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Statement by the Managing Director on
the Fund's Financial Resources
Executive Board Meeting
March 24, 1995

The Executive Board is considering a series of issues relating to strengthening the Fund's surveillance. I believe the steps under discussion will enhance the Fund's ability to have a closer and more continuous understanding of the evolution of members' policies and to provide early advice to members where that is needed. But fundamental as a strengthening of the Fund's surveillance is in helping ensure the stability of the international financial system, it is not itself sufficient. The strengthening of Fund surveillance may help reduce the incidence and perhaps the severity of crises in member countries, but it is likely that crises will continue to occur among the membership. The Fund will need to respond to such situations because members will have a need to resort to Fund financing in support of their adjustment efforts. In these circumstances, I believe we need to seek the guidance of the Interim Committee on the adequacy of the Fund's financial resources to enable it to play its essential role of fostering stabilization and adjustment through financial support in the new and volatile environment of the global economy.

It is clear that to play that role effectively in such an environment in coming years will require preparedness on the part of the Fund to make resources temporarily available to members on a larger scale than in the past in dealing with international financial disturbances. Consequently, it is of basic importance that the size of the Fund reflects recent developments in the world economy, including, in particular its growth since the last review of quotas was agreed. Furthermore, the systemic changes in international capital markets make economies more vulnerable than hitherto to changes in global economic conditions and financial market sentiment. These changes call for the Fund to be in a position to help members counteract sudden sharp reversals in their external payments positions, while maintaining the Fund's catalytic role in the provision of financing and ensuring at all times its monetary character, including the liquidity of members' reserve positions in the Fund. In this statement, I wish, therefore, to ask you to consider some of the issues which bear on the adequacy of the Fund's resources in terms of quotas, the possible need to supplement quota resources through borrowing, and the potential role for the SDR in responding to members' financing requirements. On a separate occasion, we shall also examine issues related to the continued availability of financing on ESAF terms.

1. The adequacy of Fund quotas

You will recall that the Board of Governors approved a 50 percent increase in Fund quotas in June 1990, which came into effect in November

1992. That increase in quotas, after taking into account the accession to membership of the FSU countries and Switzerland, raised total quotas to SDR 145 billion. The increase in the Fund's usable resources as a result of the quota increase was in the order of SDR 35 billion. Without such a large infusion of usable assets, the Fund would not have been in a position to provide the support it has for the stabilization efforts of the economies in transition, including the establishment of the STF in early 1994, to increase the limit on access to the Fund's resources in the credit tranches and under the EFF in October 1994, and to act forcefully to deal with the situation in Mexico. The need to maintain Fund quotas at an adequate level has been greatly underscored by recent developments.

As pointed out in the latest review of the Fund's liquidity position, which is now before Executive Directors, the Fund's response in the transition economies and in the Mexican and other cases is expected to result in a substantial decline in the Fund's liquidity ratio to close to its long-term average of 70 percent by the end of 1996. While a liquidity ratio at this level does not represent a limit to the Fund's financial activities, it is, nevertheless, an important indicator; and, given the prospective fall in our liquidity, the Fund needs to examine the adequacy of quotas soon and certainly well before that ratio is actually reached, especially taking into account the time it takes for an increase in quotas to become effective. I also believe it would be appropriate to have an early examination of the adequacy of Fund quotas in view of the role the Fund may be called upon to play in the new environment of global capital markets.

The bases on which the Board came to its conclusion on the size of the increases in quotas under the Ninth General Review included a review of quota calculations which were made with data ended in 1985, and which took into account the evolution of the international monetary system in the late 1980s. The work undertaken for the Tenth General Review was based on quota calculations using data that ended in 1990, and Executive Directors also took into account developments relating to the early 1990s. I believe the Fund came to the correct conclusion in closing the Tenth General Review. However, you will also recall that the Executive Board, in its Report to the Board of Governors on the Tenth Review, noted that while the Fund was relatively well positioned to meet a prospective substantial demand for its resources over the next few years, there would be a likely sharp decline in the Fund's liquidity position (even before any significant account was taken of the possible reversal of capital flows which has now taken place) and it could be reasonably assumed that further consideration would need to be given to the adequacy of Fund quotas within the next three years. I believe the crisis in Mexico and its contagion effects, particularly in other Latin American countries, warrant an earlier than expected opening of the Board's consideration of the adequacy of the Fund's quotas.

