

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/151

10:00 a.m., October 31, 1983

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

Executive Directors

Alternate Executive Directors

A. Alfidja

G. Ercel, Temporary
X. Blandin
J. Delgadillo, Temporary

R. D. Erb

T. Alhaimus
T. Yamashita
Jaafar A.
L. Leonard
C. Robalino

T. Hirao

J. E. Ismael

G. Laske

C. P. Caranicas
A. S. Jayawardena
J. E. Suraisry
T. de Vries

J. J. Polak

A. R. G. Prowse

O. Kabbaj
E. I. M. Mtei
J. L. Feito
A. Lindø
T. A. Clark
Wang E.

N. Wicks

Zhang Z.

L. Van Houtven, Secretary
J. A. Kay, Assistant

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Also Present

African Department: F. d'A. Collings. External Relations Department: H. P. Puentes. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; G. F. Rea, Deputy General Counsel; W. E. Holder, Ph. Lachman, A. O. Liuksila, S. A. Silard. Middle Eastern Department: F. Drees. Research Department: R. R. Rhomberg, Deputy Director. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; W. J. Byrne, W. L. Coats, Jr., D. Gupta, M. A. Tareen, T. M. Tran. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, C. J. Batliwalla, H.-S. Lee, W. Moerke, Y. Okubo, I. R. Panday. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, H. Arias, R. Bernardo, M. B. Chatah, G. Gomel, V. Govindarajan, N. U. Haque, M. Hull, J. M. Jones, A. K. Juusela, H. Kobayashi, P. Leehtam, G. W. K. Pickering, E. Portas, A. A. Scholten.

1. SDRs - SIMPLIFICATION OF OPERATIONS, AND PROCEDURES FOR
"SETTING ASIDE"

The Executive Directors considered a memorandum on the simplification of operations in SDRs prepared by the staff (SM/83/187, 8/15/83; and Cor. 1, 10/28/83), together with a memorandum establishing special procedures for security operations in SDRs (SM/83/188, 8/16/83).

The Chairman explained that SM/83/187 built on the Executive Board's discussion on June 7, 1982 of the staff paper on possible further improvements in the existing SDR (SM/82/92, 5/7/82; and Cor. 1, 5/28/82), in order to propose a further broadening and simplification of the authority to use SDRs in operations. It also proposed that the application of the equal value requirement to operations should be eliminated, and that the existing reporting requirement should be reduced. SM/83/188, dealing with the establishment of procedures to set aside SDRs to secure the performance of obligations, examined a further way to improve the existing SDR and proposed the establishment of special subaccounts. He proposed that Executive Directors should consider the two papers together.

The Deputy General Counsel noted that the purpose of SM/83/187, Correction 1, circulated three days previously, was to make clear that in a transaction by agreement the day on which the exchange rate was determined could be any one of the days within the period commencing three business days before the value date of the transaction. The period would include the value date itself.

Mr. Wicks recalled that when the SDR had been created there had been expectations that it might in due time become a central monetary asset of the international monetary system. The development of the multicurrency reserve system in the past few years had put an end to such ambitions. In the circumstances, there were those who felt that it might not be unreasonable to let the SDR decline into obscurity before giving it a decent burial. He would not accept that view. The history of the international monetary system showed that its development was extremely uncertain and that there could be circumstances, not easily foreseeable, in which the SDR might have a renewed role to play. Meanwhile, it seemed sensible to take whatever steps were possible to simplify operations in SDRs in order to facilitate its greater official use.

He did not regard the proposals in the two papers before the Executive Board as making changes in the basic use of or arrangements for SDRs; he regarded them as simple steps forward in clarifying operations in the asset, Mr. Wicks said. He fully supported all the staff proposals and the two proposed decisions. The reduction in the number of requirements attached to SDR operations, and the consolidation of the remainder into a comprehensive code, represented a further useful technical improvement. Nor did he have any difficulties with the proposed changes in the so-called setting-aside procedure. Although the staff proposals would not of themselves necessarily lead to an increase in operations in SDRs,

they would at least have cleared the way for a greater use of the asset. His authorities hoped that, as transfers of SDRs among participants and other holders became easier, the wider use of SDR-denominated transactions might also be encouraged.

While the proposals were neither wide ranging nor fundamental, Mr. Wicks went on, the staff was right to propose building in certain safeguards. He agreed that the Fund should retain the right to seek additional details, both about specific operations and on a consolidated basis. The right was necessary, first, to enable the Fund to assess the functioning of the SDR system and, second, to prevent the proliferation of any type of operation that might be identified as undesirable. He also agreed that the Executive Board should continue to review SDR operations annually; if there was an unexpected increase in activity, or a different sort of activity made its appearance, the review should be particularly thorough. Between reviews, the staff could always bring notable developments to the attention of the Executive Board.

Regarding the proposed elimination of the equal value requirement for future operations in SDRs, Mr. Wicks said that he understood that the staff was concerned only with operations. Transactions connected with purchases would of course continue to be subject to the so-called official rate. His authorities had considered the proposal with great care, and they fully supported the idea of giving greater freedom to participants, by no longer requiring them to use the official rate in operations. His authorities realized that, in theory at least, it would be possible for SDRs to change hands at a price higher or lower than the official value established by the Fund, an outcome that might be detrimental to the effective functioning of the SDR system, and in particular to the designation process. However he did not anticipate the widespread appearance of discounts and premiums. If they did appear, he expected that the difference from the official price would be small. He saw no reason to suppress any divergences that might appear. The best approach would be to do everything possible to make the yield on the SDR comparable to that on similar assets, including maintaining a competitive interest rate.

Turning to other future work on the SDR, Mr. Wicks explained that his silence on the subject of SDRs at EBM/83/150 (10/24/83), when Executive Directors had been discussing the work program, did not mean that he was uninterested in the future of the SDR. On the contrary, his authorities continued to support progress toward increasing the attractiveness of the SDR and promoting its use, as well as that of SDR-denominated assets, as strongly as ever. Although the proposals for the Executive Board seemed to complete the package of specific measures agreed upon by Executive Directors in 1982, he hoped that work on improving the SDR would continue.

While he had some sympathy for the view that it would be harmful to the SDR to introduce minor changes in its characteristics very frequently, Mr. Wicks observed, he supported the elimination of any unnecessary complexity in the way that the Fund conducted its business, and hence the

adoption of worthwhile improvements in the SDR on a step-by-step basis. The staff should therefore continue work on improving the SDR, and the Executive Board should be involved in that work. If further significant improvements in the SDR were identified, they should be brought to the Executive Board for consideration in a timely fashion. Meanwhile, he looked forward to the opportunity of seeing the results of the staff's continuing analysis of the SDR in the fields mentioned in the work program--meaning, not only the work on the level of the SDR interest rate and the composition of the interest rate basket, but also that on the possibilities of a Fund clearing facility and a wider scope for transactions in SDRs.

Mr. Ismael welcomed the staff proposal to simplify operations in SDRs, a move that was long overdue. The current practice was cumbersome and complex, as could be seen from the limited number of dealings involving SDRs. Every effort should be made to eliminate the characteristics that made the SDR less attractive than other reserve assets, while striving for simplicity and efficiency so that the SDR should truly become the principal reserve asset of the international monetary system. It was a step in the right direction to reduce the procedures in dealing with SDRs to the fewest possible; the objective should be to make dealings in SDRs similar to the transfer of currency in a banking system. In that connection, it seemed superfluous to him to require that a party to an operation in SDRs should declare that "the use of SDRs is pursuant to an operation authorized by the relevant rules." He wished to know what the consequence would be of not making such a declaration. If the cost to the Fund were minor, he would prefer to do without it.

For the same purpose of simplification, Mr. Ismael went on, he would support the relaxation of the equal value principle. However, he was not yet fully convinced that such a relaxation would approximately preserve the value of the SDR. It seemed likely that the SDR would sell at a discount in comparison with alternative reserve assets because the Fund's rules hindered its widespread use in international financial dealings. Similarly, the freedom of the General Resources Account to buy and sell was comparatively limited, and there might well be circumstances in which the Account would be powerless to defend the value of the SDR without appealing to members for cooperation, contrary to their better judgment and market sentiments. On the need to distinguish between transactions and operations, he saw no material differences between the two. Such a distinction had become artificial and arbitrary. Executive Directors should eliminate it as rapidly as possible, except perhaps for dealings involving gold. Finally, he would support the proposal to establish subaccounts in SDRs to secure the performance of obligations.

