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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/15

3:00 p.m., January 25, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
	L. E. J. M. Coene, Temporary
	X. Blandin
A. Donoso	
R. D. Erb	
M. Finaish	
T. Hirao	T. Yamashita
	Jaafar A.
	D. I. S. Shaw, Temporary
	H. A. Arias, Temporary
G. Laske	
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
F. Sangare	
M. A. Senior	J. L. Feito
J. Tvedt	
	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present
African Department: F. d'A. Collings. European Department: P. W. Stanyer. Exchange and Trade Relations Department: S. Kanesa-Thasan, F. L. Osunsade, P. J. Quirk, C. M. Watson. External Relations Department: A. F. Mohammed, Director; P. J. Bradley. Legal Department: G. P. Nicoletopoulos, Director; S. A. Silard. Middle Eastern Department: F. Drees. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; D. J. Mathieson, J. S. Smith. Treasurer's Department: W. J. Byrne, W. L. Coats, J. A. Gons, T. M. Tran. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, C. J. Batliwalla, H.-S. Lee, W. Moerke, Y. Okubo, I. R. Panday, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, J. Bulloch, G. Ercel, G. Gomel, V. Govindarajan, N. U. Haque, A. K. Juusela, H. Kobayashi, E. Portas, M. Rasyid, J. Reddy, C. A. Salinas, A. A. Scholten, S. Sornyanyontr.

1. SDRS - ALLOCATION

The Executive Directors continued from the previous meeting (EBM/84/14, 1/25/84) their discussion of a staff paper on considerations pertaining to the allocation of SDRs (SM/83/266, 12/28/83; and Sup. 1, 1/20/84).

Mr. Clark said that his authorities continued to feel that, in terms of the requirements of the Articles of Agreement, a decisive case had not yet been made for an immediate resumption of allocations of SDRs. It was particularly difficult in present circumstances to reach any conclusion on the adequacy of global reserves. External positions generally were clearly not in equilibrium, and reserve holdings, while perhaps low at present by historical standards, were also being adjusted. Indeed, in the medium-term time frame implied by the Articles, it was unclear whether, in the current situation, there should be an injection of liquidity into the system as a whole. Moreover, within the total of reserves, there was some question about the distribution as between the borrowed and unborrowed elements. Structural changes in the international capital markets might lead one to believe that the desired balance between the two had changed, but it was unclear from the evidence presented in the staff papers what the consequences had been for the demand for unborrowed reserves. He was not claiming that the evidence argued clearly against the need for a further injection of liquidity; rather, given the present disequilibria, an "agnostic" approach was indicated.

In general, he could endorse some of Mr. Laske's remarks about the provision of conditional rather than unconditional liquidity, Mr. Clark continued. He remained convinced that the most appropriate action that the Fund could take in present circumstances was to provide conditional financing that might be used to boost the level of reserves of individual countries under Fund programs. In that connection, he had some difficulty with the argument on page 13 of the staff paper that SDR allocations would avoid "excessive" adjustments in many countries. In sum, while he remained open minded on the question of an SDR allocation, he did not feel that the case for an immediate allocation had yet been made.

Mr. Sangare said that he wished to restate his chair's earlier support for new SDR allocations, which, in the view of his authorities, were more appropriate and justified at present than ever before. Any further delay in arriving at a positive decision on allocations would increase the hardships confronting many Fund members and expose the international monetary and financial systems to new risks. He had no difficulty with the general thrust of the staff paper, which itself provided a useful analysis of the situation and would, he hoped, lay to rest the fears that some Directors held about the effects of new SDR allocations.

Two important issues dealt with in the paper concerned the long-term need to supplement international reserves and the requirement in the Articles of Agreement to make the SDR the principal reserve asset of the system, Mr. Sangare continued. The staff had rightly pointed out that the long-term need to supplement global reserves did not "require the simultaneous existence of a need on the part of every country for an increase in its reserves." It was well known that the distribution of international reserves was highly skewed; many countries faced acute shortages, while a few were quite comfortable with their current level of reserves. The expansion of commercial bank credit was not the answer to the problem; indeed, as Mr. Ramtoolah had observed at EBM/84/14 the evidence seemed to show that a reliance on the international capital markets as a source of liquidity could pose problems for individual debtor countries and for the smooth functioning of the system itself.

Any decision on new SDR allocations should take account of the resulting effects on the overall performance of the world economy and the international monetary system, Mr. Sangare considered. The importance of limiting inflationary pressures should be weighed against the need to expand the growth of international trade, to achieve a stable system of exchange, and to avoid competitive exchange depreciation. The tendency of a few countries to be overly preoccupied with only the inflationary aspect ignored those other elements and the overall interests of the system. The persistence of such an attitude could only lead to hardships for the vast majority of members; it would also have serious implications for the entire international community.

In its analysis, the staff had employed a number of indicators of reserve adequacy, including the ratio of non-gold reserves to merchandise imports, trade balances, and external debt to banks, as well as the variability of changes in trade and exchange rates and of inflation and interest rates, Mr. Sangare noted. All the staff conclusions pointed to the need to supplement reserves through new SDR allocations. Moreover, the staff had argued that "the potential inflationary effect of an SDR allocation must be considered within the context of the current state of slack demand and high unemployment in the world economy and with special reference to the stabilization and adjustment policies of developed and developing countries." In the tight situation in which most countries found themselves at present, it was doubtful whether an allocation of SDRs would lead to a significant relaxation of policies currently in place. At any rate, countries' SDR holdings were small in relation to the domestic monetary base; and, even if new SDRs were monetized, they would only be a substitute for other government borrowing from the banking system that would have taken place in any event. The fact that many countries had extremely low reserve levels seemed to suggest that a major proportion of any allocation would be used to rebuild depleted reserve holdings. In his view, if there was concern about the control of inflation, attention should be focused on other crucial areas, including the mix of economic policies and the management of exchange rates, particularly those in the major industrial countries.