Taking account of the staff's quota calculations made in connection with the Tenth General Review, it is apparent, as more fully explained in the staff paper to be issued as background to this statement, that the size of the Fund in relation to the world economy is small and is projected to

continue to shrink. The relative size of the Fund was broadly restored under the Ninth Review to its position as of the first half of the 1980s. However, the present evolution of the world economy, including the changes arising from the increasing globalization of capital markets, would seem to call for a Fund that would be relatively larger in terms of the traditional variables than hitherto. Furthermore, the Fund should also be in a position to meet potential demands on it in the late 1990s, and probably in the early years of the next century, that may well turn out to be far larger than can be accommodated by the Fund's lending capacity based on present quotas.

As discussed below, borrowing from Fund members has been an appropriate and effective response on earlier occasions in the Fund's history even when the Fund was larger relative to the size of the world economy than it is at present. However, the conditions for large-scale borrowing may now be less propitious than hitherto, partly because of the changes underway in the world economy, including the redistribution of balance of payments surpluses and reserves among members. For example, current account surpluses among both developing and industrial countries are considerably less concentrated than in the late 1970s and early 1980s, and indeed tend to be smaller in terms of GDP and trade than at that time. The liberalization of capital markets, and the consequential unprecedented growth in portfolio flows which can be quite volatile, have fundamentally affected the adequacy of members' reserves and increased their need for maintaining highly liquid reserves in order to respond rapidly to changes in the markets' perceptions of their policies. 1/

In consequence, and also taking into account the growth of the more traditional variables in measuring the size of the Fund in relation to the world economy, early consideration of an increase in Fund quotas would be warranted. On the basis of the available statistical evidence, which as noted above is based on calculations using data ended in 1990, and also after taking some account of the far-reaching changes in the international financial situation over the last few years, I am of the view that a doubling of quotas is needed. As mentioned, an increase in quotas normally takes considerable time to come into effect--the quickest increase was nine months in 1983, but it took almost two and one half years for the increases in quotas under the Ninth Review to come into effect. Realistically, we need to consider now the likely adequacy of Fund quotas to address problems of the last few years of this century and the early years of the next, and that would imply consideration of this issue starting in the very near future.

1/ As indicated in the staff paper on data bearing on the adequacy of Fund quotas, for most of the G-7 countries, cross-border transactions in bonds and equities rose ten-fold in relation to GDP in the 1980-92 period. For developing countries, net private capital inflows rose from 1 percent of GDP in 1987-90 to 3 percent of GDP in 1991-94.

I have stressed the importance of an adequate level of quotas to enable the Fund to meet its responsibilities because quotas are the fundamental source of financing the Fund's operations. The Fund is a quota-based institution and quotas have functions which go beyond that of providing the Fund with financial resources to carry out its mandate, including the determination of the distribution of voting power in the Fund, members' access to its resources, and the distribution of any allocation of SDRs. It is, therefore, important that changes in quotas should normally reflect changes in members' relative positions in the world economy, and under the Eighth and Ninth Reviews the distribution of the increases in quotas to a considerable extent reflected changes in members' relative positions in the world economy.