Mr. Polak stated that he shared the views of Mr. Wicks. He, too, would be interested in the future work on the improvement of the SDR that the staff had promised, including papers on a clearing account and a trustee account, which would permit the passage of SDRs from official to private hands. Meanwhile, Executive Directors should dispose of the

comparatively minor issues raised in SM/83/187 and SM/83/188. While the points raised by the staff might be minor, the SDR was the Fund's business, and it was appropriate for the Executive Board to spend the time needed to simplify operations in SDRs.

The two main proposals in SM/83/187--namely, to allow members to use SDRs in any operations without prescribing the use of the official rate of exchange for the SDR (for which in any event it generally did not apply), and the consequential cutting down on information--were entirely sensible, Mr. Polak said. On the question discussed in Chapter III of the mandatory use of the official rate of exchange for the SDR in transactions, meaning the exchange of SDRs for monetary assets, he did not agree with the staff regarding the elimination of the equal value principle. After lengthy analysis, with most of which he agreed, the staff had concluded, at the bottom of page 7 of SM/83/187, that a more extensive *freedom for participants and prescribed holders to agree on exchange rates of their choice* was unlikely to have a material adverse effect on the functioning of the SDR system. He would replace that conclusion by the opposite, which seemed to be just as well proved. To do so he would write: "For these reasons, it is concluded that the continuation of the prescription of official rates for transactions in SDRs was unlikely to have a material adverse effect." Much more discussion of the need for, and the role of, designation in the SDR system would be required before a decision could be taken.

As to the staff proposal for a prohibition against operations involving gold, Mr. Polak suggested that the section be deleted. While he did not believe that the inclusion or exclusion of the provision would make any difference in the real world, the Fund should cease to legislate about gold in the abstract unless there was good reason to do so. He could see no reason why the Fund should object to one country's exchanging SDRs with another for gold. In any event, the Fund would be unable to prevent such operations, if only because they could be divided into two stages, namely, exchanging SDRs for U.S. dollars, and then exchanging U.S. dollars for gold. The first would be a voluntary transaction that the Fund's rules permitted; in the second, the Fund would have no means of interference.

As to the proposals for setting aside SDRs in connection with the performance of obligations (SM/83/199, 9/6/83), Mr. Polak commented that the staff had shown that the Fund was not well equipped to be a guardian of set-aside SDRs. Although members could dispose of all their SDRs, they could not legally set them aside in the Fund because the Fund had to be able to have access to the SDRs if interest had to be paid, charges to be met, or repayments to the Fund fell due. Consequently, the SDRs set aside in the Fund would not make particularly good pledges. The situation was not unduly disappointing; if there was a demand for such a facility--a point that the staff had by no means proved--the Bank for International Settlements, as an other holder, would probably be prepared to set aside any SDRs that were confided to it more effectively than the Fund could. When gold had been the heart of the Fund's operations, the

Fund had never proposed a facility by which it would help members to set aside a certain amount of gold as a guarantee for the discharge of obligations. There seemed no good reason why the Fund should now introduce such a facility for SDRs.

Mr. Laske remarked that his authorities were grateful for the postponement of the discussion, which had been scheduled for September 16, 1983. The delay had enabled them to examine the proposals thoroughly, and they had come to conclusions that differed from those put forward by the three previous speakers.

The staff was proposing possible improvements in the SDR, some of which had been discussed in June 1982, Mr. Laske noted. As to the liberalization of the use of SDRs, his authorities emphasized that they supported the agreed objective of making the SDR the principal reserve asset of the system. In that context, they had found it quite appropriate to look into the possibility of further broadening the use of the asset, but they had instructed him to advocate caution in changing the present practices too rapidly. In view of the present state of the international monetary system, being too progressive might not be advisable. To allow all participants and prescribed holders to engage in SDR operations of any kind by mutual agreement, subject only to the limitations imposed by the Articles, would imply a radical change of present practices, thus entailing substantial uncertainties. His authorities believed that the possibility of SDR operations; the nature and type of which would come to the knowledge of the Fund only after the event, could adversely affect the international monetary system and the financial stability that was so much desired.

It was by no means impossible, as the staff itself had pointed out, Mr. Laske observed, that dealings in SDRs could be contrary to the interests of the Fund and could impair the Fund's control over SDR operations. The staff had argued that in such an event it would be possible for the Fund to change the rules. In the view of his authorities, that would not be a satisfactory solution. It would be more appropriate to forestall potentially undesirable developments rather than to try to correct them at a later stage. Undesired and undesirable operations could create precedents that it would be difficult to erase.

In view of those doubts, Mr. Laske went on, his authorities had not been convinced by the considerations of a more practical nature set out on pages 2 and 3 of SM/83/187. The limitations imposed on the variety of SDR operations available to participants and the complexity of the relevant decisions were in themselves no self-evident cause of the relatively little use that had so far been made of SDRs in voluntary operations. Seven types of operations in SDRs had been permitted by specific Executive Board decisions, but only two of them had so far actually been used. It was difficult to deduce from that circumstance that the limitation of choice inherent in the present procedure stood in the way of a wider use of SDRs, and the staff had not given any evidence in proof of its contention. Moreover, his authorities did not believe that the Articles obliged

the Fund to look actively for ways to bring about additional uses of SDRs, even at the risk of unwelcome side effects on the international monetary system. Needless to say, his authorities were prepared to consider additional specific SDR operations. Writing a blank check, however, did not appear to his authorities to be either appropriate or advisable.

His authorities were not convinced by the argument that maximum simplicity would be achieved if holders were able to transfer SDRs among themselves in the same way as they could transfer currency through the banking system, Mr. Laske stated. In liberalizing SDR operations, Directors should bear in mind not only the rationale for creating SDRs but also the possible detrimental effects of liberalization on the SDR system itself. The staff seemed to recognize the possibility of such effects and therefore proposed a time limit for the setting aside of SDRs, a proposal that seemed to support the view of his authorities that too much liberalization might well provide dangers for the future. Nor did his authorities agree with the staff's reasoning that the present terms on which holders might use their SDRs tended to conflict with the objective of making the SDR the principal reserve asset.

In their view, there was no strong evidence that the use of SDRs among central banks had been frustrated by the limited number of prescribed SDR operations, Mr. Laske went on. Requests by institutions other than the original holders did not necessarily provide guidance on how to shape the SDR system. It was his authorities' strong belief that regulations guaranteeing the responsible use of SDRs would better promote the SDR as a reserve asset than would excessive liberalism. The willingness to engage in SDR operations was most likely to be determined more by factors like the rate of interest paid on SDR holdings and by changes in its value, and less by the scope for different types of operation. The far-reaching liberalization in the use of the SDR proposed by the staff could, in the view of his authorities, create substantial uncertainties and thus lead to significant drawbacks that could be detrimental to the proper functioning of the SDR system and even prove harmful to the participants themselves. Allowing operations in SDRs subject only to the limitations imposed by the Articles would be a risky undertaking. The present practice of limiting the use of SDRs to specifically prescribed types of operation was the most appropriate way of handling the system; it should meet the justified needs of all participants.

The staff had put forward a number of arguments in favor of replacing the equal value principle by freedom for SDR holders to determine the value of SDRs used in voluntary operations, Mr. Laske noted. His authorities had failed to find any benefits in such a change. The fact that the equal value principle did not bring about perfect equality with the Fund's official rates in certain cases did not seem to his authorities to justify the complete elimination of the principle in favor of voluntary SDR operations. Even though interest rates on SDR-denominated loans were freely negotiable and might thus permit the bypassing of the equal value requirement, such a possibility would not be sufficient to encourage his

authorities to abandon the legal requirement for equal value. Nor were they convinced by the argument that the parties to a swap in SDRs were free to apply any rate they wished when determining the rate for the forward part of such an operation. That freedom was a necessary corollary of that particular type of SDR operation, and thus the exception to the rule. It could not be a justification for the suspension of the rule itself.