In determining the size of a new SDR allocation, Directors should not forget the objective in the Articles of Agreement of making the SDR the principal reserve asset of the international monetary system, Mr. Sangare commented. The current situation, in which the share of SDRs in total non-gold reserves had declined from 10.2 percent at the beginning of 1972 to 5.3 percent at end-October 1983, could hardly be seen to be consistent with that objective. Moreover, according to the staff, despite the efforts to improve the attractiveness of the asset, it would be "difficult to sustain the potential usefulness of the SDR as a reserve instrument in any possible future reform of the international monetary system that may require a noncurrency reserve asset as an important ingredient."

With regard to the various alternatives listed in Tables 5 and 6 of the main paper, all but one failed to provide any movement toward the objective of making the SDR the principal reserve asset, Mr. Sangare remarked. The only one that made even a small move in that direction was that which aimed at increasing SDRs by a fraction of projected non-gold reserve growth and, even if that approach were followed, the laudable objectives set for the asset were unlikely even to be met. In the circumstances, he urged an immediate resumption of SDR allocations in order to provide a clear signal to the international financial community that the objective of making the SDR the principal reserve asset had not been forgotten. It made little difference whether such an allocation was made under an extended fourth basic period or a new basic period, provided that it was substantial and began immediately. As many Directors had already remarked, Mr. Polak's useful proposal (EBM/84/14) for a new allocation on the order of SDR 9 billion deserved the consideration of the Executive Board. It should be noted that only a substantial annual allocation could help to offset the reduction of borrowed reserves, particularly from the commercial banks, associated with the recent disruptions in international financial markets.

An immediate resumption of SDR allocations would also meet the need for additional reserves to finance the expansion of world trade resulting from the ongoing economic recovery, Mr. Sangare said. It would reduce the vulnerability of the reserve system to future disturbances in financial markets and would also enhance the relative importance of SDRs in the reserve mix, thereby re-emphasizing the goal of achieving a proper role for the asset in the system. Finally, the staff had covered the technical aspects of SDR allocations in various studies; what remained to be done was the taking of a political decision on the matter. He hoped that the discussion would make that decision an easy one.

Mr. Jaafar joined those who had strongly supported a new SDR allocation. The staff had demonstrated beyond a reasonable doubt that there was indeed a case for an allocation in the current basic period. In earlier discussions, some Directors had argued against an allocation on the grounds that it would adversely affect inflation and inflationary expectations, but that point had been met by staff comments on page 14 of SM/83/266. Numerous member countries were currently experiencing a considerable slack in demand as well as high unemployment, and inflation had fallen to lower levels than in the past. Moreover, international reserve positions had declined significantly, and some had almost been depleted as a result of the deep global recession. Many countries had of course undertaken adjustment measures, a number of them with Fund assistance, and any evaluation of the potential inflationary impact of an SDR allocation should be considered in that context. In his view, a modest addition to the stock of members' existing reserves would not have an inflationary effect, either in the long term or in the short term, unless adjustment policies were significantly relaxed; and he did not see such a relaxation occurring, given the relatively small proportion of reserves that an allocation would represent. For major countries, an allocation might lead at most to a marginal increase in inflation; for others, the SDRs would be used mainly to shore up depleted reserve holdings.

He was grateful for the information presented in Table 4 on page 11 of the staff paper, which served to illustrate in a convincing manner the degree of uncertainty that surrounded trade and prices at present by comparison with the period 1965-73, Mr. Jaafar commented. It was important to note that import volume and prices far exceeded the mean of past years. It would have been useful if the staff had also included figures for exports, since it was clear that, for most open economies, fluctuations in exports--particularly primary commodity exports--had reached extreme proportions in the past several years. As a result, it had been necessary for those countries to accumulate more reserves than usual by comparison with other countries. The present evidence on trade, prices, and interest rates--all of which created uncertainties regarding economic development--underscored the need for a larger cushion in terms of reserves. While he agreed that the present, albeit slow, recovery would help in the accumulation of reserves, the constraints on capital flows seemed to suggest that there was a need to supplement existing reserves through an allocation of SDRs.

A significant development affecting reserve adequacy was the dramatic change in financial and capital flows within the industrial and developing countries, Mr. Jaafar noted. It was encouraging to see some improvement in the successful rescheduling for major debtors, but the problem was far from over. Table 3 of SM/83/266 and Table 1 of the supplementary paper showed clearly that reserves in most of the developing countries--with the exception of some in Asia--remained insufficient. And the situation in Africa and Latin America was particularly bleak. The ratio of non-gold reserves to debt had declined from 19 percent to 10 percent in Africa between 1980 and 1983, from 13 percent to 5 percent in Latin America, and from 47 percent to 20 percent in Asia. As a consequence, the system continued to suffer from strains, and countries were at present less able to cope with their debt and adjustment problems than they had been in 1980. The picture painted by the figures he had given pointed to the need for more reserves. Without going into a discussion of the desirable amount of an allocation, he noted that any figure that might be agreed should be a meaningful supplement to global reserves. The figure of SDR 9 billion mentioned by some Directors would meet that criterion, although he was open minded on the matter, pending a closer look on another occasion at the relevant numbers.

Mr. Kabbaj remarked that the staff had adopted a positive approach to the question of allocations and had correctly stressed the importance to the system of maintaining and enhancing interest in the future of the SDR as the main reserve asset in the system. At the 1983 Conference on International Money, Credit and the SDR, it had been mentioned that the supply of international reserves would play a more important role during the 1980s and that, in order to stabilize the stock of reserves, changes in the supply of the SDR could be envisaged to offset unanticipated increases and decreases in the supply of other reserve assets, including decreases brought about by abrupt withdrawals of borrowed reserves. It was also clear from the staff paper that large short-term external debts encouraged reserve holdings as a cushion for meeting any difficulties involved in the more frequent financing of those liabilities. To that important consideration could be added the evident difficulty experienced by many potential seekers of reserves in securing sufficient private resources to correct balance of payments disequilibria. In short, in addition to the general need that had already been established for greater overall reserves, the exceptional financial and credit circumstances prevailing in the 1980s in the face of severe and recurring credit crises made the case for SDR allocations even more compelling. Table 3 of the staff paper showed that the ratio of reserves to external indebtedness to banks had generally declined--on both an individual country basis and a regional basis--particularly over the past three years. However, the picture would have been far more dramatic if all debt--not just external debt to commercial banks--had been taken into account.