The past discussions on the restructuring of quotas, i.e, on the share of the overall increase in quotas that should be equiproportional and the share that should be distributed selectively among members, were very time consuming. While I am aware that our work in this area is far from complete, Directors will also recall that many members are of the view that before consideration is given to the issue of further restructuring, the Executive Board would first examine the results of the quota formulas and related issues such as the share of developing countries in total Fund quotas. Indeed, the Executive Board has indicated in its Report to the Board of Governors on the Tenth Review that such an examination would be conducted in preparation for the work on the Eleventh General Review. I have no doubt that these discussions will again be time consuming. As indicated above, I am of the view that we need to give early consideration to an increase in quotas. Consequently, I would propose the following for the consideration of the Executive Directors:

a. as under the Seventh General Review in 1977-78, we consider now an equiproportional increase in quotas, say, of the order of a doubling;

b. the staff would continue the work program on quotas which was indicated in the Report to the Board of Governors of last December with the view to conclude the discussion in the latter part of this year;

c. consideration would be given to the issue of selective increases in quotas in the light of the Board's conclusion of the work noted in (b), with the possibility of making any recommendations to the Board of Governors, for both equiproportional and selective increases, in early 1996.

In this way we would split the next review of quotas into an early consideration of an equiproportional increase and a subsequent discussion of the need for any selective increases in quotas.

2. Borrowing by the Fund

The Fund has the authority under its Articles of Agreement to supplement its resources through borrowing, including, if need be, borrowing from the private financial markets. At present, the Fund has a small residual amount of borrowing outstanding, which it undertook in connection with the enlarged access policy in the 1980s, and borrowing under the General Arrangements to Borrow (GAB) is available. The GAB has not been drawn upon since the arrangements were enlarged and modified to provide for activation of the GAB for non-GAB participants in 1983. The lines of credit under the GAB amount to SDR 17 billion, and an associated agreement with Saudi Arabia to lend to the Fund under the same terms as the GAB amounts to SDR 1.5 billion.

The GAB can be activated at any time in accordance with its procedures. The GAB is, of course, an extremely important buttress to the Fund's liquidity position. While the size of the GAB has shrunk relative to the size of quotas, from about 21 percent at the time of its enlargement (including the agreement with Saudi Arabia) in 1983 to almost 13 percent of quotas now, it would seem preferable at this time to deal first with the issue of the size of Fund quotas rather than initiate a possibly wide-ranging review of the GAB. We can, of course, come back to this issue as and when the need arises. I would welcome Directors' views on how they would wish to proceed as regards the GAB.

As regards other borrowing alternatives, the Fund, as you know, has borrowed outside the GAB in three instances in the past: to finance the oil facilities in 1974-75, to finance the Supplementary Financing Facility in 1979-81, and, most recently, to finance the policy on enlarged access in 1981-86. The Fund's need to borrow from members resulted from decisions to create specific and temporary lending facilities when the Fund's quota resources could not reasonably support the increases in access that were called for to meet the particular needs of members arising from the oil shocks of the 1970s and the debt crisis of the early 1980s. 1/ Furthermore, Fund borrowing was generally undertaken in the light of expectations that Fund resources would soon be increased through the periodic reviews of quotas, such as occurred in 1978, 1980, and 1983.

The Fund's financial structure is based on the principle that quota subscriptions are its basic source of financing and borrowing is essentially a temporary supplement to its quota resources. I do not perceive a need at present to engage in a new borrowing exercise to supplement the Fund's general resources. It is also to be noted that in the past the Fund borrowed from generally well defined groups of members that were in

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1/ This discussion refers to borrowing by the Fund's General Resources Account. The Fund has also borrowed, as Trustee of Administered Accounts, on several occasions to meet the needs of low-income countries with balance of payments problems, including most recently for the ESAF Trust.