In considering the elimination of the mandatory use of the Fund's official exchange rate, Mr. Laske observed, two questions would require a clear answer. First, could any detrimental consequences flow from the elimination of the official exchange rate for transactions in which official rates had to be used, namely, designation and transactions by agreement? Second, could the elimination of the official exchange rate have negative effects on the SDR system itself? The staff itself had quite explicitly mentioned the possible difficulties that might arise for the designation process and for the Fund if significant widespread discounts or premiums from the official price were to occur. The staff had tried to demonstrate that more extensive freedom for SDR holders to determine the value of the SDR would not result in significant departures from official values, either upward or downward. The staff arguments had not convinced his authorities.

Even if the staff argument that significant departures from official SDR values were unlikely to occur were accepted, Mr. Laske stated, his authorities had been surprised by the methods suggested for maintaining the value at or close to the official rate, should it be necessary to do so. On pages 7 and 8 of SM/83/178, the staff had proposed not only intervention in SDRs, but nothing less than allocations and cancellations of SDRs as well. He would be quite surprised if allocations and cancellations were not illegal as a means of stabilizing the value of the SDR; the Articles of Agreement clearly stipulated that the sole criterion for allocations and cancellations of SDRs was the global need for reserves.

For practical reasons, Mr. Laske went on, he did not find much merit in the staff proposal to manage the relative attractiveness of the SDR by changing the interest rate. Since such changes required a 70 percent majority, it might not be easy to vary the interest rate as often as necessary. In brief, his authorities' view was that it would be far better to maintain the equal value principle for voluntary operations. He was unable to support the proposed draft decision in its present form both because it included the elimination of the equal value principle, and because it would allow all possible operations without limitation other than those imposed by the Articles themselves.

He had no difficulties of a technical nature with the proposals in SM/83/188, Mr. Laske concluded. However, he had the same kind of worries about the reasoning for the proposals as had been put forward by Mr. Polak.

Mr. Suraisry remarked that his chair had long believed that strengthening the SDR was in the interest of all Fund members. Indeed, the process should be seen as a continuous one on both the demand and the supply sides. On the supply side there was a strong case for resuming SDR allocations as soon as possible. He therefore endorsed the recommendation of the Interim Committee that the discussions on new allocations should be pursued as a matter of priority. On the demand side, much had already been done to make the SDR more attractive and more widely used. It had, for example, recently been decided that the SDR interest rate should be adjusted more frequently. The proposals to simplify and expand operations in SDRs were another useful step in the right direction. He would therefore support them. More specifically, he agreed with those who considered that the present requirements governing operations in SDRs were too complicated and too rigid. They deterred instead of encouraging the greater use of SDRs. The staff had provided convincing reasons why the requirements were no longer necessary or desirable, and the proposed changes appeared fully consistent both with the Articles of Agreement and with the smooth functioning of the SDR scheme. In practice, the effects of the proposed changes might not be very great, at least in the short run, but they could make the SDR more attractive to hold and easier to use. They created the potential for a greater use of SDRs over time, and they should help them to stand on their own feet as a full-fledged reserve asset.

Executive Directors should not be content to stop with the changes proposed by the staff, Mr. Suraisry considered. All Fund members had accepted the undertaking in Article VIII, Section 7 to make the SDR the principal reserve asset. The task would not be easy, and it would take time; but the goal would never be reached unless Executive Directors took every opportunity to strengthen the SDR. He was by no means suggesting that they should tinker with the SDR for the sake of taking action, but he did believe that there was scope for expanding the role of the SDR and that Executive Directors should use the opportunity constructively. Otherwise, there was a risk that the SDR would decline into insignificance. He therefore welcomed the inclusion in the work program of three further papers on the SDR. He hoped that they would be discussed in December 1983 or January 1984 as planned, especially as some of the issues had been raised as far back as June 1982. There had, for instance, been considerable interest in the level of the SDR interest rate and in the question whether it might be more appropriate to calculate the rate with reference to selected Euromarket instruments. There had also been considerable interest in expanding the Fund's brokerage activities, and in looking again at the idea of establishing a clearing facility for SDRs either with the Fund or with interested central banks. All those topics should be examined carefully. It was also time to see whether the Fund could not borrow SDRs, a facility that would be helpful in present circumstances. He could agree with Mr. Wicks that the Executive Board should continue to review the SDR annually.

He had listened carefully to Mr. Laske's doubts about eliminating the equal value principle, Mr. Suraisry stated. In his view, the proposed

reforms would not lead to a vast or uncontrollable increase in SDR operations. Any increase was likely to be on a small scale and spread over time. Moreover, the Fund would retain safeguards that it could use if necessary. The proposed liberalization was by no means excessive. He could therefore support the proposed decisions.

Mr. Kafka remarked that the proposals put forward by the staff were by no means earthshaking; moreover, they were surrounded by ample safeguards. He could therefore support them. Indeed, he hoped that it would be possible to go a step further and apply liberalization not only to operations but also to transactions by agreement. Like Mr. Wicks and others, he would appreciate it if the staff were to press on rapidly with further technical work on improving the SDR. Finally, like Mr. Suraisry, he felt that the matter of SDR allocations should be urgently pursued in line with the views expressed by the Interim Committee.

Mr. Lind^ø observed that the Nordic countries continued to attach great importance to the efforts aimed at strengthening the role of the SDR as a reserve asset. To that end, he could support the proposals to simplify the procedures for operations in SDRs. Against that background, he could agree to the proposal that the participants should be allowed to agree among themselves on the exchange rate and the types of operations that they carried out in SDRs. The Fund should, however, closely follow the developments and change the decisions if, contrary to expectations, they should prove to have a destabilizing effect on the SDR system.

He had no objections either to the other changes and additions proposed in the P-Rules and Q-Rules or to the special procedures proposed for operations to set aside SDRs to secure the performance of obligations by participants, Mr. Lind^ø stated, even if he was not fully convinced of the practicality of the procedure, considering the Fund's right to dispose of amounts set aside in certain conditions.

Mr. Prowse recalled that, at EBM/82/78 (6/7/82), the Chairman had noted that there had been a great deal of sympathy for the notion that there should be a single Executive Board decision allowing all operations that were not prohibited, and simplifying the reporting requirements. He had supported the proposal at that time, and he would support the present proposed decisions. He had observed that there were potential advantages in the freer use of SDRs and had supported the idea of a single decision. At the same time, he had signaled the need for some discussion of the possibilities of abuse of such a simplified decision, and he was not sure that the present papers had fully covered that aspect. Nevertheless, he commended the staff for the work that it had put into the present papers.

He considered the merits of the proposed changes to have been well demonstrated, Mr. Prowse continued. There was a quite evident need to simplify the present restrictive requirements. Consequently, he agreed

with the proposed changes that would allow the use, in particular, of any exchange rate acceptable to the parties in those cases where an exchange rate was relevant. He was, however, not entirely clear about the proposal that the Fund might take steps to avoid the possibility of SDRs' being traded at widespread discounts or premiums. The staff had mentioned that measures were open to the Fund by which it could control the situation, including the adoption of measures to modify the relative attractiveness of returns on the SDR or to increase or reduce the number of SDRs in circulation at any given time. The possibilities of increasing or reducing the number of SDRs in circulation seemed to be fairly constrained. In any event, it was not certain that it would be desirable to adjust the volume of SDRs or even the level of SDR interest rates because of the emergence of limited discounts or premiums in private transactions. There would clearly be more important considerations affecting the volume of SDRs and the rate of return on the assets. He would therefore like the staff to elaborate on the consequences to the SDR of allowing larger or smaller discounts to surface in operations, and to state how important it would be to take measures to offset such discounts.