Exchange rate variability had been a predominant feature of the financial system for many years, and indications were that it would continue to be so in future, Mr. Kabbaj went on. Table 1 of the staff report showed that, since 1973, there had been a high rate of reserve accumulation, and it was important to determine whether that change had come about despite a shift to greater exchange rate flexibility--as mentioned on page 8 of the staff report--or because of it. Reserve accumulation and the need for reserve holdings was partly stimulated by uncertainty with respect to financial markets, a point acknowledged by the staff in mentioning that reserve accumulation was likely to continue in the remaining years of the fourth basic period. It would therefore have been helpful if some information had been included in the staff report on the effect of the nonallocation of SDRs between 1972 and 1976 on trade and capital flows and on demand for reserves. Also, an analysis of the relationship between high SDR interest rates and the demand for, and transactions in, SDRs would have thrown some light on the sensitivity of demand to interest rate changes and hence to the future need of present users--as against holders--for further SDR allocations under current conditions.

It was imperative to take a long-term perspective in attempting to arrive at meaningful conclusions about SDR allocations, Mr. Kabbaj considered. A similar approach should be taken in considering the general aim of making the SDR the principal reserve asset in the international monetary system. The staff had made the point that, given the dwindling share of the SDRs in total reserves of members, any attempt to promote the asset should in some way hinge on the desirability of increasing the ratio, or at least halting its decline. He endorsed the view that it was not possible to enhance the role of the SDR as the principal reserve asset and its potential usefulness as a reserve instrument if the decline continued. Of course, fundamental institutional changes were needed to achieve the purpose, including steps to enable the Fund to transact more extensively in SDRs so as to spread its usage. Meeting the problem required a comprehensive approach; however, an appropriate allocation of SDRs would be a significant step in the right direction.

Another issue covered in some depth in the staff paper was the availability of, and access to, additional borrowed resources associated with the disruptions in the international financial markets over the past two years, Mr. Kabbaj recalled. Most indications were that the debt crisis of 1981 and 1982 was far from over and that an SDR allocation would, depending on its size, ease the pressure that had already built up on available resources. An allocation would also help to produce an improved pattern of debts and total reserves with less reliance on borrowed resources. In sum, the case for an appropriate allocation of SDRs seemed overwhelming. His authorities favored a sizable allocation, perhaps of the order of magnitude mentioned by Mr. Malhotra.

Mr. Morrell reported that there was not an agreed position among the members of his constituency on the matter of an SDR allocation. The majority of the votes in the constituency were in opposition to an allocation of SDRs at present; on the other hand, the majority of members favored an allocation, and some of them preferred one that would be fairly large. As the arguments in favor of an allocation of SDRs had been ably put forward by so many Directors in the course of the discussion, he would focus his remarks on some of the points raised by those in his constituency who were not convinced of the need for an allocation.

While accepting that the argumentation in the staff paper was better than in most papers in the past, some of his authorities remained unconvinced, Mr. Morrell continued. All the tables in the staff paper spoke of non-gold reserves, and the exclusion of gold reserves from those numbers could make a material difference, they noted. Also, while observing that the variable and declining ratios of imports and trade imbalances to reserves probably meant that reserves were less adequate than they had been previously, the conclusion could not be drawn that they were inadequate. For example, Table 2 of the supplement to SM/83/266 showed the ratio of non-gold reserves to imports for the largest borrowers and for those countries with operative Fund programs; the figure for countries with Fund programs had fallen dramatically in the past couple of years. He assumed, however, that the numbers must be heavily weighted by the fairly recent inclusion of Mexico and Brazil, which might have distorted the indicator.

Although they could agree with the staff that there was probably a need for an increase in international reserves because of the growth in world trade and in capital flows, some of his authorities had found no convincing arguments in favor of the need to supplement those reserves by an allocation of SDRs, Mr. Morrell continued. Also, while there might be less risk at present than in the past of increased inflation through an allocation of SDRs, there were many countries where inflation remained high; hence, it was difficult to accept the argument that inflation was under control or that an allocation of SDRs would have no impact on inflation.

Mr. Zhang considered that the staff had put forward convincing arguments for a new allocation of SDRs. He was in full agreement with Mr. Polak's statement and could support his proposal.

Mr. Hirao remarked that the issue of a new allocation of SDRs must be carefully examined on the basis of the criteria set forth in the Articles of Agreement, which called for the determination of a long-term global need for reserve supplementation and demanded that any allocation should be consistent with the objective of avoiding deflation or inflation. His authorities, having made such an examination in the context of the current world economic situation, continued to believe that the case for an allocation had not yet been fully established.

The staff paper had provided information that should aid Directors in considering the question of a global need for reserves from a longer-term perspective, Mr. Hirao continued. Two points were clear: first, for most country groupings, the ratio of non-gold reserves to imports and to trade imbalances had fluctuated over the past decade with no clear trend; second, for the group of heavily indebted countries, the level of reserves had declined recently in relation to imports. No case for a new allocation of SDRs could be made on the basis of the first observation, and the effort to argue the case solely on the basis of the second might be premature.

The staff had also pointed out that the ratio of reserve holdings to external debt had generally declined as a consequence of financial market strains during 1981 and 1982, Mr. Hirao recalled. The question therefore arose of how the level of reserves related to the outstanding external debt. As long as external borrowing grew at a steady pace under sound debt management programs, there should be no cause for concern; indeed, in those circumstances, it was even questionable whether there was a need for non-gold reserves to increase in line with growing outstanding external debt. Of course, there would be cause for concern if the debt grew very rapidly or if the increase were concentrated at the short end of the maturity range. However, in such cases, priority should be given to assisting the adjustment efforts of member countries in a way that would contribute to restoring the creditworthiness of debtors. The Fund had long been playing a central role in that respect and, after the coming into effect of the Eighth Quota Increase and the enlarged GAB, was even better equipped financially to continue its role. Present debt problems could thus appropriately be dealt with by Fund-assisted adjustment together with, in some cases, private resources generated by the cooperative efforts of commercial banks.

