November 17, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Final Minutes of Executive Board Seminar 82/5

The following correction has been made in the minutes of Executive Board Seminar 82/5 (7/2/82):

Page 3, para. 3, line 9: for "a systematic role" read "a systemic role"

A corrected page is attached.

Att: (1)

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Seminar 82/5

10:00 a.m., July 2, 1982

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L. Van Houtven, Secretary
M. P. Blackwell, Assistant

Also Present

African Department: K. Yao. Asian Department: R. C. Baban. Exchange and Trade Relations Department: K. B. Dillon. External Relations Department: P. de Fontnouvelle, H. P. G. Handy, H. P. Puentes. IMF Institute: U Tun Wai, Deputy Director; O. H. Lobo. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; G. F. Rea, Deputy General Counsel; Ph. Lachman, A. O. Liuksila, J. M. Ogoola, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; R. R. Rhomberg, Deputy Director; C. P. Blackwell, M. Goldstein, J. S. Smith, P. Verdin, G. von Furstenberg. Secretary's Department: A. P. Bhagwat. Treasurer's Department: R. J. Familton, Deputy Treasurer; W. J. Byrne, W. L. Coates, L. E. Escobar, J. R. Karlik. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, E. A. Ajayi, C. J. Batliwalla, S. E. Conrado, L. Ionescu, M. A. Janjua, K. V. Jännäri, G. Jauregui, P. Kohnert, S.-W. Kwon, P. D. Peroz, F. Yeo T. Y. Assistants to Executive Directors: E. M. Ainley, L. E. J. Coene, R. J. J. Costa, A. Halevi, Jiang H., J. M. Jones, M. J. Kooymans, J. S. Mair, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, E. Portas, D. V. Pritchett, J. Reddy, D. I. S. Shaw, H. Suzuki, A. Yasseri, A. A. Yousef.

## 1. THE EVOLVING ROLE OF THE SDR IN THE INTERNATIONAL MONETARY SYSTEM

Executive Directors considered a staff paper on the evolving role of the SDR in the international monetary system (SM/82/107, 6/4/82; and Cor. 1, 6/15/82). They also had before them staff papers on possible further improvements in the existing SDR (SM/82/92, 5/7/82; and Cor. 1, 5/28/82) and on the evolution of the SDR outside the Fund (SM/82/93, 5/10/82), together with a departmental memorandum on SDRs and plans for reform of the international monetary system (DM/82/23, 4/14/82).

Mr. Erb explained that he had asked that the discussion of the evolving role of the SDR in the international monetary system be held in seminar form because of the complexity of the subject, and because his authorities had not yet formulated a specific position. His comments would, therefore, be preliminary and personal, not official.

In the issues that it had identified for discussion by the Executive Directors, the staff had first asked the basic question whether the SDR should be considered the appropriate principal instrument to be used in the conduct of international financial relations, Mr. Erb commented. From SM/82/107 it emerged quite clearly that, for the SDR to play a significant role as a monetary or reserve asset in the international monetary system, a return to some measure of exchange rate stability would be required. In other parts of the paper the staff seemed to have experienced some difficulty in describing a systemic role for the SDR in a multicurrency reserve system in which the economies of different members were not closely coordinated, and where the main characteristics were economic divergence and fluctuation. He himself was skeptical about how the SDR as a reserve asset could fit into a multicurrency system where national economic developments changed in divergent ways. The previous and current staff papers seemed to focus rather narrowly on the SDR as a financial instrument for the Fund per se, or as an instrument that might compete with national currencies. He wondered what would be the implications of giving the SDR an increasing amount of independence and allowing it to compete with national currencies. Would so doing lead to greater stability in the international monetary system? He doubted whether that would be the case without the convergence of national economic fundamentals. The existence of the SDR and the implementation of some of the specific proposals discussed in the paper could lead to asset switching between national currencies and SDR-denominated assets both in the private and in the public sectors.

The historical discussion of the development of the SDR in the staff papers was most interesting, Mr. Erb continued. He would have liked to see a more critical assessment of the debates and discussions of the 1960s, when the SDR had been conceived. In his view, the heavy focus on liquidity in the context of the Bretton Woods system of fixed exchange rates had probably distracted attention from more fundamental problems facing the system at that time. Some of the problems had been discussed, but most attention had been given to what had been perceived as the greatest problem at the time--the need to ensure adequate liquidity under the

Bretton Woods arrangements. Perhaps more attention should have been given to the failure of exchange rates to adjust to shifts in the underlying fundamentals under the Bretton Woods arrangements. The implications of the shift in current account positions as a result of rapid growth in Japan and in Europe, and the emergence of economies in a number of other parts of the world, requiring adjustments on the trade account, could usefully have been given greater attention in the discussions of the 1960s.