As to possible abuses under the simplified system, Mr. Prowse noted that the staff had written on page 10 of SM/83/187 of the possibility that the Fund might find holders undertaking dealings that would give it grounds for concern. He would be interested to hear rather more from the staff on what the possibilities for abuse might be, and what might be needed to deal with them. He was confident that draft Rule P-10 set out on page 18 of SM/83/187 did provide sufficient safeguards, by empowering the Fund to call for periodic reports, as well as giving it an opportunity to deal with abuses. Nevertheless, he was by no means sure that it would be possible to foresee all abuses in advance.

Taking up two comments made by Mr. Polak, Mr. Prowse remarked that the proposals for establishing special procedures for operations to set aside SDRs in SM/83/188 seemed worthy of support, contrary to what appeared to be Mr. Polak's views. On the other hand, like Mr. Polak, he was not clear why the staff, on page 14 of SM/83/187, had proposed that prior approval should be required for any operations involving gold. He would like a rather broader explanation by the staff of its proposal on that matter. In conclusion, the staff had prepared an excellent response to the Executive Board discussion of June 1982.

The Deputy Managing Director took the chair.

Mr. Feito recalled that his chair had always strongly supported any measures to enhance the role of the SDR. One of the inherent shortcomings in the whole project for creating a universally acceptable monetary asset had been the belief that the functions of money were separate, meaning that it had been thought possible to establish an internationally competitive asset by offering something that might be relatively attractive insofar as interest rates were concerned, although practically useless as a means of payment for discharging obligations. Consequently, like others, he looked forward to the forthcoming review of the SDR as an opportunity to assess its role in the international financial system.

To be effective, Mr. Feito continued, a number of improvements would have to be made simultaneously in full understanding of the proper functions of the SDR as a financial asset, paying special attention to the related questions of its usability and the volume in circulation. So far as liability was concerned, it was clear that there was a long way to go before the SDR became a fully operational means of payment, similar to other international reserve assets. Hence, a further broadening and simplification of the authority to use SDRs in operations would be useful. He could therefore support the proposed decisions, even though their probable impact in making the SDR more attractive might not be very significant.

Taking up the proposals in SM/83/188 for setting aside SDRs to secure the performance of obligations, Mr. Feito stated that he was not convinced that there was an overriding need to limit the period of the subaccounts that would be opened in the name of participants to not more than two years. He could think of many legitimate operations, especially loans of SDRs between participants, that would entail a duration of much more than two years. Limiting the subaccounts to two years might well defeat the purpose of achieving greater flexibility. Clearly, it was understandable that large numbers of SDRs ought not to be frozen for long periods of time, even though many of them did not move at all frequently at present. In any event, SDRs intended to serve as security for the performance of obligations should certainly have the same maturity as the operations that they were securing. He would therefore appreciate further comment from the staff; in particular, it would be useful to know what would happen if SDRs had to be set aside as security for loans with a maturity of longer than two years.

Second, Mr. Feito remarked, he was not convinced that the staff proposals for setting aside SDRs would achieve the desired objective if the SDRs had to be available to discharge certain obligations to the Fund. In operations between participants, there would be no need for setting aside procedures if the participants believed that the obligations would be discharged as arranged. The perceived need for setting aside SDRs could only be based on the lack of such confidence. Consequently, any setting-aside procedure should include a clause to the effect that the SDR would be available to secure the performance of certain obligations between participants. Such an arrangement did not seem compatible with the provision that any SDRs set aside would be drawn upon by the Fund to meet charges or fees due from holders, or to discharge other obligations with the Fund. In those circumstances, the debtors could certainly reduce the volume of set-aside SDRs and thus lessen the security of the creditor. While he could support the two decisions put forward by the staff, he would appreciate comments on the points he had raised.

Mr. Blandin noted that the staff papers were overdue, not because of the scope of the reform that they would introduce--indeed, he doubted whether the role of the SDR in the international monetary system would benefit greatly from the changes proposed--but because they clearly

revealed the unnecessary complexity surrounding the use of SDRs in operations. Even if the proposed simplifications did not achieve much, they were a step in the right direction, and he could certainly support them.

His only comment would be on the proposal that restrictions should remain on the exchange of SDRs for gold, Mr. Blandin observed. He could agree with what Mr. Polak and Mr. Prowse had said on the point. While there might be excellent reasons for the restriction, he would like to hear more about them. It would also be interesting to know whether the discrimination that would be introduced by the maintenance of the present restrictions had some legal foundation. He could support the proposal for the setting aside of SDRs. Provision of better assurance to creditors that their financial interests would be fully protected by the use of SDRs as security was certainly an improvement upon the present arrangements.

Mr. Erb remarked that he did not consider that the proposals put before the Executive Board represented minor modifications. They went to the heart of the question of what attributes the SDR should have to induce governments voluntarily to hold it. Among those attributes would be the interest rate, the price, and any restrictions on transactions or operations. Currently, the SDR was not an instrument that governments would widely hold on a voluntary basis. His authorities recognized that measures simplifying the use of the SDR in operations might contribute to its development by making it easier to use. However, they feared that the staff's proposals could prove counterproductive by impairing the functioning of the designation system. In particular, they felt that the staff's proposals would open the door to the development of a two-tier SDR pricing system that would place unacceptable strains on the designation process and thus impair the liquidity of the SDR. Second, they feared that the proposals would provide virtual carte blanche for operations in SDRs without adequate safeguards to protect legitimate international interests. Looked at differently, the distinction between transactions and operations would be reduced, if not eliminated, thus modifying the provisions of the Articles. Third, his authorities feared that the proposals would weaken the Fund's ability to obtain the information that it needed to reach an important decision or to maintain a sufficient overview of operations in SDRs.

The SDR was a unique international asset, Mr. Erb considered; its continued viability and development depended largely on maintaining the confidence of holders that they would be able to mobilize their assets in case of need. The designation system was the key to protecting the liquidity of the SDR, and any measures that could adversely affect designation could have a significant impact on the evolution of the SDR. His authorities recognized that there was a risk that holders of SDRs might find the asset unattractive and that they would take measures to reduce their holdings. Thus, the staff's proposals could increase the potential scope for developments that could add to the uncertainties regarding the instrument itself as well as the workings of the monetary system. They were concerned that the safeguards mentioned in the staff paper did not appear to be sufficient to prevent the development of a dual pricing system.

The Fund's SDR holdings were limited, and its ability to support the price of the SDR was constrained by the provisions of the Articles, Mr. Erb observed. The vast bulk of SDR transactions that resulted in significant increases in SDR holdings above allocations involved designation, and the international community had a legitimate interest in voluntary operations that could affect the official SDR. Therefore, his authorities did not agree that a blanket authorization for SDR operations was appropriate at the present time. By substantially reducing the reporting and recording requirements, the Fund would deprive itself of the background information needed to determine whether a voluntary operation would adversely affect the SDR. Therefore, his authorities believed that, until the implications of a dual pricing system were spelled out more clearly, and, more important, until more information was provided on what the Fund's response could be in those circumstances, his authorities were not prepared to support the staff proposals.

It was not surprising, Mr. Erb remarked, that Mr. Ismael had concluded that if there were an explicit price for the SDR different from the official one, the SDR would in fact sell at a discount. There were after all very few voluntary operations in SDRs, and he did not see any great demand on the part of governments voluntarily to hold them. What, for example, would the implications be if the SDR were selling at a discount at a time when an allocation was being considered? His question was a specific instance of the more general one regarding the characteristics that the SDR would need to encourage countries voluntarily to hold it. He was by no means convinced that the proposals set out in SM/83/187 were adequate to create a voluntary market for SDRs. The partial steps that were being suggested might make it more explicit that governments were unwilling to hold the SDR except at a discount, and such an outcome would fundamentally affect decisions regarding the future of the SDR, including allocations.

He had no difficulty with the proposals for setting aside SDRs to secure the performance of obligations, Mr. Erb concluded. While he had questions similar to those posed by Mr. Polak, they would not prevent him from supporting the proposed decision.