Over the past few years, there had been a sharp reduction in the availability of credit through the international financial markets, Mr. Hirao noted. However, it would be too pessimistic to anticipate that the declining trend would continue. It was in fact possible that the amount of credit available might increase as prospects for economic recovery became brighter and progress was made toward adjustment. It was encouraging to note that significant progress had been made in a number of industrial countries to bring inflation under control through firmly committed anti-inflationary efforts. Still, inflationary expectations had not yet subsided in some industrial countries, and inflation remained relatively high in a number of developing countries. Given that a new allocation might impart wrong signals, Directors should continue to give very careful consideration to the issue of SDR allocations.

Mr. Nimatallah remarked that the staff paper had confirmed his view that there was a convincing case for resuming SDR allocations as soon as possible and that the conditions for allocations set out in Article XVIII had been satisfied. There was certainly a need to supplement existing reserve assets; more particularly, the growth in world trade projected by the staff for the period through 1986 would need to be financed by commensurately, growing reserves. As the staff had explained, the supply of reserves--particularly from the international capital markets--had been significantly reduced over the past two years. In some cases, bank lending had slowed or ceased entirely. The tables in the staff paper showed that a shortage of reserves and difficulties of access to market resources were being experienced by numerous Fund members, which could have serious consequences for the adjustment process and could threaten the incipient world recovery. There was little doubt, therefore, that the need for additional reserves was a global one. Furthermore, the debt problem demanded not only adjustment but also economic growth to enable indebted countries to repay their debt. Balance of payments equilibrium at lower levels of income should be a temporary objective; adjustment with growth was a more viable, medium-term objective that needed commensurate growth in both trade and reserves. A steady allocation of SDRs at reasonable rates could provide a much needed element of stability and make the international payments system less exposed to disruptions.

Another point to be emphasized was the need to strengthen the SDR itself, Mr. Nimatallah continued. From a longer-term perspective, new allocations would meet that aim and, since they would benefit the international monetary system as a whole, they would be in the interest of all Fund members. The instability inherent in the present mechanisms for international liquidity creation had been clearly demonstrated in recent months. The Fund had an international alternative in the SDR, which should be used to its full potential. SDR allocations would be a more reliable form of reserve growth that would improve the quality of members' reserve holdings. The Fund should ensure, at the least, that the share of SDRs in non-gold reserves did not fall below its present level; indeed, the SDR could not become an important reserve asset unless, inter alia, its relative share in total reserves was allowed to grow.

Mr. Finaish observed that the existence of a global need to supplement existing reserves had been substantiated by a number of arguments in the staff paper, thus reinforcing the widespread support for an SDR allocation in the current basic period. Reserve supplementation through an allocation of SDRs at the present stage was appropriate because it was unlikely either to have inflationary consequences--given the recent progress in curbing inflation--or to interfere with the adjustment process already under way in many countries. Furthermore, an allocation would help to alleviate some of the burden of the recent contraction in the international credit markets. It was likely that the countries that were finding it difficult to gain access to the markets in the present conditions of constrained credit would have a particular need for reserve supplementation.

The declining share of SDRs in non-gold reserves since 1972 had not been helpful in moving toward the stated Fund objective of making the SDR the principal reserve asset in the international monetary system, Mr. Finaish noted. It might therefore be important for the Fund to provide appropriate signals regarding its commitment to that objective by reversing the decline.

Many Directors had expressed their support for an adequate and meaningful allocation in the current basic period, Mr. Finaish recalled. Among other things, an allocation could help to alleviate the threat to an incipient global recovery posed by an excessively tight international liquidity situation. Increased country reserves could also help in dealing with both expanding world trade and any unanticipated developments in key economic variables such as exchange rates, trade imbalances, and rates of inflation. It was probably worth noting as well that an allocation would help to moderate contractionary policies, such as excessive import compression, that a restrained international credit market might require but that might be regarded as detrimental in the long term. Finally, while it was clear that some Directors considered an allocation to be unsuitable in present circumstances, it remained unclear what set of circumstances and conditions would be required in their view to make an allocation both appropriate and feasible.

Mr. Donoso stated that, like others, he could support the staff's conclusions in favor of an SDR allocation. The analysis in the paper was convincing and provided all the elements to support the view that an allocation in the near future would be highly beneficial.

Since the disruptions in international financial markets during 1982, it had become difficult for countries to increase international reserves through borrowing, and they were often resorting to measures that should be avoided, Mr. Donoso observed. An SDR allocation would help to offset those difficulties. The recovery of the world economy should induce an increase in world trade, which, in itself, was necessary for the recovery to be durable; an increase in reserves would facilitate that process, and an SDR allocation could help to satisfy the need for additional reserves. Because of the specific character of the SDR, an allocation would also improve the quality of the international reserves of member countries by lowering the ratio of borrowed to total non-gold reserves. If there was an expectation that access to international financial markets would remain difficult, an allocation would be particularly important as a way of avoiding unnecessary negative effects of financial disturbances on trade.

The aforementioned benefits of an SDR allocation illustrated in concrete terms the existence of a global long-term need to supplement existing reserve assets as required by the Articles of Agreement, Mr. Donoso considered. He could not accept the argument of those who suggested that the need was not global because shortages in reserves did not exist in all member countries. If a situation were to arise in which all member countries were suffering from a shortage of reserves, the economies of the world would be behaving in a manner that should be avoided, and the International Monetary Fund would have failed in its objectives. Of course, the extent of the need for additional reserves was a matter of judgment; however, in analyzing the ratio of non-gold reserves to existing debt to banks, the staff had presented figures that he would consider to be disquieting and calling for immediate action. There was not only a need to facilitate the longer-term process of accumulation of reserves but also a need to cope with the present shortage. In the circumstances, therefore, he attached great importance to a prompt and meaningful allocation of SDRs.

Mr. Erb remarked that the U.S. Government had not reached any final conclusions regarding an allocation of SDRs; it was prepared to consider with an open mind whether or not the criteria contained in the Fund's Articles of Agreement had been satisfied. However, the latest staff paper covered much the same ground as earlier papers and shed little new light on the fundamental issues to be examined in determining whether or not a new SDR allocation was justified.