The inability of the Bretton Woods arrangements to allow for exchange rate adjustment to compensate for differences in inflation between Fund members was another fundamental issue that had not been fully discussed, Mr. Erb considered. In SM/82/107 the staff had argued that the primary problem of the international monetary system in the second half of the 1960s had been a liquidity shortage. In his view, however, the primary problem had been the rising rate of inflation in the United States relative to other countries and the strengthening of the yen and the deutsche mark. The staff had referred to the work of Robert Triffin, and particularly to the "Triffin dilemma." Triffin himself had recognized in his later work that he had focused too much attention on the problem of liquidity. Triffin's early analysis had been set within the narrow context in which he had studied the demand for an international currency, in that the attractiveness of the dollar--or any currency--as an international currency, either as a reserve asset held by official institutions or as a reserve and transaction currency for the private sector (and the latter clearly overwhelmed the official holdings) was fundamentally dependent on the size and stability of the economy that was generating the currency and also on the ability of that currency to maintain itself as a store of value vis-à-vis real goods. The emphasis on the relationship of dollars outstanding to the amount of gold in the United States was misplaced; the relationship represented only a minor part of the U.S. balance sheet--or any country's balance sheet--in determining the strength or weakness of the currency. It was the strength of the underlying economy and the ability of the currency to maintain its value in terms of real goods that was fundamental in influencing the international role of that currency.

The staff had made the point that if dollar balances were accumulated as the United States ran an official settlements deficit, the United States would face no reserve restraint in the formulation of its monetary and fiscal policies, Mr. Erb continued. The experience of the 1970s showed, however, that if the United States--or any major reserve currency country--shifted to a more inflationary policy, there would immediately be shifts out of that currency, leading to the exchange rate adjustments that had been seen in the late 1970s. If a reserve currency country did not follow a policy of maintaining price stability or maintaining the value of its currency vis-à-vis real goods, there would be a shift away from that currency, no matter what kind of exchange rate regime was in existence.

The staff had mentioned that the indicators used to justify the first creation of SDRs had related to capital controls and other conditions, Mr. Erb noted. In his view capital controls at that time had not been an indication of lack of reserves in the system, but rather an indication that the major reserve currency country had been pursuing an excessively inflationary policy in comparison with other reserve currency countries. The creation of SDRs at that time had been a wrong approach, to the extent that it had given the United States the impression that it could continue its domestic policy course and cushion the exchange rate consequences of that course through the use of reserves, including newly created SDRs.

The creation and distribution of SDRs might have had an inflationary impact on the domestic policies of the countries receiving them, Mr. Erb said. To the extent that an increase in reserves through SDR creation led countries to believe that they could pursue a more expansionary domestic policy, the creation of SDR reserves had the potential to be inflationary in its consequences. SM/82/107 had touched briefly on the issues that he had raised in a paper circulated some months previously ("Changing Concepts of International Liquidity") about how to judge liquidity needs in a system characterized by flexible exchange rates and large private capital flows, but SM/82/107 had not analyzed those questions in depth. He could agree with the staff comments on page 13 that "by making the state of global liquidity derive more directly from the monetary policies of major countries than may have been the case in the past, such developments may make it difficult to focus on global liquidity as an issue separate from these policies." However, he would prefer to link the growth in global liquidity to the underlying monetary policies in the major reserve currency countries. The question was then raised as to what role the SDR should play as an additional source of liquidity in a system of multiple reserve currencies, floating rates, and independent monetary policies. There was a danger that the impact of the SDR as an additional source of liquidity would lead to a higher rate of inflation, unless it brought about a reduction in the domestic money base growth of the reserve currency countries.

He questioned the assumption made by the staff on page 21 of SM/82/107 that had allocations been higher in the 1970s, the SDR would have progressed further on the road to becoming the principal reserve asset in the international monetary system, as had originally been intended, Mr. Erb said. The central problem during the 1970s had been excessive money creation in many of the major currency countries, and in particular in the United States. If there had been larger allocations of SDRs, they might have encouraged additional growth of the underlying money base in the major currency countries, particularly if that reserve base had been used to attempt to defend an exchange rate that had not been defensible in view of the underlying inflationary thrust of domestic policy. Had there been larger allocations of SDRs, there might well have been a larger growth in reserve assets; while there might have been an increase in the relative share of SDRs in official reserve assets, there would have been also a large increase in the total level of reserve assets, which would have had an inflationary effect.