relatively strong balance of payments and reserve positions and from which it seemed sensible to borrow to assist a large number of countries experiencing large current account deficits. The distribution of surpluses and deficits is now less clear-cut, and any large-scale borrowing by the Fund would probably need to be more diffused than before. Furthermore, in establishing any policy of borrowing by the Fund, which I stress should not be a substitute for increasing the Fund's financial resources through quotas, the Executive Board would need to consider a large number of issues, including amounts that could reasonably be borrowed and whether the Fund should borrow from members or from the private markets (or both), the denomination of any borrowing, the maturity structure, the determination of interest rates, and the role of the Fund's gold. The staff could prepare a paper on issues involved in Fund borrowing, if that were the wish of the Executive Board. However, I would conclude that in present and prospective circumstances, a program of borrowing would not seem to meet the medium-term requirements of the Fund and its evolving role in the international monetary system. Nevertheless, borrowing is an option for the Fund in any review of its financial resources, and Directors may wish to indicate whether to consider a program of borrowing by the Fund in present circumstances.

3. SDRs

It is opportune to resume our discussions on the SDR. Following the discussion at the Interim Committee meeting in Madrid in October 1994, a compromise remains to be found on the issue of an SDR allocation in the sixth basic period. Three main proposals were discussed in Madrid on the basis of Directors' Report to the Interim Committee. 1/ First, I proposed a general allocation of SDR 36 billion, which could be structured in a number of different ways. I am more than ever convinced of the need for a general allocation of SDRs to supplement existing reserve assets. The staff background paper contains some updated material that has a bearing on the issue of a general allocation of SDRs. An SDR allocation in present circumstances, in my judgment, would help restore confidence in the financial markets through a strengthening of members' reserve positions and would also strengthen members' confidence in their pursuit of sound policies, including in support of an open trade and payments system. The role of the SDR as a supplement to existing reserves would, of course, be small in the context of large-scale movements of funds across borders and foreign exchange markets. Executive Directors may wish to consider again a general allocation of SDRs of SDR 36 billion, or perhaps an even larger order of magnitude, which would provide a modest, but nevertheless useful, boost to confidence in many countries and to the system at large.

The Interim Committee also considered the proposal by the United States and the United Kingdom for a special allocation of SDRs through an amendment of the Articles, in order to correct a perceived inequity in the SDR system that had arisen since the last allocation of SDRs was agreed in 1979. The

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1/ ICMS/Doc/43/94/10, 9/23/94; pp. 6-8.

size of the proposed special allocation was a modest SDR 16 billion. You will recall that a general allocation of the order of twice this amount would essentially provide the same "equity" effects for the newer members as the special allocation, and would not need an amendment of the Articles. A third proposal by a group of 11 other Executive Directors would combine a general allocation with a special allocation of the type proposed by the United States and United Kingdom for a total allocation of SDR 30.5 billion.

In further considering the SDR issue, it may be useful if the Executive Directors could revisit the issue of an SDR allocation which would support the Fund's conditionality. I have in mind three variants of such an allocation, on which Directors may wish to express their views. First, you will recall that in the mid and late 1980s, a number of proposals were made, in particular by the Belgian and French authorities, under which countries with relatively large reserve positions would lend newly allocated SDRs either to the General Resources Account of the Fund, 1/ or bilaterally to members with low reserve positions, or through an administered account. The loans would be made only to finance programs directly or in conjunction with an upper credit tranche stand-by arrangement or extended arrangement. These redistribution schemes, which would be voluntary and could not be made a condition for the allocation of SDRs, were put forward in part to meet objections to the unconditional nature of an SDR allocation and were also partly influenced by the long delay in completing the Ninth General Review of Quotas. However, these schemes might be reviewed again as a means to supplement the Fund's quota resources in the context of the new global environment, particularly to provide a strengthening of the Fund's capacity to mobilize financial support during the period preceding the next quota increase.

Second, as Directors will recall, in 1991 the Japanese authorities proposed a voluntary post-allocation redistribution scheme under the present Articles, in an amount of SDR 20 billion, under which the G-7 and other industrial countries would lend the equivalent of their newly allocated SDRs to the Fund for use for countries with upper credit tranche arrangements or to finance a new "liquidity facility" in the Fund to provide relatively short-term financing to countries with liquidity difficulties caused by the external economic environment. 2/ This scheme, which is usually referred to as the Hashimoto Proposal, would be temporary and the allocated SDRs could be canceled if the need for such reserve supplementation had disappeared, say, after ten years. It may again be useful to revisit this proposal and Executive Directors may wish to express their views on this matter.