The staff had pointed out that an assessment of the need for an SDR allocation must focus on the effects of reserve supplementation on the performance of the world economy, the overall functioning of the international monetary system, and matters related to the purposes of the Fund, Mr. Erb continued. As a general proposition, he had no difficulties with such an approach; however, as a practical matter, he found it difficult to judge the potential impact of a further SDR allocation on the world economy because there were no analytical or empirical bases for making judgments about the impact of an allocation on the behavior of governments. Put somewhat differently, there was no empirical framework for determining the demand for reserves, and he had some of the same difficulties as those mentioned by Mr. Laske, Mr. Polak, and Mr. Shaw with the indicators that the staff had put forward as guidelines for judging the need for SDR creation. In particular, he had problems using the ratios of reserves to current account balances and overall debt and the ratio of SDRs to total reserves as criteria for assessing the desirability or the need for a further allocation.

Much of the staff's analysis and conclusions seemed to be based on the assumption that governments would substitute SDRs for other reserves, an action that for many countries would result in less external borrowing, Mr. Erb commented. That assumption also lay behind the staff's conclusions on pages 14 and 15 of SM/83/266 that an allocation would not contribute to inflation. Many of those who had resisted a further allocation had done so out of concern that it might, in fact, induce more expansionary policies and greater borrowing by some countries, which might eventually be forced to use their SDRs. If SDRs were used, the question arose as to what effect the SDRs would have on the designated countries. Two developments were possible. First, the SDRs transferred might be inflationary unless the countries sterilized the additional SDRs upon receipt. He tended to agree with the staff that, given the current monetary policies of the major reserve currency countries, an allocation would likely not be a source of inflation because the major reserve centers would probably sterilize the additional SDRs they received. However, the effect of an allocation would then be to raise interest rates in the recipient countries. For example, to the extent that the United States received SDRs and they were sterilized, larger-scale borrowing by the U.S. Government would be required to finance the designated SDRs.

In general, there were fundamental differences of judgment about the behavioral responses of governments to an allocation of SDRs, which made the U.S. authorities quite skeptical about, and negative toward, an SDR allocation, Mr. Erb continued. They were not as confident as the staff that an allocation would be used to strengthen members' reserve positions; rather, they felt that countries would be tempted to delay adjustments or follow more expansionary policies.

In discussing the criteria for an allocation, the staff had noted that the objectives of promoting better international surveillance of international liquidity and making the SDR the principal reserve asset in the international monetary system were among the important aims recorded in the Fund's Articles of Agreement that were closely linked with SDR allocations, Mr. Erb recalled. However, the meaning of those objectives was not particularly clear in the context of the current system of floating rates and a multicurrency reserve system. It was not evident, for example, how an allocation would aid the SDR in becoming the principal reserve asset in the current system, and he strongly disagreed with the staff that it would be difficult to sustain the potential usefulness of the SDR as a reserve instrument in any possible future reform of the international monetary system that might require a noncurrency reserve asset as an important ingredient. Put another way, it was difficult to accept the idea that the Fund should continue to create SDRs as a way of keeping the concept of the SDR "alive" or enhancing its possible future role in a different kind of system. Indeed, it could be argued that, if SDRs were allocated in circumstances of great uncertainty or differences of view about how the asset fit into the current system, the result could be a constraint on, or weakening of, the SDR's potential usefulness in any possible future reform of the system. It was for that reason that he was not attracted by the arguments of the staff or by the suggestion of Mr. Polak, which related the basis for an SDR allocation to the current circumstances of a number of countries within the international financial system.

While it was true that many countries were facing a liquidity squeeze, it was not clear that the liquidity problem was a pervasive or systemic one, Mr. Erb remarked. And while it might seem attractive to use a generalized approach like an allocation to deal with specific liquidity problems, that was not an approach that was focused sharply on the objective of dealing with the specific adjustment problems of a subset of countries within the system. In many ways, Mr. Polak's proposal was a variation of one put forward by Mr. de Groote, which was far more explicit in linking an SDR allocation to a conditional provision of financing by the Fund; however, that would require a change in the Articles of Agreement with respect to the structure of the SDR, which would then be a very different instrument from the one currently envisaged in the Articles. In conclusion, while he was not able to support an SDR allocation at the present stage, he would continue to address the fundamental questions underlying any decision on an SDR allocation.

Mr. Polak said, in response to a point raised by Mr. Erb, that he had intended not so much to follow Mr. de Groote's idea as to indicate that Mr. de Groote's concern might be dealt with by the existence of conditional credit arrangements between the Fund and many members. The risk of allocations being spent by countries in difficulty and the risk of an expansion in their demands would be pretty much taken care of by their existing stand-by arrangments with the Fund. What he had in mind was certainly not any change in the Articles of Agreement or any move in the direction of conditional SDR allocations.

On another matter, it was of course appropriate for Mr. Erb to want to study the effects of an SDR allocation on the world economy as a whole, Mr. Polak continued. SDRs had originally been introduced in the belief that the world economy could function a little better with allocations than without them. Since then, much analysis of the issue had been produced, and he did not feel that it was reasonable to suggest that nothing was known about the effects of an SDR allocation on the world economy. Finally, he understood from his studies of the Federal Reserve System over the years that the action to offset balance of payments surpluses had been taken to avoid a lowering of interest rates. He found it difficult to see how offsetting one particular form of a balance of payments surplus through the purchase of SDRs--or the sterilization of allocated SDRs--would do anything other than prevent a reduction in interest rates.

Mr. Erb replied that a monetization of acquired SDRs might in fact lead to lower interest rates in the short run; however, if the allocation raised the underlying inflation rate in, say, the United States, that would in effect raise the interest rate. If the acquired SDRs were not monetized, the Government would achieve the same money base growth that it had planned to achieve without the allocation, which meant that it would have to acquire less in government securities in its open market operations. The result also would be higher interest rates.

With regard to Mr. Polak's first point, Mr. Erb considered that, for the approach to work, it would have to be made explicit that any allocation a country might receive should be devoted to a higher reserve target than would otherwise have been contemplated under the program; and that would require a change in the understandings between the Fund and the country concerned during the program period with respect to the reserve objective. Also, there were a number of countries under Fund programs that were on the borderline of deciding whether to continue with the adjustment and maintain the Fund program or to avoid the adjustment. To the extent that an SDR allocation made it easier to avoid the adjustment, it was quite possible that some countries would choose to relax their policies and not to engage in a Fund program.