There was a discussion in the staff papers about the desirability of facilitating the evolution of the SDR into an asset with characteristics of real money--unit of account, store of value, medium of exchange--which might be used in private as well as official transactions, Mr. Erb noted. That type of evolution had not been envisaged in the Articles of Agreement; moreover, it would raise a number of questions about the effects of the SDR becoming more competitive as a monetary instrument. SM/82/107 correctly pointed out that the SDR could make an important contribution as a monetary asset if it "could be expected to maintain its value as well as other national currencies, while being superior in spreading the risks and reducing the information and transaction costs that remain." However, those benefits would have to be measured against several potential difficulties that would arise if the SDR were to become widely used as a form of money in competition with national currencies, whether for domestic or for international transactions. If the SDR were to compete with national currencies in domestic transactions, it would complicate the task of controlling money growth in the countries involved. Moreover, although the paper forcefully ruled out the possibility that the Fund would exercise leverage over the growth of SDR money in member countries, if the supply of SDR money were to reach significant proportions, it would necessarily influence the rate of growth of the global money supply. In consequence, the Fund would have to accept the major responsibility of creating an efficient mechanism for controlling the supply of SDR-denominated assets. Such a task would be more difficult for the Fund than for national central banks, which exercised at least some degree of control over their own domestic money base and financial institutions.

In view of the technical and the political difficulties faced by national central banks in exercising control over the money base, the obstacles to the Fund's exercising control over an SDR-denominated money supply appeared formidable, Mr. Erb continued. There would, for example, have to be coordination of monetary policies with national monetary authorities in order to maintain an appropriate degree of liquidity and to minimize the impact of exchange rate fluctuations, which might lead to a potential conflict of interest with the Fund's responsibilities for surveillance over exchange rate policies.

If attempts were to be made to coordinate national monetary policies and to achieve price stability among the major currency countries, the need for an additional monetary instrument in the system would be quite limited, Mr. Erb suggested. The only justification that he could see for trying to build an SDR-based monetary system was that it might maintain stability over time. That point had been made in Section VII of SM/82/107. The paper also focused on the issuance of SDR claims by the Fund, placing emphasis on the expansion of the SDR in and of itself and its usefulness in Fund activities, rather than on the broader role of the SDR in the system.

In discussing the relationship between the Fund and the SDR, the staff had suggested three possible courses of action, Mr. Erb noted. Those were: first, to increase the SDR portion of quota subscriptions; second, to substitute SDR acceptance limits for paid-in quota increases and to have the Fund issue--rather than allocate--SDRs in the process of granting credit to member countries for balance of payments purposes; and third, to have the Fund issue SDR-denominated claims to finance its lending operations. Each of those techniques, while raising interesting possibilities, raised potential problems. As to the use of SDR allocations for the purpose of funding quota subscriptions, he wondered how the Fund would be perceived not only by governments but also by international markets, if the basis of the Fund's financial activities were the very instruments that the Fund could create itself. In such circumstances, the SDR would have to command a high degree of confidence in the international community if the creation of SDRs to pay for quota subscriptions was to be perceived as adding to the strength of the Fund. If there were questions about the SDR in the minds of governments and in the international community, the credibility of the Fund could be undermined.

The technique of issuing SDRs for use as credit to members was an intriguing proposal, but it had some serious potential pitfalls, Mr. Erb continued. The staff had pointed out correctly that such a technique could be used to increase the volume of SDRs without necessarily increasing the issue of unconditional Fund credit, as was the case with allocations. The staff noted that such a technique would, in effect, make Fund operations more similar to the money creating process of commercial and central banks. However, it was precisely in that type of parallelism that a potential danger lurked. When the Fund granted conditional credit, the borrower received an effective transfer of liquidity in the form of foreign exchange from the countries whose currencies formed part of the exchange currency. Those latter countries received an increase in their reserve tranches in the Fund, and since those tranches were not transferable they could be used only in case of balance of payments need. That type of reserve asset was not particularly liquid. The analysis would have to be qualified to the extent that the borrowing countries received reserve currencies or SDRs, but it remained valid. In the case of the unconditional provision of Fund credit through SDRs--for example, when a member used its SDR line of credit through the designation mechanism--the members to which SDRs were designated received SDRs in exchange for their loss of foreign exchange. SDRs acquired through designation were more liquid than reserve tranches in the Fund, because of the potential for voluntary transactions in SDRs. Admittedly, the small volume of voluntary transactions obviously limited the current liquidity of SDRs relative to foreign exchange. Nevertheless, the very liquidity of SDRs would intensify his concern at using SDR creation for conditional Fund financing, particularly if other proposals for extending the use of SDRs were adopted.