Mr. Alhaimus stated that he looked forward to further proposals for improving the SDR on the basis of practical experience by the management and staff. Continuous dialogue with the holders was extremely useful, and he hoped that the staff would be able to take advantage of the forthcoming informal meeting of prescribed holders organized by the Arab Monetary Fund for January 1984. The role of the SDR could not be substantially improved as long as the uncertainties regarding its future role persisted as manifested in particular by the reluctance to allow further allocations. Nevertheless, improvements in the working of the system could make the SDR more attractive.

On the whole, Mr. Alhaimus considered, the staff had made a convincing case for the need to address the broad issues covered in SM/83/187 and SM/83/188. It was clear that the rigid procedures had inhibited the

use of SDRs in operations: there had been only 23 cases, amounting to SDR 553 million, in which SDRs had been used to settle financial obligations. While hitherto the SDR had mainly been a unit of account, recent measures, such as the introduction of more frequent calculations of the rate of interest, maintenance of the interest rate close to market values, and the simplification of the valuation basket, had improved it as a store of value. The current proposals were intended to allow participants and prescribed holders to transfer SDRs among themselves in voluntary operations at a commonly determined exchange rate, simply by informing the Fund. The simplicity itself was desirable; he hoped that the changes would also make the SDR a more acceptable medium of exchange.

The staff had tried to show that, even if holders were allowed to use SDRs in operations at an exchange rate of their own choosing, significant departures from the official rates were unlikely to occur, Mr. Alhaimus noted. The fact that exchanges of SDRs for other assets would continue to be made at official rates certainly strengthened the staff's case. Nevertheless, it was possible that the market-determined exchange rate and the basket-determined exchange rate might differ. The staff, dealing with that aspect, had indicated that even when there was scope for avoiding the use of the official rate, holders had shown little wish to do so. He had been interested to see the staff argument for maintaining restrictions on trading SDRs for gold, especially in view of Mr. Polak's observations.

As to the proposal for setting aside SDRs to ensure the performance of obligations, Mr. Alhaimus remarked that the staff was quite right to refer to the need to avoid involving the Fund in disputes. The use of SDRs for the purpose of securing the performance of obligations should not be allowed to expand to the point where a large fraction of the supply of SDRs would be frozen. He noted, in that connection, that the staff's reason for restricting contracts involving the use of SDRs as a means of securing performance of obligations to two years was based on the view that the volume of SDRs available was highly constrained.

Mr. Hirao commented that he was in general agreement with the thrust of the staff proposals. As to the elimination of the mandatory use of the official exchange rate, it was fundamental that any transactions or operations in SDRs should be carried out in such a way as to guarantee equality of value between the different currencies provided, regardless of whether the SDRs were transferred to or from the Fund or among participants. For that purpose, the equal value principle set out in the Articles was of significance. However, as the staff had pointed out, the present system of normally adopting the Fund's official exchange rate on the third business day preceding the settlement date did not achieve complete equality. He also agreed with the staff that as long as the SDR interest rate remained competitive with the yield on comparative assets, it was unlikely that the freedom to deal at agreed rates would result in widespread discounts or premiums from the official price. In general terms, the liberalization of exchange rate requirements would facilitate the conduct of operations by holders. He could therefore support the staff on that point.

However, Mr. Hirao went on, the arguments put forward by the staff seemed to apply not only to operations but also to transactions by agreement. In view of the provisions of the Articles of Agreement on transactions, the only way out would be to adopt the staff's proposal to allow the parties greater freedom in selecting the date for calculating the exchange rate. There would therefore be some degree of inconsistency in the treatment of SDRs. He was rather disturbed by that prospect and shared the concerns expressed by Mr. Laske and Mr. Erb. However, as the cost involved did not seem to be substantial, he could go along with the proposal if the majority supported it.

He had no difficulty in supporting the proposal for expanding the scope of operations by replacing the existing seven decisions by a single comprehensive definition of "operations" or in supporting the proposal for simplifying the recording requirements, Mr. Hirao concluded. He could also support the proposal for offering a facility to set aside SDRs for use as security, in view of the potential usefulness of the special subaccount.

Mr. Mtei remarked that he understood that the proposed operational changes in the SDR Department were intended to further the use of the SDR in international transactions. Such changes would clearly be in line with the Articles of Agreement, which, among other things, stipulated that the SDR should become the principal reserve asset in the international monetary system. His chair had always supported that position. Accordingly, he could go along with the recommended changes, since they only aimed at simplifying the rules governing the use of SDRs. In so doing, he stressed that the changes that the Board was being asked to approve were but a small step in moving toward the objectives of the Articles of Agreement, since the SDR had scarcely begun to assume the role of a key reserve asset. The proposals were neither epoch making nor a major step; indeed, unless Executive Directors were careful, the SDR would continue to be relegated to a minor position. It would be unfortunate if the Executive Board unwittingly allowed so-called multicurrency reserve assets--over which the Fund as an institution had no control--to lead to a still further diminution in the importance of the SDR. While improvements in operational procedures were a step in the right direction, achieving the ultimate objective of the Articles insofar as the SDR was concerned would require political will by the whole membership, including in particular a timely decision on a substantial allocation of SDRs.

The staff had suggested that the Fund should not become a judge or mediator in disputes over SDRs deposited as security for the fulfillment of obligations, Mr. Mtei observed. He wondered, however, whether the Fund could avoid finding itself in such a position, since members had been known to bring bilateral debt disputes to the Fund in the hope that some pressure could be exercised on debtor countries to settle their obligations. In conclusion, he supported the proposed decisions in both SM/83/187 and SM/83/188.

The Managing Director resumed the chairmanship.

Mr. Alfidja remarked that the two papers before the Executive Board were intended to enhance the attractiveness of the SDR as a reserve asset by reducing both the complexity and the restrictiveness of the requirements governing operations. Any measures that would of themselves make the SDR a more attractive reserve asset would be favored by his authorities. He could support not only the proposals in SM/83/187 but also those to set aside SDRs to secure the performance of obligations. He welcomed the removal of restrictions on the scope of prescribed operations, giving greater freedom to holders of SDRs to make any operational arrangements that they might wish. He would, however, not support the elimination of the mandatory use of the official exchange rate in voluntary operations in SDRs. On that point, more circumspection was warranted.

Mr. Kabbaj recalled that his chair had consistently supported proposals aimed at enhancing the attractiveness of the SDR and, in line with the provisions of the Articles, making it the principal reserve asset of the international monetary system. Actions in that direction had already included improvements in the valuation system, an adjustment in the interest rate, and a considerable broadening of the types of operations for which participants might use SDRs. Nevertheless, the permitted uses were still somewhat limited and the procedures rather complex. The Executive Board had encouraged the staff to explore the possibility of enlarging the number of uses of SDRs by participants and prescribed holders and of making the procedures more flexible. The staff recommendations seemed both timely and appropriate. Their adoption by the Executive Board would be in line with the two objectives of improving the characteristics of the SDR and simplifying its use.

However, Mr. Kabbaj continued, he would reiterate his chair's concern regarding the Executive Board's efforts to enhance the role of the SDR as the main international reserve asset, without taking action to deal with the supply side of the question. Improvements in the characteristics of the SDR, including the scope for use and flexibility of procedures, would be of little help in making it the centerpiece of the international monetary system unless there were a substantial allocation. While the attractiveness of the SDR and its competitiveness with other reserve assets would certainly be important, the real emphasis should be on the fundamental factors that had brought the asset into existence, namely, the need to supplement global liquidity.

As to SM/83/187 and SM/83/188, Mr. Kabbaj went on, he was particularly glad that the staff had tried to find a way of offering the greatest simplicity and flexibility in use, while preserving the supervisory role of the Fund and allowing for reviews to enable Executive Directors to take stock of experience under the proposed decisions. He was therefore pleased to see the recommendation that the Fund should continue to restrict operations in SDRs directly or indirectly involving gold, and that it would set a maximum period of two years for the operation of the subaccounts containing SDRs set aside in connection with the performance of obligations. However, the maximum period of two years would not satisfactorily deal with the risk referred to by the staff that a substantial quantity of SDRs might be removed from circulation.

