchange prospects and of future policies likely to affect exchange rates--a need and responsibility that many of the private participants in international trade and finance currently feel. For businesses, the saving of information, transfer, and management costs and the convenience and efficiency of worldwide standardization that is associated with using a single and common standard of denomination in diverse transactions with many countries could then outweigh any opportunity losses that could be associated with ceasing to adjust and manage day by day the currency composition of contracts, exposures, and positions. Financial investors might also be more comfortable holding SDR claims when their value in terms of most currencies is likely to remain stable, even though small devaluations of particular currencies against the SDR may occur from time to time, which would increase the value of the SDR in terms of those currencies. 2/

1/ Even if par values were fixed in terms of the SDR, a country whose currency is contained in the SDR might choose to continue using individual foreign currencies underlying the SDR to meet any intervention objectives or obligations it may have, rather than buying SDR claims with, or selling them for, domestic currency.

2/ To prevent the value of the SDR from falling in terms of the stronger currencies contained in it when a devaluation occurs, consideration could be given to an "asymmetrical basket" technique of valuation for the SDR of the kind that was already considered by the Committee of Twenty (C-20, p. 44). Application of such a technique could imply that par value changes are always expressed as devaluations of a particular currency against the SDR, with the resulting decline in the share of its value in the SDR compensated by raising the amount of that currency

Thus it is argued that the SDR would become a major competitor of the national currencies that are currently dominant in the international monetary system if, as a result of price level and exchange rate stability, it first becomes an acceptable substitute for each of those currencies in international use. But, as noted above, to be successful in that competition, the SDR will have to compare favorably with national currencies in terms of convenience and transaction costs.

b. Development of institutions and practices outside the Fund

There is no reason to suppose that the preference for using national currencies in domestic transactions will in any way be reduced in the more stable conditions under consideration in this section. But the contention of this paper is that it is more likely that the use of SDRs in international transactions would develop in these circumstances. It is more likely, that is to say, that the supporting structure of commercial banking in SDRs, domestic clearing of SDR claims through central banks, and international clearing through SDR accounts of central banks with the Fund, which was described earlier in Section 2 of this part, would evolve.

Were such a supporting structure of assets and liabilities in SDRs to develop, it is conceivable that practices could also evolve whereby commercial banks would maintain reserves in SDRs with their central banks and the central banks would regard their SDR accounts with the Fund as reserves against their own SDR liabilities. In these circumstances the Fund could, in theory, acquire leverage over the high-powered SDR liabilities of those central banks and, through their reserve requirements, over the SDR liabilities of commercial banks.

This structure of monetary assets and liabilities in the system is perhaps conceivable in a well-integrated international economy marked by stability of prices and exchange rates. The further step of achieving, for the Fund, leverage over the creation of money generally, and not just over a particular form of money, through the direct control of

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2/ (cont'd from p. 20) in the SDR. Under such a valuation adjustment rule, the SDR would retain its value as much as the hardest currency, or succession of hardest currencies, within it. The interest rate that would be appropriate on such an SDR would normally be below the weighted average of interest rates on the five national instruments currently used. There would be numerous other implications, including an increased ability of the SDR to compete with official gold holdings as a possible hedge against inflation, as well as possible complications of private use of SDR-denominated claims, neither of which can be further discussed here.

high-powered money within member countries, would not seem to be within even the remote ranges of possibility. Nevertheless, the commitment to stability of prices and exchange rates by countries implies a commitment to money supply control compatible with those goals by the major central banks in the system. In the exercise of surveillance, the Fund would be accorded leverage by virtue of those commitments, and it could assist countries in carrying out their commitments by making resources available to them under suitable conditions.

c. Implications for the functions of the Fund

Should the role of the SDR evolve in the general direction indicated in the earlier sections of this part, the Fund would continue to perform all of the functions it performs today. The system's needs for some functions would clearly be greater than today, while the need for some other functions might show little change. Flexibility in the evolution of the Fund would permit the emphasis placed on various functions to shift as required. A brief review of key functions, and the importance of each relative to the situation pertaining today, follows.

(1) The function of SDR allocation, or of equivalent ways of creating unconditional liquidity by means of the Fund's SDRs, could be of relatively greater importance in the system envisaged in this section than it is today. With the commitment to stability that underlies the system envisaged, the need for international reserves to be used to protect the external value of the national currency relative to the SDR could grow, even though intervention would have to be coupled with timely adjustment. SDR-denominated claims could have been generated by members lending to the Fund or substituting foreign exchange for SDR-denominated claims on the Fund during a transition period, but all countries might feel a continuing need for the supply of SDRs or SDR-denominated reserve assets to grow along with the volume of trade.

In the circumstances envisaged in this part, there are more specific reasons for anticipating an increased emphasis on allocation. If monetary policies of the major reserve currency countries are restrained so as to maintain reasonable stability of their domestic price levels and if there is no specific inducement to the expansion of Eurocurrency markets such as was occasioned at the time of the growth of OPEC surpluses, the apparatus for the supply of reserves in the form of reserve currencies may well not be adequate to meet the felt needs of countries for reserves. In such circumstances the need for allocation of SDRs may well be more evident than it has been in the conditions that have prevailed in the world recently. Indeed these are the kind of circumstances that were envisaged at the time the SDR was created.

In addition, the need for allocations could be further enhanced to the extent that the practice of asset settlement is adopted in the monetary system.

(2) The function of credit extension by the Fund would remain important. The need of countries for additional reserves in periods of pressure on exchange rates would continue even though, in general, the system's performance would be characterized by greater stability of exchange rates than it is today. As now, there would be alternative ways for countries to supplement their international reserves through recourse to international markets and other monetary authorities. But the Fund would continue to offer short-term balance of payments financing on varying degrees of conditionality and it might well become more normal for all countries, including the major industrial countries, to come to the Fund for supplementary balance of payments financing. Once an SDR standard has evolved, the Fund would almost certainly finance credit extension by the creation of SDRs, rather than with currencies as today.

(3) The function of surveillance would continue also to be exceedingly important. It is sometimes asserted that the surveillance function of the Fund is accented most heavily in circumstances such as now prevail when there is widespread instability and a limited commitment to the restoration and maintenance of stability. It is the case that the system now lacks the discipline of the commitment to stable exchange rates, which it would have in the circumstances under discussion in this section. On the other hand, in the tighter system of more stable prices and exchange rates, it could be just as difficult for economies to stay on track. In addition, the fact that the track would be more clearly marked with rules would provide agreed criteria and lines of orientation for national policies and for consultations between national authorities and the Fund. In view of these considerations and in view of the increasing experience of the Fund with the conduct of surveillance, surveillance by the Fund could be more effective in a more structured system of stable exchange rates than it is today. It could effectively apply to industrial countries to a much greater degree than at present, as countries whose currencies are included in the SDR would acquire special powers and responsibilities in the process of international liquidity creation in conjunction with the Fund. International capital markets would remain as free as they are today and national and international capital markets could become even more integrated by common use of SDRs and SDR-denominated assets. 1/ Nevertheless, the total growth of international reserves would have to be closely monitored and reconciled with the requirement of approximate price stability in the major countries, on which the potential usefulness and feasibility of the entire system envisaged in this part would depend.

1/ As part of this integration, clearing for central banks, and, indirectly, the private sector might be added to the transfer services the Fund currently provides with the SDR, particularly if SDR claims should become the principal monetary asset in international use.