If SDR liquidity were to increase through a significant increase of voluntary transfers, the liquidity injected into the system through SDRs would be controlled through the allocation mechanism, Mr. Erb remarked. Moreover, if the Fund were to issue SDRs in the process of granting conditional credit, the global supply of SDRs would become a function of the members' individual balance of payments need. In contrast, effective monetary policy required that central banks or monetary authorities use their credit granting functions as a mechanism for controlling the aggregate money supply. In other words, credit creation should be subordinate to money creation rather than vice versa. Of course, if SDRs created through Fund lending resulted in an amount of SDRs judged excessive for international reserve and liquidity purposes, a portion of the SDRs created through the allocation mechanism could be cancelled to decrease the global supply of SDRs. Nevertheless, the more SDRs were used as a form of reserves and as a form of money, the more complex would become the task of exerting adequate control over the stock of SDRs. The same issues of control over the growth of SDRs would arise, although in a somewhat different form, if Fund borrowing through issuance of SDR-denominated claims were to increase significantly the outstanding volume of SDRs.

The fundamental question of what role the SDR should play in a multicurrency system with independent monetary authorities remained to be addressed, Mr. Erb concluded. It also needed to be asked whether the SDR could facilitate the operations of the Fund. Another interesting question, which the staff had left open at present and which could be addressed at a later stage, was whether the evolution of the SDR as a vehicle for funding or for carrying out Fund transactions would conflict with any role that the SDR might play in the international monetary system, either in the context of a multicurrency reserve system with independent monetary policies, or in the kind of exchange rate system that the staff had considered, namely one with stable currencies and implicitly coordinated national monetary policies.

Mr. Nimatallah noted that in the concluding remarks in DM/82/23 the staff had pointed out that after the abandonment of the Bretton Woods system and the adoption of floating exchange rates, two schools of thought had emerged: one advanced proposals concerning a return to a managed exchange system with a central role for the SDR; the second expressed doubts about the desirability and political feasibility of a more closely controlled system. He sided with the first school of thought. He believed that since both fixed exchange rate systems and the freely floating exchange rate system had failed to function satisfactorily, a more managed floating exchange rate system with a central role for the SDR would help to reduce the difficulties produced by the other two systems. The subject at present under discussion was of great importance, therefore, both for the future of the Fund and for the international monetary system in general.

The role of the SDR depended ultimately on international monetary reform, Mr. Nimatallah remarked. In the meantime, measures to expand the role of the SDR should in themselves promote reform. International monetary cooperation should be designed to achieve the two basic objectives of facilitating transactions among countries and safeguarding international financial stability. The SDR should be made to serve both objectives.

Since the completion of the work of the Committee of Twenty in 1974, it had been the conventional wisdom that further discussion of international monetary reform would be premature, Mr. Nimatallah commented. It was generally considered that the international community should concentrate rather on immediate problems while avoiding measures that might inhibit reform at a later date. In his view, it would be better if steps could be taken now that were designed to contribute to reform. It was unfortunate that there should be such a reluctance to approach reform directly, in view of the flexibility regarding the operation of the international monetary system that had been built into the Second Amendment of the Articles of Agreement. From the papers the staff seemed to believe that reform could wait for more favorable circumstances. He would argue, however, that achieving favorable circumstances required some interim preparation for reform. Moreover, agreement on effective action of any kind could probably only be achieved at times of instability, when the need for action was readily apparent.

The authorities of developing countries found present conditions in the exchange markets unsatisfactory, Mr. Nimatallah observed. They believed that the Fund and its membership should not wait for improvements in international circumstances before taking bold measures with regard to the SDR. Continued heavy reliance on the dollar entailed problems. The world had already been through one period of excessive dollar creation during the 1970s, when the United States had been in severe deficit and the value of the dollar had declined to a point at which it had been substantially undervalued. As a result, the Executive Board had been able to hold discussions on the establishment of a substitution account and a consequent massive creation of assets denominated in SDRs. That scheme had, however, fallen apart. The dollar had since risen in relation to the SDR as U.S. policies had been strengthened. As the dollar had risen, the Executive Board had no longer been concerned with excessive dollar holdings. The Board had left unanswered the question of what would happen if the United States in the future wished to finance large deficits once again with the creation of dollar liabilities.