While he could go along with the recommendations contained in both the staff papers, including the removal of restrictions, a more concise definition of transactions, and the simplification of the reporting requirements, Mr. Kabbaj stated, all the new provisions should be brought under regular review to determine whether they were truly serving the interests of the SDR system. As to the setting aside of SDRs as pledges for the performance of obligations, the granting of priority to the Fund would certainly limit the attractiveness of SDRs as pledges, and he asked the staff to say to what extent that priority might affect other envisaged uses of the asset as well.

Mr. Leonard stated that he regarded the proposals in SM/83/187 and SM/83/188 as a good move, even though a small one. He could therefore support the proposed decisions in both papers.

However, Mr. Leonard remarked, he was not altogether satisfied with the provisions of proposed P-10, which stated that "the Fund may call for periodic reports from participants giving details of their operations in SDRs; and that each party to an operation should provide such additional information as the Fund might at any time request, provided that the recording of an operation should not be subject to the receipt of such information." He agreed that the Fund should have the right to seek more detailed information if there were a special reason for doing so, and provided that such a request should not be a usual event. He was however rather disturbed by the comment on page 12 that the staff would request the holders concerned to provide information periodically on a consolidated basis. He hoped that reports would not become too detailed or frequent, since there was a risk that the proposed increase in flexibility would be eroded by any undue proliferation of paperwork.

More generally, Mr. Leonard went on, his Irish authorities had some slight hesitation about allowing full freedom in determining the exchange rate to apply to prescribed operations. In that connection, they referred to an intermediate idea, floated in June 1982, of allowing a choice of rates within a band around the official rate. They would have liked to have seen further reference to that idea, and they regretted its omission from the paper. Official and private use of the SDR should not be treated in isolation, and more might have been said about the development of the latter. One way of tackling the matter might be to analyze why the use of the SDR in private markets had not expanded as rapidly as that of the European currency unit (ECU). Finally, his authorities felt that the moves proposed by the staff could certainly not be regarded as a substitute for action on the more fundamental policy issue of a new allocation of SDRs, an issue that he hoped would be given priority in coming months.

Mr. Jayawardena stated that his authorities welcomed any proposals to simplify the SDR and its operations, provided that they would help it to become the main reserve asset of the international monetary system. While he agreed with the proposals for the reduction of complexity and restrictiveness in connection with operations in SDRs, any changes should avoid seriously affecting its nature and character.

As to the main proposal, which was to modify the application of the equal value principle to operations in SDRs, he had some misgivings, Mr. Jayawardena observed. He feared that the abandonment of that principle at present might lead to the establishment of a permanent discount for the SDR in current markets, if only because the SDR value would be an average of the value of the major currencies as well as a function of the interest rate. He also had reservations on the ability of the Fund to use open-market and other operations in determining a desirable rate for the SDR. Thus, Executive Directors would inevitably have to face the question of the yield of the SDR vis-à-vis that of other currencies; shortly there could be pressure to bring the remuneration in line with the yield on stronger currencies, with similar implications for the interest rate and charges. In other words, the SDR, which currently formed only a small proportion of international reserves, could thereafter be strongly influenced by movements and fluctuations in other currencies. As a result, his authorities feared that it might not be able to play the role envisaged for it as the principal reserve asset of the system.

A more useful way of making the SDR more acceptable as an international reserve asset would be to increase the supply, especially at present, when there was a strong need for additional liquidity, Mr. Jayawardena stated. Unless more SDRs were available, little purpose would be served by making the few existing SDRs more marketable. The proper procedure would be to conduct a full-scale review of the role of the SDR in conjunction with a review of proposals to make it a more attractive reserve asset. He hoped that the Executive Board would conduct such a discussion in the not too distant future.

He agreed with the proposal to simplify the recording of operations in SDRs, Mr. Jayawardena remarked, but he had some misgivings with the proposal to liberalize the number of permissible uses. Only two types of operations had taken place out of a possible seven; consequently, he doubted whether liberalization alone would help the SDR to achieve wider acceptance. Moreover, the suggestion that if dealings in SDRs gave grounds for concern, the Fund could change the rules was rather disturbing. Such a procedure might not be desirable if the aim was to build confidence in the SDR. However, if the staff felt that the proposed liberalization would make the SDR more acceptable, he would go along with the majority. Finally, he could support the proposals in SM/83/188 relating to procedures for setting aside SDRs to secure the performance of obligations.

Mr. Ercel and Mr. Zhang stated that they could both support the proposals in SM/83/187 and SM/83/188.

Mr. Delgadillo said that he was in broad agreement with the general principles set out in the two papers. Most of the recommendations made by the staff seemed necessary as a means of enhancing the role of the SDR and making them more attractive in the future. On the other hand, he shared the concerns expressed by other Executive Directors regarding

the designation arrangements and the uncertainties that liberalization might create for the system as a whole. He had no difficulties with the special procedures to set aside SDRs, and he could therefore support the proposed decision set out in SM/83/188.

Mr. Caranicas commented that he had no basic objection to approving the proposed decisions contained in the two papers before the Executive Board. However, before reaching that point, he would like to have a further explanation by the staff of some of the questions raised by Executive Directors, particularly by Mr. Erb on the question of the equal value principle. He would also like to hear views expressed on the questions raised by Mr. Polak.

Mr. Polak observed that the philosophical view adopted by the staff on the equal value principle seemed to differ from that of many Executive Directors, including Mr. Erb and Mr. Alfidja. The staff seemed to have based its arguments for eliminating the equal value principle for operations on the grounds that the principle was of little significance for operations, as opposed to transactions. It was on that basis that he had been prepared to go along with the staff's suggestion. But many Executive Directors, including Mr. Erb, had taken the staff's suggestion as being a pointer to a direction that many Executive Directors did not wish to follow. In the circumstances, he would be interested in hearing whether the staff felt that its work on simplifying operations in SDRs would be much hurt by the insertion of a provision stating that, "insofar as applicable, the equal value principle should also apply in operations." While the flag would point in the opposite direction, the actual impact on operations might be quite small.

The Treasurer replied first to questions on the equal value principle, also described as the application of the official exchange rate determined by the Fund for the SDR, to operations in the asset. A preliminary point that was worth settling was whether there was a field of operations that could be conducted in SDRs beyond the seven on which decisions had already been taken. One Executive Director had seemed to feel that many other operations were only awaiting the permission of the Fund. The staff did not think so, even though it was prepared to concede that there could be some that it had not considered.

On the question of whether the official exchange rate should be applied to operations in SDRs, the Treasurer remarked that the staff would have to consider the matter further before replying to Mr. Polak's proposal that the equal value principle should apply to operations in SDRs "insofar as applicable." Mr. Polak's proposal would require at least a definition of the cases in which the official exchange rate would be applied, thus restoring the web of legal provisions that the staff had hoped to eliminate. Naturally, he could tackle the matter in that way if the Executive Directors so wished.

Regarding the simplification of operations, the Treasurer explained that the staff did not believe that there would suddenly be a vast increase in the volume of operations. It seemed likely that operations in SDRs would expand gradually as participants found that they could enter into operations without having frequently to consult the Fund staff to assure themselves that their proposed operations were in conformity with the rather complex legal requirements. Insofar as the possible divergence of rates was concerned, it was worth bearing in mind that there could be both discounts and premia in the price of the SDR. There had been times when the demand for the SDR had been strong; the staff did not however see that either an occasional discount or an occasional premium would be at all harmful. Nor did it see why a discount or a premium should arise in present circumstances. There was, after all, no proposal to eliminate the equal value principle from transactions in SDRs, and the designation plan would continue to exist.

Another question, the Treasurer recalled, had been whether the elimination of the equal value principle would put a serious strain on the designation plan. The staff had no evidence that the SDR would be exchanged in large quantities either at a permanent premium or at a permanent discount. Nor did the staff have evidence that the SDRs currently in circulation were held involuntarily; members had several ways of ridding themselves of SDRs, in particular through the designation plan at the official price. The staff had not noticed any systematic tendency of participants to prefer using SDRs over other reserve assets when they needed to settle a balance of payments deficit. There was therefore little risk that the SDR would not be held voluntarily as it had been held in the past. Indeed, greater simplicity in operations in SDRs ought to relieve the designation plan from some of the functions it performed at present.