While he agreed with Mr. Polak that considerable studies on the SDR had been made, he continued to see differences among Directors in their judgments about the impact of an SDR allocation on the behavior of government policymakers, Mr. Erb commented. That was the issue that remained open, and he was not certain that additional empirical work would affect those differences in judgment. In passing, he noted that, over time, most of the SDRs had flowed into a relatively few countries; many countries--even prior to the current squeeze--had used the SDRs essentially as a line of credit, and that had influenced their own domestic policy behavior.

Mr. Malhotra said that he had not understood Mr. Polak to be saying that, in the event of a future SDR allocation, the Fund in dealing with members that required some growth in reserves should make it conditional that SDRs would be drawn upon only if they went into reserves and not into expenditure. Reserve creation could take place in various ways. There was no good reason for making SDR drawings conditional or for suggesting a change in the Articles.

Mr. Erb noted that Mr. Malhotra seemed to be expressing a concern about the fact that the Fund had little or no control over other forms of liquidity. If it was agreed that very high liquidity growth in the past had, per se, been a problem, he wondered why an international institution would want to add to liquidity creation. If, in fact, an SDR allocation induced the sort of behavior that he had suggested earlier, it might add to liquidity growth by potentially inducing more expansionary policies.

Mr. Malhotra commented that the idea behind an internationally created asset had been to try to correct the imbalances to which uncontrolled liquidity growth had led. It was not expected that SDR creation would much improve the control of overall liquidity. Certain countries--because of their economic strength--were in a position to create large amounts of liquidity, while other countries were not. The result was an imbalance that could be improved through the allocation of an internationally created asset.

The Economic Counsellor, commenting on the discussion thus far, noted that Mr. Polak had raised a fundamental point in relating a new allocation of SDRs to members' access to the Fund's resources. That relationship, or lack of it, had apparently troubled a number of Executive Directors. At present, there was in fact a total lack of integration of the lending activities of the Fund and the creation of liquidity through the allocation of SDRs. There was no lack of a relationship between the capital of the Fund and its lending; indeed, the reliance of the Fund on resources borrowed by means of SDR-denominated instruments established the connection between lending and the creation of liquidity quite clearly. And, to the extent that those instruments were transferable among their holders, the connection became even more apparent. Mr. Polak's suggestion of thinking in terms of access when considering an allocation of SDRs called for a somewhat wider view than that adopted by the staff, which had limited its analysis to those possibilities that fell within the confines of the existing Articles of Agreement. However, the idea had been touched upon in an earlier paper on the size of the Fund--which had been produced as part of the quota exercise--and the staff would be happy to pursue the matter further if Executive Directors so desired. It was of course open to the Fund in the management of its programs to take account of allocations in determining the appropriate balance between financing and adjustment in individual cases; and it need not be presumed that, in every case, the Fund should or would decide in favor of a lower rate of adjustment. In fact, if it decided the other way, the deleterious effect that some Directors saw in allocations at the present stage would be neutralized.

While he accepted that Mr. Polak's suggestion touched upon a fundamental issue in relation to Fund arrangements, he would wish to study the specifics of the suggestion before passing judgment on it, the Economic Counsellor continued. It seemed at first glance that Mr. Polak wished to establish the connection between allocation and access on the grounds that countries should not be moved into a higher category of access than that in which they would have been placed in the absence of an allocation. He presumed that Mr. Polak was viewing countries in an "average" sense; otherwise, a country that was already at its access limit could not participate in an allocation, which would be contrary to the existing Articles of Agreement. In any event, to move Mr. Polak's proposal from a conceptual to an operational procedure would require great effort.

The Deputy Director of the Research Department, responding to specific questions, noted that the staff's decision to focus in its paper on non-gold reserves rather than on total reserves was based on the procedure that had been followed when there had been great uncertainty about the valuation of gold. Also, gold was a less liquid component of reserves than some other elements; while it was possible to use gold as collateral or in certain other ways, gold movements had been rare. In addition, gold reserves were subject to rapid and sharp fluctuations over the years in their total value as a result of price changes, and it was thus difficult to make a judgment that a particular value of the gold stock had any permanence. If Executive Directors so desired, the staff could of course provide analysis that took account of gold holdings. What such an analysis would show was that the value of gold reserves had risen strongly over time, approximately in step with non-gold reserves. More recently, the price of gold had been on a declining trend, and the analysis would probably show that total reserves--including gold at market value--would not have risen as fast as non-gold reserves.

On a question by Mr. Polak, the Deputy Director noted that, in the present paper, the staff had not referred to the reserve growth that would correspond to the increased demand for reserves generated by the real growth in the world economy, although it had done so in past papers.

Taking the latest projection in the World Economic Outlook for a real growth of imports of 3-3.5 percent over the next few years, and assuming that the demand for reserves associated with that real growth would increase by a similar--or slightly smaller--percentage, the result would be an increase in non-gold reserves of SDR 7-11 billion a year. That increase was not inconsistent with the range of SDR allocation figures that the staff had mentioned in its table on the size of allocations for the fourth basic period.

In past discussions, a number of Directors had requested clarifications with respect to the concept of the long-term global need for reserve supplementation, the Deputy Director recalled. He was pleased to note that the clarifications suggested by the staff in SM/83/196 and in the present paper (SM/83/266) had in general been acceptable to Directors, in particular with respect to the long-term and global character of the reserve need. Of course, there would always be room for judgment as to when a need was "global"; but no Director had suggested that every single country would have to experience a reserve need for a judgment of global need to be warranted. Mr. Erb had, in principle, been able to accept the clarification with respect to the need, as distinct from the demand, for reserves, but he had also pointed to some of the practical difficulties involved in an assessment of the need. The framework of analysis in the World Economic Outlook was by no means sufficiently refined for such an assessment, although an attempt could be made to improve it, perhaps by showing projections with and without an SDR allocation.