The Executive Board had not been prepared to discuss asset settlement in payments deficits, Mr. Nimatallah commented. The discussion of that subject should not be delayed indefinitely, because the world might soon be faced again with another period of declining value for the U.S. dollar; much in the world economic outlook pointed in that direction. When interest rates declined and the U.S. economy began to expand, resulting in sharply rising imports, a downward adjustment in the value of the dollar frequently occurred. The gradual evolution of the use of a few currencies other than the dollar for reserves and for other international payments purposes was not a satisfactory substitute for reduced reliance on the dollar. Countries issuing the currencies involved undertook to play a reserve role willingly only when they experienced current account deficits. Moreover, a multicurrency system was inherently unstable.

The conclusion to be drawn from experience was that efforts should be made to strengthen the SDR by improving its qualities as a reserve asset, increasing its use in Fund transactions, and encouraging its use in private financial markets, Mr. Nimatallah continued. For many years to come, the dollar would inevitably remain the principal channel for international transactions, but its role as a reserve asset and a standard of value should be reduced. In the process, perhaps the United States itself could be prepared or persuaded to finance at least a part of its future payments deficits in SDR terms. The Fund membership would probably need positive contributions from the United States, if it was to have hopes of promoting an important international role for the SDR. The United States would realize that its longer-term interests would be served by such a policy. Even in the best of circumstances, the use of the SDR as a reserve asset and as a standard of value would evolve slowly, but Fund members could take steps to make the evolution more rapid.

He had been particularly intrigued by the staff suggestion that Fund activities could be based largely or entirely on the SDR, and by its comment that the SDR as an instrument was neutral with respect to the provision of unconditional liquidity, Mr. Nimatallah said. While it was necessary to move cautiously in modifying present practices, steps should be taken to enhance the qualities of the SDR and increase the flexibility of the Fund as an international financial institution. A number of specific objectives for the near term could be identified; for example, the role of the SDR should be expanded continuously over time, particularly through an increase in the share of SDRs in global reserves. Thus, while the extension of conditional credit was given emphasis in a period of exchange rate instability, in a period of stability an excessive net withdrawal of conditional credit and unconditional allocations might take place. Accordingly, the expansion of unconditional SDRs over time should be sizable enough not only to cover the shortfall in conditional SDR credit, but also to increase the share of SDR reserves in total reserves. There should be no confusion between the role of the Fund's providing credit to members in SDR terms during periods of instability and providing SDRs for reserves during periods of stability, and the role of the SDR itself. The most important issue was that the role of the SDR not only should not be interrupted when periods of instability gave way to periods of stability, but also should be enhanced systematically and the SDR pulled to the center of the system at all times.

The quality of the SDR issued by the Fund should be improved along the lines outlined by the staff in SM/82/92, Mr. Nimatallah recommended. Above all, the staff should be requested to make specific proposals of how to do away with designation procedures and acceptance limits. One way might be to create a market for SDRs among an extended list of authorized holders. Certainly, the yield on SDRs created by the Fund should be brought into line with SDR claims issued outside the Fund.

The forthcoming quota increase should be made partly payable in SDRs accompanied by an allocation of SDRs for that purpose, Mr. Nimatallah suggested. Such an arrangement would add to the strength that the Fund derived from the increase in quotas by increasing its usable assets. At the same time, all members would have their reserve tranche positions enhanced. The staff should be requested to make specific proposals for consideration that were designed to move the Fund's operations gradually onto an SDR basis.

Increased use of SDRs in the private market would reinforce any improvements in quality of the SDR within the Fund, Mr. Nimatallah continued. From the Fund's viewpoint, increased use of SDRs in the private market would be a desirable development, reinforcing the improvement in the quality of the SDR within the Fund. The two processes should be regarded as mutually reinforcing. Central banks should, in appropriate circumstances, be encouraged to take steps to facilitate the opening of SDR-denominated accounts with commercial banks. For example, those monetary authorities that had considered or were considering the authorization of domestic deposits denominated in foreign currencies as a way of halting the flow of domestic funds to the Euromarkets, might be better served by providing also a basis for deposits denominated in SDRs. The possibility of doing so could be discussed by the staff in the course of its consultations with members.

Mr. Anson remarked that the staff's historical analysis of the SDR had been useful in showing the enormous changes both in surrounding circumstances and in thinking that had taken place during and since the long debate leading to the creation of the SDR. Many ideas had been considered and discarded, both in the diagnosis of the problem and in the possible ways of approaching it. As the staff had noted, a number of fundamental changes in the world economy during the 1970s had raised profound questions concerning the role that might be played by the SDR. The basic premise, articulated on many occasions by Triffin and others, that the traditional sources of reserve creation might dry up, had been based on fears that had been widely shared in the early 1960s and that had led to the production of many proposals, including one by the U.K. authorities in 1962. Those fears had been overtaken by a number of farreaching events, including the suspension of dollar/gold convertibility and the subsequent widespread adoption of floating exchange rates, the enormous growth and development of the Eurocurrency markets, and the development of what had come to be called the multicurrency reserve system. (That term seemed rather a misnomer, in the sense that the dollar remained predominant within it.) Another change, to which Mr. Erb had drawn attention, was the growing problem of inflation, both in the United States and in other reserve currency countries. All of those changes had required, and continued to require, a reappraisal of the role of the SDR. But along with all the changes, one thing had remained constant--the search for a greater measure of stability in international monetary affairs.

