

**FOR
AGENDA**

SM/83/187
Supplement 1

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INFORMATION

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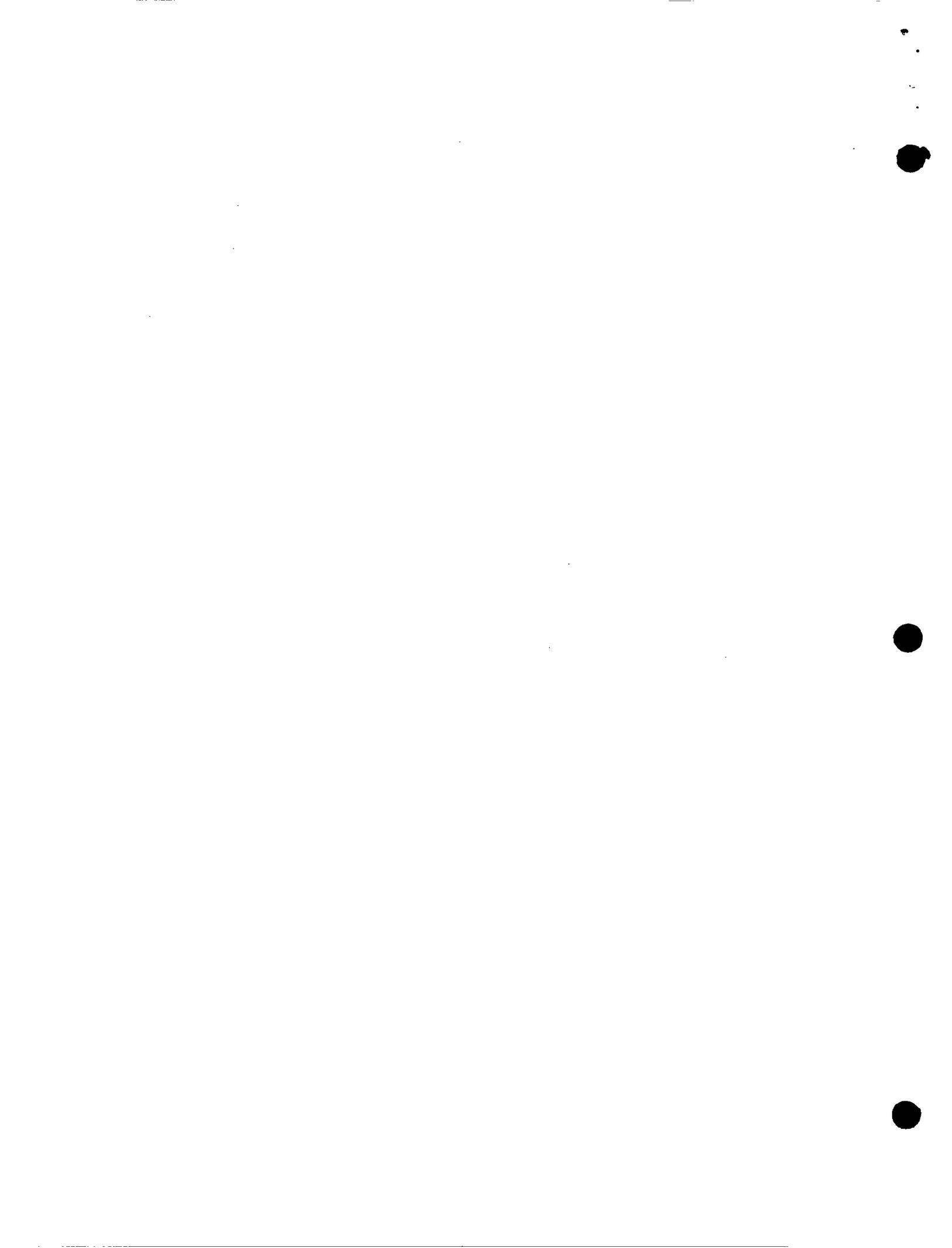
To: Members of the Executive Board
From: The Secretary
Subject: Simplification of Operations in SDRs - Further Discussion

There is attached for consideration by the Executive Directors a supplementary paper on the simplification of operations in SDRs. A draft decision appears on pages 8 and 9.