A more fundamental doubt about the distinction between the need for reserves and the demand for reserves had been expressed by Mr. Laske, the Deputy Director observed. It was certainly clear that the Articles spoke of the "need for reserves" when they could have employed the term "demand." The staff had attempted to clarify the implications of that choice of terms in the light of the argument sometimes put forward that, in the present system, countries could get all the reserves they demanded, and that there was therefore no scope for reserve supplementation. The reference in the Articles to the need for reserves was important in that context, since a need could exist even though the demand was satisfied.

Mr. Polak recalled that Mr. Erb had earlier asked a rhetorical question: Considering how little control there is over international liquidity, what business does the Fund have in adding to the problem? In a sense, Directors needed to answer that question, because there was widespread concern over the lack of control of international liquidity. The basic answer was that there were a number of institutions in the world charged with the creation of money, including the central banks of all member countries and the Fund. Central banks had the task of providing the "correct" amount of currency, mainly from the point of view of the country concerned. The Fund, on the other hand, had the function of providing for the external needs of all its members. Those various functions could easily be reconciled if dollars, for example, circulated only in the United States or deutsche mark circulated only in Germany; indeed, that had been the idea put forward by the Committee of Twenty in talking about wholesale substitution and the use in reserves only of SDRs. In fact, dollars, yen, and deutsche mark were far more important in international reserves than SDRs, and the problem of reconciliation still had to be faced. The substitution argument that the staff had provided--and which he himself supported--went a long way toward providing the answer to that problem. However, he did not see how the conclusion could be that one of the various liquidity creating institutions--namely the Fund--should back off and let all the others do the work of creating liquidity. Rather, since the Fund had control over its production of SDRs, Directors should come to a decision on what was a reasonable amount of SDRs that should exist or that the Fund should create on an annual basis.

Mr. Coene, recalling the concern expressed by Mr. Erb that a new SDR allocation would be spent by recipient countries, wondered whether a reconstitution obligation could not alleviate that concern. The Executive Board had abolished that obligation harder to increase the attractiveness of the SDR as a reserve asset; however, if the risk of unlimited use of the SDR was a problem for some Directors, the reconstitution obligation might help to meet their concerns by inducing adjustment in the recipient countries. The obligation could be moderated in such a way that it would allow countries sufficient time to adjust and to satisfy the reconstitution obligation.

Mr. Erb, responding to Mr. Polak's most recent intervention, said that he himself would not characterize the SDR as another type of money; rather, it was a way of allocating or directing the flow of credit. What the SDR potentially allowed was an allocation from, say, within the domestic part of a country to external sources of demand for credit. If a country used its SDRs through whatever process--either designation or voluntary transactions--and another country provided its currency in return, the result was to give the user of SDRs special access to the capital markets of the country providing currency; unless the SDRs were monetized and resulted in inflation, they would raise the real cost of capital within that country. SDR allocations would not necessarily be inflationary per se, but an allocation could influence the behavior of countries in determining their monetary policy.

Mr. Polak replied that the issue of whether or not the SDR was considered a currency was irrelevant. All the various credit mechanisms, including the Fund, created purchasing power, which was at the disposal of the borrowers and had an impact on demand all over the world. If, for example, U.S. banks loaned money to another country, that country could spend the dollars in the United States or elsewhere, and the dollars would have an effect, wherever they were created. If the Fund extended credit to one of its members from the General Department or allocated SDRs, the effect was also the same. Countries could keep some part that they did not spend, and that part would help to build up reserves, just as they could keep some of the dollars that they borrowed. The basic point to be remembered was that, in addition to the national agencies that created liquidity, there was an international agency for which a place had been agreed.

The Chairman made the following summing up in concluding the discussion:

Our discussion today has been most interesting, although by no means conclusive. I was heartened to hear that the latest papers produced by the staff, while they did not fully convince all Directors, were considered to be helpful and to contain an improved argumentation vis-à-vis preceding papers.

There remains, of course, a wide spectrum of views in the Executive Board on the subject of SDR allocations, ranging from those opposed at this stage, to those not convinced but open minded, to those partially convinced or agnostic but ready to accept a modest allocation, to, finally, those fully convinced and insistent on immediate and substantial action. Perhaps not surprisingly, the informal "tally" of Executive Directors' positions on the question of an allocation has not changed from those taken in other discussions over the past few years. Seventeen Directors, representing 58.5 percent of the voting power, are in favor of an allocation; five Directors, representing 40 percent of the voting power, are opposed to or have not yet been convinced of the need for a new allocation.

Still, the discussion has moved beyond the repetition of traditional views and has, as I see it, provided some--albeit insufficient--give and take among Directors and has covered new ground, which I believe is extremely important that the membership should now pursue.

In the following paragraphs I shall summarize the highlights of the discussion.

1. The long-term global need to supplement existing reserves is very difficult, perhaps even impossible, to assess in precise and indisputable quantitative terms. Several Directors indicated that the fluctuations in the ratio of non-gold reserves to imports or trade imbalances, as described in the staff paper, did not show clear evidence of a long-term global need that would be sufficient to justify an allocation. In their view, moreover, the sharp deterioration in the ratio of reserves to external debt was perhaps more a manifestation of excessive borrowing in the past and of deficient economic management or adjustment policies than a sign of an increased global need for reserves.

2. The discussion also focused on some aspects of the general economic and financial background against which the assessment of the global reserve need should be made in present circumstances. The question at hand was not only one of determining the size of a given ratio that would make a convincing case for an allocation; it was also a matter of relating the ratio analysis to the general economic and financial environment in which a decision could be taken. In that regard, several points stressed during the discussion were deserving of further consideration.

a. The first was the very magnitude and abruptness of the shrinking of capital markets in recent years. It was clear that, until 1982, capital markets had been the major source of the meeting of reserve needs.

b. The second point concerned the present intensity of restrictions on imports that are part of the drastic adjustment process currently under way in large segments of the world. This is not, in the view of a number of Directors, solely an immediate problem, but it is one aspect of the balance of payments readjustments over the medium to longer term that the international community has to face.

c. Finally, it was clear that significant progress had been made in the fight against inflation in a number of industrial countries. In the view of a large number of Directors, that progress had reduced the concern of some--expressed in earlier Board discussions and in the Interim Committee--that an allocation of SDRs in an environment of inflation would be a wrong signal. It was also fair to say, however, that several Directors continued to underline both the gravity of inflation in a number of countries, particularly in developing countries that had not yet mastered the adjustment process, and the fragility of the gains that had been realized on the inflation front in the industrial countries.