1/ Neither the Fund nor an administered account can borrow SDRs, as a consequence, the SDRs would need to be converted into currency acceptable to the Fund and to the administered account.

2/ See *International Liquidity and the SDR Mechanism*, SM/92/106 (5/27/92), pp. 42-43 and ICMS/Meeting 36 (April 29-30, 1991), pp. 31-34.

Thirdly, the Executive Directors could consider developing further the SDR as a "safety net" instrument. Among the several schemes which could be considered, a useful formula could consist in safety nets provided in the form of temporary allocations of SDRs for individual countries facing balance of payments or external liquidity problems, which could require substantial amounts in crisis situations. The purpose of such SDR allocations would be to help members overcome their liquidity problems through the adoption of appropriate adjustment measures. In other words, such allocations would be conditional and SDRs that had been created would be canceled as IMF support would start to be repaid. Such temporary and conditional allocations of SDRs would, needless to say, require an amendment of the Articles, and would not be based on a finding of long-term global need. Directors may wish to indicate their interest in having the staff prepare a detailed proposal accompanied by a draft amendment to give effect to such an approach for the SDR, in a paper which the Directors could discuss in due course.

The SDR has not fulfilled its potential in the system. In certain respects, the SDR may need to be modernized, but, above all, it needs to be revitalized as an asset that can be adapted to meet the needs of members, which is something difficult to realize in the absence of prospects for allocations. I would appreciate Directors' views regarding these three possible schemes, which bear on the role of the SDR in the international monetary system as it seems to be evolving and, in particular, its role as an instrument of Fund financing in the context of a conditional safety net. As soon as decisions are taken on these options, the Executive Board could start working on the modernization of the asset. I would wish to remind you that, for example, we have agreed to look at possible schemes to "harden" the SDR so that it might develop into a universal standard of value. We will have such an opportunity at the time of the quinquennial review of the method of valuing the SDR and the SDR interest rate basket in the summer of 1995. It would also seem useful to review the working of the SDR system, including perhaps the criteria for allocation, not only to attach conditions to the receipt of SDRs allocated by the Fund, but also to reduce or eliminate conditions that restrict its uses among members and the possibility of private market institutions holding and transacting SDRs.

4. Gold

Some Directors have recently raised the issue of gold in the Fund and its possible mobilization. Gold is an important financial asset of the Fund, and I can understand Directors wanting to consider more active forms for its use than at present. The staff will issue in the near future a paper, as indicated in the last Work Program discussion by the Executive Board, on gold in the Fund. This paper could serve as background for a more general discussion on the role of gold in the Fund. Furthermore, a staff paper to be issued soon will touch on the issue of gold in the context of discussions Directors will be having as a follow-up to the recent meeting on issues relating to multilateral debt.

5. Conclusion

The purpose of this statement is to elicit the views of Directors as regards the adequacy of the Fund's financial resources. This issue will be one of the crucial elements to be considered at the Interim Committee in the context of the evolving international monetary system. We must ensure that the Fund's financial resources are adequate to enable it to fulfill its mandate in this new environment. I regard our discussion on the Fund's financial resources as complementary to our discussions and proposals for strengthening the Fund's surveillance activities. This statement is intended to help develop an approach to the various options which could help secure the Fund's financial resources for the future. I would suggest that a review of the Fund's quotas should be our first priority; we should also revisit the SDR issue; the role of borrowing by the Fund could be considered as the need arises. We will also consider soon issues related to the continued availability of financing on ESAF terms. After hearing the reaction of the Executive Board to these suggestions, I will stand ready to formulate more precise recommendations for consideration by the Executive Board and the Interim Committee.