It is proposed to bring this subject to the agenda for discussion on Friday, February 10, 1984.

Att: (1)

Other Distribution:
Department Heads



INTERNATIONAL MONETARY FUND

Simplification of Operations in SDRs:
Further Discussion

Prepared by the Treasurer's Department and the Legal Department

Approved by Walter O. Habermeier and George P. Nicoletopoulos

January 12, 1984

I. Introduction

A large number of Executive Directors favored the proposals of the staff during the Executive Board discussion of "Simplification of Operations in SDRs", EBM/83/151 of October 31, 1983, but some Executive Directors expressed reservations on certain aspects of the proposals. In particular, the staff was asked to provide more information and analysis on the likelihood and consequences of the development of a two-tier market in SDRs if the obligatory use of official exchange rates is eliminated for certain uses of SDRs in operations, and the possible repercussions of this on the designation mechanism. Some Executive Directors also expressed misgivings about uncertainties and the possibility of abuses that might result from moving from a restricted list of permissible operations to a general prescription of operations, defined as transfers that are not transactions.

This supplement reviews these issues and enlarges upon the view that the proposals of SM/83/187 would not jeopardize the effective functioning of the SDR Department. When compared with the potential advantages over the longer term of judicious measures to simplify and develop operational uses of the SDR, these risks, in the view of the staff, are very small. The greater risk to the SDR system as a whole would seem to lie in a perception of users that the usability of their SDRs will continue to be tightly constrained by restrictions and cumbersome procedural requirements for the indefinite future. Even under the simplified arrangements proposed in SM/83/187, the Fund would retain substantial control over operations in SDRs, and could move quickly to counter any adverse development before it could impair the effective functioning of the system. This supplement draws attention to the powers of the Fund in this regard, and proposes a further protective safeguard.

II. The Use of Agreed Exchange Rates

The revised rules proposed in SM/83/187 would authorize participants 1/ to engage in operations on such terms and conditions as may be agreed between the parties, i.e., insofar as the official exchange rates were relevant, their use would no longer be obligatory. It is mainly the abolition of the obligatory use of official rates that would make possible the substantial simplification of the seven existing decisions prescribing operations in SDRs. 2/

The abolition of the obligatory use of official rates for operations would significantly widen the possibility of transacting SDRs at non-official exchange rates, from the possibilities which exist at present. But it will be recalled that all "transactions", i.e., spot exchanges against currency, and all SDR transfers to and from the Fund, would take place at the official rates, but SDR operations might, if the parties involved agreed, take place at exchange rates which could differ from the official rates.

There are two situations which might motivate the use of agreed exchange rates that differed from the Fund's official rates. The first is when the Fund's rates have become stale, that is, when changes in market conditions during the course of the day have caused prevailing rates to differ significantly from the earlier ones used by the Fund to establish its official rates. Official SDR rates are established only once during the day. In this situation the agreement on an SDR exchange rate in one type of dealing on the basis of prevailing exchange rates would not directly conflict with the continued use of official rates for other types of dealings. Indeed, it would better achieve the principle of equal value than would the use of the Fund's official rates and is not likely to be considered undesirable.

In the other situation, where SDRs might be valued by potential recipients either more or less than would result from the use of prevailing exchange rates as well as the Fund's official rates, and users

1/ By virtue of proposed Rule Q-2, all references to participants should be read as referring to prescribed holders also, except when the reference is to parties in a transaction with designation.

2/ If official rates were required only insofar as applicable, it would still be necessary to classify, and therefore define in appropriate legal ways, the nature of the transfers to which they would be applicable and those to which they would not be applicable, and information on the amounts and denominations of whatever amounts are relevant would need to be provided by participants with the payment instructions so that the Fund could verify that the requirements have been observed. Little simplification would be achieved as this approach would require the retention of most of the current information requirements before the operation could be registered.

were either prepared to take advantage of the resulting premium or unable to use their SDRs at anything other than the discount currently offered, the emergence of a premium or discount would be a move away from equal value.