Some speakers had asked, the Treasurer went on, whether the existence of a discount in the price of the SDR used in operations would not create a presumption against an allocation of SDRs. In reply, he would say once again that the staff had seen no evidence that participants wished to rid themselves of the SDR. Consequently, it did not expect that there would be widespread discounts in the price. Second, more theoretically, SDR allocations were made in response to the global need for SDRs, and the global need was certainly not identical with the momentary preferences of individual participants insofar as the desirability of SDRs or other assets was concerned. A decision on the allocation of SDRs would therefore not be taken on the basis of whether some SDRs were exchanged at a discount at a given moment.

On a more general level, the Treasurer recalled, it had been argued that there was a risk that if either discounts or premia did arise, they might create uncertainty, which would be harmful to the SDR. He did not believe that the significant and widespread divergences would take place. On the other hand, if the Fund failed to make headway in improving the SDR, it might reinforce the view that the SDR should be allowed to wither

away. One of the questions to be decided by Executive Directors was whether to try to promote the SDR or to do nothing on the grounds that action always entailed risks.

A number of speakers had asked what the Fund would do to cope with potential abuses if the monetary use of official exchange rates were eliminated, the Treasurer remarked. As the staff had written in SM/83/187, the Fund would still retain the capacity to call for reports on any individual case if it considered it desirable to do so. Second, the Fund would receive periodic reports from members about its operations in SDRs, and those would be reviewed by the Executive Board annually. Naturally, if there were any unexpected increases in operations, the Executive Board would take a close look at them. Similarly, if the operations were judged detrimental to the working of the system, the Fund could slow down the process of further liberalizing operations, or even reverse the liberalization already granted. His own view was that such a procedure would not be found necessary. Naturally, any effort to improve the SDR involved judgment. He did not believe that there would be potential abuses in the freer operations with SDRs; if abuses arose the Fund had safeguards that it could use to handle any unexpected problems.

The staff representative from the Treasurer's Department, taking up the technical points raised by Executive Directors, dealt first with the question whether it might not be desirable for the Fund to introduce a band around official rates as a way of retaining some control over the price of the SDR when used in operations. For the most part, exchange rates were not pertinent to operations in SDRs, so that in any event only a small proportion of the volume of SDRs used in operations would be affected by the application of the official exchange rate as opposed to any other rate. Departures from the official rate--which would be few and unimportant--might occur when two parties making voluntary operations felt that they would more closely achieve equal value by taking a more current calculation of the exchange rate than would be embodied in the Fund's official rate at the time. Such departures from the official rate would more closely achieve equal value. Another occasion on which there might be a departure from the official rate could be one in which liquidity was a problem, so that negotiating at a different rate might temporarily improve the liquidity of the asset. The staff had not proposed the elimination of the mandatory use of official exchange rates only because it felt that to do so would improve the way in which operations were carried out, it had also made the proposal primarily because it was a necessary condition for simplifying operations in SDRs. The retention of the mandatory use of official rates, even with a band, was bound to be a hindrance to any real simplification in the use of the SDR.

Executive Directors should bear in mind, the staff representative explained, that the proposal contained in SM/83/187 in no way altered the scope of transactions by agreement. All that had been done was to sharpen the definition. Such transactions would of course continue to be subject to the use of the Fund's official rate. It was also perhaps

worth bearing in mind that throughout the history of the SDR scheme, the volume of transactions by agreement had been roughly equal to that of transactions by designation. It would be wrong to believe that transactions by designation constituted the vast majority of dealings in SDRs.

Regarding Mr. Polak's suggestion that perhaps the Bank for International Settlements or another similar agency could more effectively set aside SDRs as a guarantee of the performance of obligations, the staff representative observed that there would be nothing to prevent individual participants from making such arrangements with the Bank for International Settlements. The staff was offering a slight expansion of two existing decisions in order to make it possible for a contractual arrangement to set aside SDRs as a guarantee of performance obligations to have the Fund's official endorsement as well.

A question had also been asked about why the staff had proposed to omit gold from the types of operation that could be undertaken with SDRs without reference to the Fund, the staff representative from the Treasurer's Department concluded. In so doing, the staff was merely trying to avoid taking up the issue of gold at the present time.

The Deputy General Counsel remarked that if the paper had proposed to permit dealings in SDRs involving gold, it would have been necessary to form a view on a number of questions, including whether gold was a "monetary asset" or not. Since the demonetization of gold, it would be possible to argue that it no longer had the status of a monetary asset, but should be considered merely a commodity. On the other hand, it could be relevant that gold did still serve as a reserve asset. For the staff adequately to examine such issues would have involved an extensive discussion of matters that were not particularly germane to the main topics dealt with in SM/83/187. The staff view had been that the preferable course was to leave the question of the relationship between gold and SDRs to be dealt with later, if the need arose.

As to the set-aside arrangements described in SM/83/188, the Deputy General Counsel observed, if the proposals in SM/83/187 were not accepted, those in SM/83/188 would fall by the wayside. What was being proposed was to provide for a set-aside facility under which the Fund would be prepared to record limitations on the holder's right to use its SDRs in cases where the SDRs were charged to secure a debt. Under the expanded definition of prescribed operations, there would be more freedom than in the past to use SDRs as security. For instance, at present, the decisions on the use of SDRs for security did not explicitly authorize an arrangement under which SDRs could be transferred to a third party to hold in escrow. Such an arrangement would be permitted by the new rules. It was not essential for the Fund to offer any special facilities to the parties to a security operation to ensure that the holder carried out its contractual obligations. On the other hand, the security available to the other party would be substantially reinforced if the Fund itself, as the registrar of the system, were prepared to record and recognize the

arrangement, thus limiting the holder's right to transfer the SDRs to third parties. That protection was available under the existing prescription decisions, and it did not seem appropriate at present to withdraw it.

The protection afforded by the set-aside facility was not complete, the Deputy General Counsel acknowledged; specifically, it did not prevent a holder from using set-aside SDRs to discharge obligations under the Articles. However, that would present no problems, if the holder under the set-aside arrangement were a prescribed holder and not a participant, because prescribed holders were not subject to obligations under the Articles involving payments in SDRs. In addition, the set-aside arrangement did offer quite substantial protection where creditors held the SDRs. If a debtor transferred SDRs to the creditor to hold under the set-aside arrangement, the likelihood that the creditor would find it necessary to draw on those SDRs to meet its obligations under the Articles would be considerably more remote than the likelihood that a debtor might find itself needing to do so. Moreover, if the creditor did misuse the SDRs, or if they were drawn down from the set-aside account inconsistently with the terms of the security, the debtor would be relieved, pro tanto, from its obligation to repay the debt. The staff had considered the extent to which it could legally reduce the scope of the limitation. As it had explained, there were certain provisions of the Articles of Agreement that must override any set-aside arrangements, including the provisions whereby the Fund could cancel SDRs. There were also provisions of the Articles under which participants were obliged to pay charges and assessments in the SDR Department. If the SDR scheme envisaged by the Articles was to work effectively, the number of SDRs received by the Fund in charges should match the volume that it would have to pay out in the way of interest. Thus, all SDR holdings needed to be equally available to meet charges. Indeed, the rules already gave the Fund the right to place a lien on the SDR holdings of a participant. There was therefore a strong legal case for overriding the set-aside arrangements.

Finally, there was the more general issue of the use of SDRs by a holder under a set-aside arrangement to meet its obligations to the General Department of the Fund, the Deputy Director explained. In that particular connection, the staff saw no strong legal reason for overriding a set-aside arrangement. However, as a matter of policy, it was felt desirable that the Fund, in its capacity as registrar of the system, should not make it more difficult for participants to perform their obligations to the Fund and the General Department, and that it might be inappropriate to extend the set-aside facility so far.