Against that background, the logical order of inquiry was first a diagnosis of the problems that would face the international monetary system during the 1980s, and then of the steps that countries could take to overcome those problems, Mr. Anson said. It could reasonably be asked what role the SDR could play in overcoming the problems--whether as a reserve asset, a medium of exchange, or as a unit of value. It was increasingly recognized in public speeches by national leaders that all countries shared a joint responsibility to work for greater stability in the system. The SDR, for its part, could not be an effective instrument unless its component currencies maintained their value. That point had been made by the Governor for the United Kingdom at the 1981 Annual Meeting and had also been recognized in the communiqué of the Versailles meeting of world leaders.

The SDR was likely to be a more effective and useful instrument in a world characterized by stability rather than by instability, Mr. Anson continued. A precondition, therefore, of developing the SDR as a more important component in the international monetary system was that efforts should be made to achieve low inflation worldwide, and particularly in the countries issuing the component currencies of the SDR. One possible area for study, therefore, was whether progress in that direction could be combined, over the medium term, with a developing obligation on central monetary institutions to consider holding SDRs or SDR-denominated assets, while avoiding, as far as possible, destabilizing movements among the major currencies. Both aspects had to be considered together, because reducing inflation was an essential precondition of the willingness to accept a unit based on those currencies. In referring to "SDR-denominated assets," he included not only Fund-related assets and the SDR itself, but also any privately generated SDRs that might come into existence.

Such a concept was not dissimilar to one proposed and examined at the time of the Committee of Twenty, Mr. Anson said, and he hoped that the staff could take it into account in its future work. It might help to promote the SDR as a "stabilizer" of the multicurrency system of the kind that the Managing Director had referred to in a speech at Palm Beach in April 1981. Such developments could, however, be expected only over the medium term. The complexity and uncertainty of the present economic environment suggested that the promotion of the SDR as an important reserve asset would take longer, and involve smaller steps, than had been foreseen earlier in the history of the SDR. In the meantime, any actions taken should be compatible with the SDR's remaining available for the kind of wider monetary role that might prove possible in a more stable environment.

If the SDR was to make progress as a reserve asset, it clearly had to be attractive to holders of international reserves, Mr. Anson remarked. The Fund should try to move toward a situation in which the SDR was considered by investing institutions to be an asset as acceptable as the major currencies, when all of its characteristics--yield, risk, liquidity, and maturity--were taken into account. The SDR needed to be able to stand on its own without the need for supporting scaffolding in the form of acceptance obligations, designation, and so on. The steps taken over the previous year or so represented important moves in the proper direction, but there was room for further improvement; he looked forward to more definite proposals from the staff in the light of the discussion to be held at EBM/82/78 (6/7/82). Due weight should be given to the SDR as a unit of account and as a denominator of financial obligations and commercial transactions. The official SDR and the private SDR markets should be seen as fulfilling complementary roles, not competing roles. Wider, and more willing, use of the SDR by Fund members would encourage the private market to see the SDR basket as a useful denominator or store of value. Conversely, a larger and more active private market in SDR-denominated assets would make such assets more readily marketable and liquid, and would thus perhaps encourage reserve agencies to accept them, including the SDR itself, as a useful medium of investment.

Ultimately, Mr. Anson continued, it was up to the markets and the preferences of traders and investors to decide how the private SDR would develop. If, for example, there was a genuine demand for clearing facilities or for central banks to open SDR-denominated accounts for commercial banks, those facilities were likely to develop in response to demand. At present, the Fund could most usefully make its own asset attractive to its own clients and undertake a sustained program of public information on the SDR and how the SDR-denominated markets were developing. The Fund could also encourage the development of the SDR as a reporting unit in international organizations and perhaps as a numeraire for intergovernmental transactions. He hoped that the Fund could examine the scope for pricing commodities in SDRs and ascertain whether there were any disincentives or restrictions on the creation or use of private SDRs in order to see whether there was any action that it, or its members, could take to reduce or eliminate them.