3. The data in Table 2 of the supplement to SM/83/266 made it clear that a great many Fund members suffered from a shortfall in their reserves; and most Fund programs were precisely directed toward helping countries to rebuild reserves to an adequate level. The fact that a shortfall in reserves was not a problem suffered by each and every Fund member did not, in the view of most of those who spoke, serve as an argument against the global need to supplement existing reserves. Other Directors, however, had qualms about accepting that logic. Some of them felt that an SDR allocation, because of its link to quotas, was a universal and systemic way of providing liquidity to the system. And it was precisely that universality that made an allocation of SDRs a somewhat inappropriate solution to the reserve shortfall problem, which was being experienced by only a segment of the international community, because there was a risk of creating more liquidity than was needed to deal with the limited group. The result could be liquidity and inflationary dangers for the entire system and might affect the future credibility of the SDR itself.

4. The impact of a possible SDR allocation on the "adjustment behavior" of member countries was one of the most important points raised in the discussion and had implications for the decision-making process on the issue of allocations. A number of Directors were worried that an increase in the SDR allocation outstanding could lead to a weakening of the adjustment process. In response to that argument, the following points were made. First,

some 45 countries were presently under working Fund programs, which was evidence that the balance between unconditional and conditional liquidity provided in the system had changed markedly in the past two or three years in favor of the latter. Moreover, the very large external financial packages that were more and more frequently being organized by commercial banks and official lending institutions, either bilateral or multilateral, were de facto being linked to the disbursement of the Fund's conditional reserves. One could say, therefore, that the conditionality of international financing and of reserves generated by the system had dramatically increased in the recent past. Those who held the view that an SDR allocation could have pervasive negative effects on the adjustment process should perhaps give consideration to the developments that I have just described. Mr. Polak made an extremely important contribution to this and related aspects of the subject.

Also touched upon in the discussion were the possible adjustment behavior effects of an SDR allocation, including comments on what use might be made of the SDRs in the event of a new allocation. It was argued by several Directors that the adjustment behavior effects would be more consistent with the Fund's objective of improving the balance of payments positions of member countries if the allocation were to be moderate and if the SDRs allocated were clearly directed toward increasing reserves rather than being mobilized.

5. On the systemic aspects of an SDR allocation, there were few new arguments in the discussion. There was some concern about the share of SDRs in total reserves, and it was fair to say that those Directors who attached great importance to that element had not convinced those who preferred to concentrate their analysis on the global aspect of the reserve creation mechanisms and did not consider that the composition of reserves was the criterion that should govern an allocation decision. Similarly, that argument was not convincing to those who felt that there was a need for an international reserve creation mechanism to be activated by the Fund to respond to a "desirable international pattern," and that the system should not rely solely on the hazard of monetary policies, which were possibly inconsistent.

I would urge Directors to return to the subject of allocations in the light of what has been discussed today, possibly on the basis of some further staff material, with a view to facilitating progress toward a consensus on the matter, which, as all who have participated in today's discussion have said, should be in strict conformity with the Articles of Agreement.

Mr. Polak said that it might be useful for the next discussion if the staff were to prepare a paper containing a selective list of analyses--including some relevant or interesting passages--that had been written over the years on the effect of SDR allocations. It might also be helpful if the staff could produce a paper, based on recent stand-by arrangements, showing what had been agreed on increasing reserves in member countries.

Mr. Malhotra wondered how the issue of SDR allocations would be handled in the forthcoming Interim Committee meeting. In the past, the Managing Director had made relatively short statements to the effect that the broad support needed for an allocation had not materialized. It might be useful to promote some debate on the issue at the political level in the Interim Committee meeting on the basis of papers that could, in advance, be made available to Ministers.

The Chairman remarked that Executive Directors would of course continue their discussions on the matter of a possible SDR allocation after Directors had had an opportunity to digest the arguments put forward in the most recent discussion and after the two additional papers requested by Mr. Polak had been circulated. If a spring meeting of the Interim Committee were to be held, it would more likely be in April than in May, which meant that a further Executive Board discussion would have to be scheduled for the first part of March.

The Economic Counsellor and the Associate Director of the Exchange and Trade Relations Department indicated that the two papers could be circulated in about mid-February, which would permit an early March discussion if Executive Directors were willing to waive the "four-week rule."

The Executive Directors then concluded for the time being their discussion on considerations pertaining to an allocation of SDRs, agreeing to aim for a further discussion in early March.

2. ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, 1984 - PART ONE - OUTLINE

The Executive Directors considered a proposed Outline for Part One of the Annual Report on Exchange Arrangements and Exchange Restrictions (EBD/83/337, 12/28/83).

Mr. Erb considered that the 1984 Report would be particularly difficult to produce. His impression was that there had been an intensification during the year of multiple exchange rate practices and exchange rate restrictions; and the staff would need to make an extraordinary effort to ensure a complete and comprehensive picture of the restrictions and practices of each country.

The Executive Directors, without further comment, approved the following decision:

> The Executive Board agrees that the structure of the 1984 Annual Report on Exchange Arrangements and Exchange Restrictions shall be along the lines set forth in the attachment to EBD/83/337 (12/28/83).
>
> Adopted January 25, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/14 (1/25/84) and EBM/84/15 (1/25/84).

3. COLOMBIA - INQUIRY UNDER ARTICLE VIII, SECTION 2(b)

> The Director of the Legal Department is authorized to transmit the letter contained as Attachment B to EBD/84/15.
>
> Decision No. 7612-(84/15), adopted
> January 25, 1984

4. BOLIVIA - INQUIRY UNDER ARTICLE VIII, SECTION 2(b)

> The Director of the Legal Department is authorized to transmit the letter contained as Attachment C to EBD/84/16.
>
> Decision No. 7613-(84/15), adopted
> January 25, 1984

APPROVED: July 11, 1984

JOSEPH W. LANG, JR.
Acting Secretary