In the staff's view, the occasional agreement among participants to deal in this way at a discount or premium cannot reasonably be regarded as having adverse consequences for the SDR scheme in general or for designation in particular. Any such risk is compensated for, by far, by the advantage of reducing present obstacles to the SDR's development. Nor would such occasional departures from official rates constitute or have the characteristics of a two-tier market, particularly since they could apply only to a certain type of dealings which do not include spot exchanges which are the normal basis for an exchange market, and could well be accounted for by special circumstances of the parties or the particular nature of the operation, without having any necessary implications for the value of the SDR per se. To the extent they improve the liquidity of the asset they can be regarded, in the view of the staff, as potentially beneficial. However, persistent and large discounts or premiums could potentially create strains for designation and for the use of official rates in transfers to and from the Fund. The staff's view has been that persistent and large discounts or premiums on uses of SDRs in operations are very unlikely to occur or prevail. This view is reexamined in the succeeding subsections.

(i) The SDR at a discount and its implications for the designation process

Potential recipients might presumably be willing to accept SDRs at a discount in preference to accepting them at par using official rates. Users of SDRs might presumably be prepared to use them at a discount if they did not have adequate access to avenues through which to use their SDRs at official rates, and if they either had insufficient reserve assets that could be used at par in lieu of discounted SDRs or considered the discounted value of the SDR as an appropriate measure of its worth to them in their foreign exchange portfolio. This class of potential users would clearly exclude countries with a balance of payments need to use reserves because they can always use SDRs in designation at official rates. Even countries not currently experiencing balance of payments difficulties, but having SDR denominated obligations to the Fund, are always able to use their SDRs at par with official value in discharging those obligations. Holders who might potentially use SDRs at a discount would, therefore, be limited to prescribed holders (who have no access to designation) and participants in reasonably strong balance of payments positions (who have little or no SDR obligations to discharge).

One could imagine a participant with a strong balance of payments reaching an agreement with another participant with a weak balance of payments whereby the latter would accept SDRs from the former at a discount and resell them with designation at par. To some extent, this

would simply set up a circular flow of SDRs with strong participants selling at a discount and reacquiring SDRs at par through the designation mechanism. However, some redistribution of SDRs would generally occur among the participants included in the designation plan, i.e., not all of the SDRs originally sold below par would necessarily return to the selling participant. Thus, some participants might conceivably try to lower their own holdings by disposing of SDRs at a discount on the assumption that they would not be designated or designated to the same extent to take them all back at par.

Use in designation of any significant amount of SDRs acquired in this way would undoubtedly have an adverse impact on the effective functioning of the SDR Department, as countries cannot reasonably be expected to acquire at par in designation, with freely usable currency, an asset that is changing hands widely at a discount. However, several factors make the use of SDRs in this way highly unlikely. Participants in a stronger balance of payments and reserve position are not as likely to be under pressure to use SDRs as those in weaker positions and they are, therefore, less likely to agree to use them at a discount. Further, the ability to dispose of SDRs at a discount would be limited to operations and would not be available for transactions, i.e., spot exchanges against currencies. However, four considerations stand above the others as reassurance that this type of use of SDRs is not likely.

The first two considerations are that holders are free under the existing prescription to sell SDRs forward, i.e., for value four days or more in the future, at freely negotiated or agreed exchange rates, or to give them away. To date, these particular prescriptions have not been used. This would seem to indicate that there is no inclination to use exchange rates other than the Fund's official rates. 1/

The third consideration is that the SDR's interest rate, as currently established, is set equal to a market-related weighted average of interest rates and since 1983 follows movements in that weighted average very closely. Hence, it is difficult to see why holders in general would be influenced by yield considerations to part with their SDRs at anything other than at par or very nearly at par with official rates.