With regard to the link between SDR creation and development finance, he believed that if the SDR was to be developed as a useful monetary instrument in the long term, it was important not to undermine confidence in the acceptability of the SDR by devices that could impair its qualities as a reserve asset, Mr. Anson observed. The staff analysis of the various proposals for a link brought out clearly the potential disadvantages, as well as the advantages that were claimed for it. It seemed clear that SDR creation as a medium of development finance would involve the retention of artificial constraints, such as designation and acceptance obligations, if the Fund itself was not to become the main final holder of SDRs. Such a development would run contrary to the central objective of making the SDR a more freely usable and competitive asset that could stand on its own. From a purely personal viewpoint, he suspected that the benefits imputed to the link between SDR creation and development assistance could prove to be illusory. As the paper showed, the monetary effect of contributing to development through a link mechanism would not ultimately be so very different--other things being equal--from that of a direct budgetary appropriation. If a link were implemented, the SDR might well become absorbed within the conventional arithmetic of national and international development assistance, while the SDR's ability to perform a genuinely monetary role would have been permanently impaired.

The major historical events to which he had referred earlier, and the growth of reserve assets in other forms, had probably made traditional SDR allocations an anachronism, Mr. Anson suggested. It was arguable that any fresh SDR liquidity should be conditional, whether SDR-denominated assets generated by the market on the basis of a country's creditworthiness, or Fund lending in support of adjustment programs. The idea of direct issues of SDRs to the General Resources Account might merit fresh study in its own right, particularly in the context of quota reviews, but the implications for the liquidity of the Fund and the size of the Fund would need careful examination. Moreover, like all developments of the SDR proper, that idea would depend for its effectiveness on improving the attractiveness of the SDR as a reserve asset. If it needed to be bolstered by increased acceptance limits, the possible benefits of the idea would be weakened. He hoped that the staff could, in some future paper, explain the proposal further, and bring out the implications in rather more detail.

He could understand the arguments, advanced by Mr. Polak in a recent publication, that basing the Fund directly on the SDR might simplify the Fund's present complicated structure of accounts, but he was not sure how much practical difference it would make to members' obligations to extend credit as the counterpart of the Fund's lending operations, Mr. Anson went on. At present, if a quota increase was backed by members' contributions, members stood ready to provide currency through the encashment of non-interest bearing notes. Under the new concept, it seemed that members would stand ready to accept larger amounts of SDRs up to some agreed limit. In essence, one form of callable capital would be substituted for another. In the one case, surplus countries would accumulate SDRs; in the other, they would acquire SDR-denominated assets in the form of reserve tranches. It was not clear to him what such a process would do to promote the SDR as a reserve asset. Indeed, it might more appropriately follow, rather than precede, steps to make the SDR more attractive to hold. He would be grateful for the staff's views on the matter, particularly on the implications for the Fund's liquidity.

He hoped that the idea of substitution would not be forgotten, Mr. Anson said. He agreed with the staff that, on the basis of experience, it would be difficult to impose substitution from the top. Rather, it should develop in response to a genuine demand for SDR-denominated assets. The staff was rightly cautious in its predictions about the growth of the private SDR. It was possible, however, that greater official use could be made of SDR-denominated assets. After all, national authorities were constantly handling SDR-denominated assets in the form of reserve tranches and loan claims on the Fund. If the SDR and SDR-denominated assets were to become the principal component of reserves, substitution seemed a more worthwhile route to explore than allocation, certainly for incremental reserve assets, and possibly for existing reserve assets as well. He hoped that the staff would consider again whether a substitution account managed by the Fund could have a role to play in a period of instability, as a means of replacing any currency or group of currencies. The account need not be tied to the particular formula worked out in 1979-80, which had been linked to the substitution of one currency only. Another possibility, which he offered on a personal basis purely for consideration, was a substitution scheme in which baskets of the five SDR currencies, in the appropriate proportions, might be converted by members through a Fund substitution account into SDR-denominated claims. Such a scheme might avoid some of the technical difficulties of mismatching and the like that had arisen during consideration of the 1979-80 proposal.

The reappraisal of the role of the SDR should take as its starting point the search for stability, which had been, and continued to be, difficult, Mr. Anson concluded. Proposals for use and development of the SDR and SDR-denominated assets should be judged against that primary objective. Within that framework, priority should be given to taking steps that would improve the SDR's characteristics, although beyond that a number of useful avenues could be explored. He agreed with the staff's conclusion that while the full development of the SDR might be gradual, the Fund should proceed in ways that would not close off options, which might prove more fruitful at a time when greater stability had been achieved and when the SDR might be able to play a larger part in the international monetary system.