Dealing with the question of abuse, the Deputy General Counsel observed that the staff had tried to envisage all the possible uses to which participants might wish to put their SDRs, and whether there were any obvious types of use that could reasonably be described as an abuse of the SDR system, or that would in themselves be detrimental to the system. Apart from the possible effects of departing from the equal value principle, already dealt with by the Treasurer, the staff could

think of no serious detriment to the system that would be likely to arise from allowing participants to use the mode of dealing that they found most satisfactory for their purposes. Nor had the staff seen any particular advantage in continuing to restrict to certain specified contractual forms the uses to which participants could put their SDRs. To define seven specific types of contractual modes of dealing was an arbitrary way of approaching the issue, especially as participants were not entitled to combine elements from one or more modes.

Even under the simplified scheme, the Deputy General Counsel noted that the Fund would retain its general power under Article XIX, Section 2(d) to make representations to participants entering into operations that the Fund considered prejudicial to the process of designation or otherwise inconsistent with Article XXII, and to impose sanctions on participants that persisted in entering into such operations. Article XIX did seem to envisage the possibility that prescribed operations could occur that the Fund might find prejudicial to the process of designation, while leaving open the question of what sort of dealing in SDRs might be prejudicial. The staff view was that if in the future the Fund observed an operation that it considered potentially prejudicial, it could focus on the issue at that time and adopt appropriate restrictions if it wished to prevent such an operation from occurring again. It seemed unlikely to the staff that one or two dealings between participants or between a participant and a prescribed holder could in themselves materially prejudice the system.

Mr. Erb said that he could not agree with the Treasurer that the issue was one of favoring or not favoring an eventual evolution of the SDR. He was quite uncertain whether eliminating the equal value requirement would have a positive or a negative effect. He could however think of circumstances in which it could have a negative effect. He did not believe that the staff had adequately thought through the implications of the change in the different circumstances that might arise. Consequently, he did not believe that the staff could say whether the changes would improve or weaken the SDR.

As a general proposition, Mr. Erb continued, the idea of having a market-related approach to the SDR was appealing to his authorities. But they were not sure what the implications would be for the SDR within a multicurrency reserve system. Reviewing the history of the past ten years, he had noted that there had been circumstances in which the market-related approach might have resulted in the SDR trading at a premium and other circumstances in which it might have traded at a discount. Setting the price of the SDR would be as important as setting the price of any other instrument. He realized that it could in effect be adjusted by changes in the interest rate and by other methods. But he wished to be clearer regarding the implications for the system of adopting an SDR that in effect had different prices over time. How would the existence of such an instrument affect the Fund's decisions with respect to the creation or the cancellation of existing SDRs, and how would it affect the willingness of authorities to hold SDRs? Those were questions that had not been sufficiently answered by the staff in SM/83/187.

The Chairman remarked that the adoption of the decisions set out in either SM/83/187 or SM/83/188 would require a majority of 70 percent of the total voting power under Article XIX, Section 2(c). It was his understanding that Executive Directors with less than 70 percent of the total voting power favored the elimination of the equal value principle. Although a majority favored the proposal for setting aside SDRs to ensure the performance of obligations, it would not be possible to adopt that decision if the first decision were defeated.

Mr. Polak recalled that he had suggested that it might be possible to agree that the equal value principle should be applied to operations in SDRs "insofar as applicable." He wondered whether Executive Directors could accept that suggestion as a compromise.

Mr. Erb said that he would not mind looking at Mr. Polak's proposal, nor would he object to coming back to the question once again. He would like to take up the matter when the Executive Board discussed broader issues relating to the SDR once the staff had worked through the implications of its proposals rather more thoroughly.

The Secretary, in reply to an inquiry by Mr. Wicks, remarked that Mr. Laske and Mr. Erb had expressed their general difficulty in going along with the proposals in the two papers. Mr. Erb could have accepted the proposal in SM/83/188, but it was impossible to adopt that proposal without approving the proposals in SM/83/187. Mr. Alfidja, Mr. Delgadillo, and Mr. Jayawardena had difficulties with the proposal to eliminate the equal value principle. Mr. Jayawardena also had difficulties on some aspects of simplification. Those five Directors together had about 33 percent of the voting power in the Fund.

The Chairman commented that it was clear that the Executive Board did not wish to accept the proposals in SM/83/187 at the present meeting. His own view was that it was not desirable to overregulate the development of financial instruments, and that it would have been useful to allow more freedom for participants in the use of SDRs in operations. Premia and discounts could not be suppressed by regulation; they were a good signal as to what was happening in the market; it was one of the basic tenets of the Fund that discounts and premia should not be suppressed by regulation when they appeared in financial markets. More generally, Executive Directors ought to be prepared to accept a small element of uncertainty; otherwise, it would be difficult to make any change.

Mr. Laske remarked that he was prepared to look at any proposals; but his authorities had felt strongly that the possible implications of eliminating the equal value principle and of introducing a virtually unlimited extension of operations had not been analyzed in sufficient detail. He would certainly welcome a further look at the issue if the staff would provide a more thorough analysis.

Mr. Jayawardena stated that his authorities had asked him to express their misgivings on certain aspects of the proposals. They were by no means firmly opposed. Now that the Treasurer and others had explained some of the points at issue, he would be happy to refer back to his authorities and obtain their instructions for any future discussion.

The Chairman commented that in the circumstances he would ask the staff to prepare a supplement to SM/83/187. While it would be able to provide a certain amount of assurance, it would not be ironclad, because there was no way of ensuring that a change in operations in SDRs would be entirely without risk.

Mr. Kafka suggested that if the matter were reconsidered, one possibility might be that the new rules should be put into effect initially for a shorter period of time.

The Treasurer said that he would provide a supplement in which some of the fundamental issues raised by Mr. Erb--in particular the uncertainties that might be created for other aspects of the SDR system--would be examined. As there was bound to be an element of uncertainty, a review could be incorporated in the procedure, perhaps best held in connection with the preparation of the Annual Report.

The Deputy General Counsel remarked that many of the concerns expressed by Executive Directors could perhaps be dealt with by appropriate procedural safeguards, such as a limitation on the period for which the new Rules would initially apply, without necessarily imposing stricter limitations. He would certainly look to see what sort of safeguards could be suggested without interfering with the main objective, which was that parties to a contract should have a reasonable assurance that their contract would be implemented.

Mr. Polak asked that, in its work, the staff should indicate whether the system would be much affected by the omission of the language dealing with operations in gold.

The Executive Directors concluded for the time being their discussion on the simplification of operations in SDRs and on proposals to set aside SDRs as a guarantee for the performance of obligations.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/150 (10/24/83) and EBM/83/151 (10/31/83).

2. BHUTAN - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/83/274 (10/26/83). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1983 Article IV consultation with Bhutan to not later than November 28, 1983. (EBD/83/274, 10/26/83)

Decision No. 7552-(83/151), adopted
October 28, 1983

3. PEOPLE'S REPUBLIC OF CHINA - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1983 Article IV consultation with the People's Republic of China to not later than November 21, 1983. (EBD/83/268, 10/20/83)

Decision No. 7553-(83/151), adopted
October 24, 1983

4. INDONESIA - TECHNICAL ASSISTANCE

In response to a request from Bank Indonesia for technical assistance, the Executive Board approves the proposal set forth in EBD/83/273 (10/24/83).

Adopted October 27, 1983

5. WESTERN SAMOA AND THE SOLOMON ISLANDS - TECHNICAL ASSISTANCE

In response to requests from Western Samoa and the Solomon Islands for technical assistance, the Executive Board approves the proposals set forth in EBD/83/271 (10/21/83).

Adopted October 26, 1983

6. APPROVAL OF MINUTES

a. The minutes of Executive Board Meeting 83/83 are approved. (EBD/83/267, 10/20/83)

Adopted October 26, 1983

b. The minutes of Executive Board Meetings 83/84 through 83/86 are approved. (EBD/83/270, 10/24/83)

Adopted October 28, 1983

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/259 (10/21/83), EBAP/83/261 (10/24/83), and Supplement 1 (10/27/83), and EBAP/83/263 (10/25/83) is approved.

8. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/83/262 (10/25/83) is approved.

APPROVED: March 21, 1984

LEO VAN HOUTVEN
Secretary