Fourth, there are considerable possibilities for participants who are not experiencing balance of payments difficulties and prescribed holders to sell SDRs at par in transactions to countries needing them. A considerable volume of such voluntary dealings have in fact occurred either in the form of transactions arranged directly by the holders concerned, or through standing arrangements whereby the Fund staff will arrange the sale of SDRs to other holders that wish to acquire them from those that stand ready to sell them. These sales are, of course,

1/ All the operations that have occurred so far have been loans or settlement of financial obligations.

transactions and occur at the official rates. As long as reasonable opportunities for selling SDRs at full value in this way continue to exist - and there is no reason to expect that the present position will change in the foreseeable future - it is difficult to see why a holder should prefer to use SDRs in operations at less than their official value. 1/

(ii) The SDR at a premium

Holders might presumably be willing to use some of their SDRs at a premium, but recipients would only be prepared to pay a premium if they could not obtain SDRs at par and valued them in their portfolio more highly than indicated by the Fund's official rates. At this point in the SDR's development, the predominant source of obligations which must be paid with SDRs are those to the Fund (charges and sometimes quota payments). The Fund itself has substantial holdings of SDRs in the General Resources Account which it is empowered to sell only at par to participants. As a result, it is extremely doubtful that a participant would be forced to pay a premium in order to acquire SDRs needed for settling obligations payable in SDRs. This severely limits the potential demand for SDRs at a price above the official price. If the SDR was being transferred in operations at above its face value, recourse to the designation process would be lessened or eliminated; there would be no obvious detriment to the designation process in such a case.

(iii) Conclusion

It is concluded that the more extensive freedom now proposed for participants and prescribed holders to agree on exchange rates of their choice in the relevant operations is very unlikely to have a material adverse effect on the functioning of the SDR system, or to result in widespread or significant discounts or premiums. The Fund could take steps of a general and specific kind to assist the smooth functioning of the SDR mechanism in the event that discounts or premiums from the official IMF rates were, unexpectedly, to become significant and widespread, i.e., by varying the number of SDRs in circulation outside the General Resources Account and by varying the proportion of SDRs and currencies transferred in the operational budget, or by adjusting the interest rate on the SDR.

Should a situation threaten to arise in which SDRs were persistently changing hands in voluntary dealings at rates significantly different from the official ones, this would, in itself, be an important signal indicating an imbalance requiring corrective measures by the Fund. However, in principle, the most appropriate method of maintaining the

1/ Sales of SDRs in transactions by agreement averaged about SDR 1.8 billion in 1982 and 1983. Transfers from participants to the Fund in repurchases and charges averaged about SDR 2.1 billion per annum over the same two years.

valuation of SDRs at or very close to par is to ensure that the characteristics of the SDR, as well as the volume of SDRs outstanding, justify this valuation in the eyes of most of the holders. This is also the method that seems most compatible with the long-term development of the SDR as a reserve asset. In addition, the Fund, as explained in Section IV (1) below has a number of other legal and administrative instruments to safeguard the proper use of the proposed new and simplified prescription, and to counter adverse developments as and when they arise.

III. Other Implications and Effects of Proposed Simplification

Some Executive Directors also questioned whether the proposed move from a restricted list of permissible types of operations to a general prescription on operations might jeopardize other uses of SDRs--i.e., transactions by agreement, transactions with designation, or SDR dealings with the Fund--or have other adverse consequences for the effective functioning of the SDR system. In the staff's view, there is no need for any serious concern in this regard, for a number of reasons:

a. The existing prescriptions already permit a broad range of operations. SDRs may be loaned, swapped, sold forward, used for settlement of financial obligations or as collateral for such obligations, or given away. These will, of necessity, continue to be the primary operational uses of SDRs, since they cover nearly all customary dealings in monetary assets other than spot exchanges. The effect of removing the existing limitations will simply be to allow holders broader flexibility to engage in other less common types of contractual dealings, if they so wish. Most, if not all, of these dealings are likely to be closely related to or to combine different elements of the dealings now permitted by the Fund. The main consequences of a general prescription thus would be to reduce cumbersome and time consuming administrative procedures.

b. The only entities that may hold or use SDRs, other than the Fund itself, are members that are participants in the SDR Department and certain other official institutions prescribed by the Fund. Quite apart from any rule and requirements prescribed by the Fund, the use which each holder may make of its monetary assets, including its SDRs, is controlled by its applicable laws and constituent instruments and by established standards governing dealings in public funds. Any arrangement that two holders may make for the operational transfer of SDRs must necessarily conform to the laws and standards applicable to each party. Since operations are voluntary, it must also be one which each party considers to be consistent with its interests. It is difficult to envisage any type of operational dealings meeting these criteria in which holders are likely to engage but which, in itself, would be an improper use of SDRs or be detrimental to the system.

IV. General Safeguards and Period of Application of New Rules

1. General safeguards

Aside from the considerations examined in Section II and III above, each participant has accepted an undertaking under Article XXII of the Fund Articles to collaborate with the Fund and other participants in order to facilitate the effective functioning of the SDR Department and the proper use of SDRs in accordance with the Articles. A similar undertaking has been given to the Fund by each prescribed holder when requesting a prescription. This formal obligation stands behind the the Rules of the Fund relating to dealings in SDRs, and in exercising their powers to enter into dealings pursuant to the Rules, holders must avoid actions which are inconsistent with their undertaking. It is not to be expected that two holders would agree to an operation in SDRs, without prior reference to the Fund, if they had grounds for thinking that it was not consistent with the undertaking.

For these reasons, the staff does not consider that the broader prescription of operations now proposed presents any serious risks for the system or is likely to involve significant risk that SDRs will be used in a manner that would be judged as undesirable and detrimental to the smooth functioning of the SDRs. At most, the risk is that an occasional operational transfer may take place in circumstances which might seem to the Fund to be questionable or which presents unexpected issues. Isolated occurrences of this nature could not have a material adverse effect on the SDR system itself, and the risk of their occurrence does not seem to justify the maintenance of the present system of advance screening of each individual transfer.

In practice, the Fund would continue to retain a meaningful and sufficient control over operational uses as they develop. First, under the new Rule P-10 the Fund intends to establish a system of periodic reports from participants giving details of their operations on an ex post facto basis. It would also have the right at any time to call for additional information about any particular operation, and it would be intended to exercise this right if further inquiry into the nature and circumstances of the operation seemed necessary. Second, the Fund is expressly empowered by Article XIX, Section 2(d) to make representations to participants entering into operations that the Fund considers prejudicial to the process of designation or otherwise inconsistent with the broad undertaking under Article XXII referred to above, and may impose sanctions on participants that persist in entering into such operations. It can follow a comparable procedure in the case of prescribed holders; in fact, the Fund has the right to revoke the prescription if it deems this necessary and appropriate for comparable reasons. 1/ In practice,

1/ Decision No. 6467-(80/71)S, April 14, 1980, Paragraph 9(a), which appears in "Selected Decisions of the International Monetary Fund", Tenth Issue, p. 273.

if the Fund concluded that a particular use which had occurred was undesirable, it should normally be sufficient to draw this to the attention of the two holders concerned, and of all other holders if this seemed appropriate, without need for formal representations, in order to prevent a recurrence. Finally, it remains open to the Fund at any time to amend its Rules on operations to prevent a particular type of operation from occurring at all, if this seems necessary in the light of actual experience.

2. Limiting the period of application of new rules

The changes in the P-Rules proposed in SM/83/187 would substantially simplify the requirements for undertaking operations in SDRs, primarily by dropping the obligatory use of the Fund's official exchange rates for operational dealings in SDRs among participants and prescribed holders. This may increase the risk that holders engage in operations at rates which differ materially from the official rates of the Fund, or which could in other respects, have undesirable implications for the SDR system.

However, for the reasons explained in this paper, the view of the staff is that this risk is not likely to be serious, that adverse implications as of such risk are substantially outweighed by the potential benefits to the system of a greater flexibility in SDR dealings, and that the Fund will retain sufficient control to counter any adverse developments if and when they should arise.

Nonetheless, in order to meet any remaining concerns of some Executive Directors who may judge the risk to the SDR scheme to be greater than does the staff, the Executive Board might wish to adopt the new Rules proposed in SM/83/187 for the trial period of, say, three years. This would put all holders of SDRs on special notice that care and cooperation would need to be exercised in the operational uses of SDRs pursuant to these Rules, if the prescription is to be renewed. It would also mean that a substantial majority of the Executive Directors would need to be satisfied at the end of the period that the prescription has not been misused, since a 70 percent majority of the total voting power would be required to renew the prescription.

V. Recommendation

In the light of the foregoing, it is proposed to adopt the decision set forth in SM/83/187, amended in line with Section IV (2) above, as follows:

1. Executive Board Decisions No. 6000-(79/1)S, 6001-(79/1)S, 6053-(79/34)S, 6054-(79/34)S, 6336-(79/178)S, 6337-(79/178)S and 6437-(80/37)S, as amended to the date of this Decision are hereby rescinded.

2. Rules P-6, P-7, P-8, and P-9 of the Rules and Regulations of the Fund are replaced by the Rules set forth in the Attachment, which are adopted as Rules P-6 through P-13.
3. The following additional Rule is hereby adopted as Rule Q-2:
Q-2. To the extent that the terms and conditions referred to Rule Q-1 permit prescribed holders to enter into transactions by agreement or operations in the same manner and on the same terms as participants, references to participants in the Rules relating to such transactions and operations shall be deemed to refer also to prescribed holders.
4. The new Rules relating to prescribed operations in SDRs shall apply for an initial period of three years from the date of this Decision. Prior to the end of that period, the Executive Board will review the scope of the prescription contained in the Rules and determine whether to renew the prescription, with or without amendments; provided that any change will be without prejudice to operations already being implemented at the time the change is adopted.

Proposed Revisions to P-Rules

Transactions by Agreement

P-6. For purposes of these Rules, a transaction by agreement under Article XIX, Section 2(b) is a use of SDRs in which, by agreement between two participants, SDRs are exchanged for currency at rates in terms of the SDR determined at any time during the period commencing three business days before the intended value date of the exchange. As used in this definition, the term currency includes other monetary assets.

P-7. (a) Currency shall be provided in a transaction by agreement at the SDR rate for that currency determined under Rule O-2 for the third business day preceding the value date of the transaction, or for a later day up to and including the value date itself if so agreed between the parties to the transaction.

(b) No participant shall levy any charge or commission in respect of a transaction by agreement.

Prescribed Operations

P-8. (a) For purposes of these Rules, an operation in SDRs under Article XIX, Section 2(c) is a dealing, other than a transaction with designation or a transaction by agreement, in which one participant in agreement with another arranges to transfer SDRs to the other participant.

(b) Participants are authorized to engage in any operation in SDRs as defined in (a) on such terms and conditions as may be agreed between the parties, other than operations in SDRs involving gold.

P-9. A participant that has arranged to transfer SDRs in an operation shall, not later than the date it wishes the transfer to be effected, give the Fund notice of the amount of SDRs to be transferred, the name of the recipient and the intended date of the transfer, and shall declare that the transfer is pursuant to an operation authorized by the Rules on Operations. The notice shall constitute an instruction to the Fund to record the transfer on the date specified in the notice, provided that this instruction may be given subject to later confirmation.

P-10. The Fund may call for periodic reports from participants giving details of their operations in SDRs. Each party to an operation shall provide such additional information relating thereto as the Fund may at any time request, provided that the recording of an operation shall not be subject to the receipt of such information.

P-11. To facilitate the carrying out of operations in which the transfer of SDRs is to occur at some future date or is contingent on some future event, the Fund may establish procedures under which, at the request of the parties to the operation, the SDRs are set aside in the books of the SDR Department and the holder's freedom to use them for other purposes is restricted pending completion of the operation.

Recording

P-12. A participant using SDRs in a transaction shall inform the Fund immediately of the receipt of currency under the transaction.

- P-13. (a) Subject to any special procedures applicable to the SDRs pursuant to Rule P-11, the Fund shall give effect to a transfer of SDRs pursuant to a transaction or operation by recording the transfer in the books of the SDR Department, provided that the Fund is satisfied that the transaction or operation complies with the applicable requirements of these Rules. In satisfying itself of such compliance the Fund shall be entitled to rely on the notices and declarations provided by the user.
- (b) A transfer pursuant to a transaction shall be recorded as of the date on which currency is provided in accordance with these Rules. A transfer pursuant to an operation shall be recorded as of the date specified in the notice given pursuant to Rule P-9, upon receipt of any confirmation to which the notice is subject.