Mr. de Vries said that the SDR was a new facility, which had had little time to grow. It "suffers from a lack of infancy, with the added complication that it arose out of the head of a multiplicity of fathers," as Mr. Polak had said at the time of its inception. He pointed to a number of prescriptions specifically designed to limit usability so as to minimize competition with other reserve assets, notably the dollar. There was also the difficulty that the SDR was not widely used by the institution that issued it. If the Fund used SDRs more widely, central banks might be more likely to accept them as a normal means of holding foreign reserves in an unstable world. Like a few other speakers, who had suggested that the idea of the substitution account should be kept alive, he was of the opinion that many problems encountered in the previous study of the idea could be eliminated if substitution were provided for the basket of currencies constituting the SDR.

He had noted Mr. Erb's comments on the difficulties for U.S. monetary policy, if the SDR was to play a predominant or important role in the international monetary system, Mr. de Vries stated. Presumably all Fund members were familiar with similar difficulties in their own monetary policies caused by the predominant role of the dollar in the international monetary system. As the freedom of the United States from outside interference was basically related to the large size of the U.S. economy, and not only to the international role of the dollar, he did not see that a larger role for the SDR would pose a grave threat to the freedom of U.S. monetary policy.

Together with some other Directors, Mr. de Vries went on, he did not agree with the staff that the current instability in the international economy substantially limited the evolution of the SDR.

Mr. Prowse said that he was in agreement with much of what Mr. Anson and Mr. de Vries had said. His comments would be of a preliminary and personal nature. The staff had produced papers of the highest quality, but perhaps in striving for objectivity and neutrality it had given insufficient emphasis to the central issue of whether or not there remained any positive reasons why the SDR should be the principal reserve asset in the international monetary system. Instead of attempting to redefine and examine that objective in the light of current circumstances, the papers tended to fall back on the fact that the Articles of Agreement prescribed such an objective. From the description of the events surrounding the creation of the SDR, it was evident that the SDR now had a different rationale.

An important element of the present rationale was the possibility the SDR provided of changing the composition of reserves in a way that was qualitatively better than simply enlarging borrowed holdings of foreign currencies, Mr. Prowse explained. That provision, however, raised a number of questions and indeed some risks. First, the need for reserves was felt more keenly in conditions in which there was a strong rise in prices and a decline in the value of currency reserves. Allocations of SDRs made in those circumstances could add to inflationary pressures or inflationary expectations more than in other circumstances. Second, efforts to promote the SDR through allocations could lead to some confusion between the role of the Fund and the need for liquidity in the international monetary system. The onus should be on the Fund to demonstrate that the changes that had occurred in the international monetary system over the previous 15 years pointed to the need to promote the SDR as the principal reserve asset before allocations were made.

He shared Mr. Anson's views with regard to the link, Mr. Prowse continued. The argument could be made that the allocation of SDRs could be regarded not so much as a transfer of resources, but as the extension of a line of credit. That argument raised the question, however, of whether raising credit ceilings facilitated resource absorption or merely led to spending that might not be productive. The staff seemed to favor an alternative link, i.e., an allocation of SDRs to the Fund itself, which could be lent to members under conditional arrangements. The staff implied that that would represent a change in the form and not in the extent of the Fund's creation of international liquidity, and that Fund members in surplus would accept SDRs rather than enlarge their reserve position with the Fund. The idea of allocating SDRs to the Fund, and the idea of basing the Fund fully on SDRs, seemed to represent a revival of one of the original concepts of the Fund--of a Fund actually creating international credit--which had been put forward by the U.K. authorities. It represented a move away from what could be called the U.S. concept of the Fund, in which the institution was based on members' contributions of currencies. By proceeding in that direction, the distinction would be blurred between the need for enlarging international liquidity on the one hand, and the need for providing adjustment finance for individual members, on the other. In his view, the distinction should continue to be observed by keeping separate the SDR scheme and the operations of the General Department.

With regard to the substitution account, he believed that it might prove futile to promote the SDR in other than a relatively minor role in official reserves necessitated by transactions with the Fund, unless there could be a deliberate substitution of SDRs for foreign exchange, Mr. Prowse commented. For a substitution account to operate successfully, members would need to accept some international control of the intervention process, and of the whole process of international liquidity creation. He was not sure that Fund members were yet ready for such a situation. Recent experience seemed to point to a lack of general acceptance of effective international control. That acceptance could not be expected while national policies were pulling in different directions.

In present circumstances, a substitution account would add to confusion and to difficulty. The staff's description of the central banks' preferences in the management of reserves was evidence of the difficulty of the substitution concept. As long as the SDR remained a Fund-guaranteed and Fund-controlled asset, it would lack certain practical advantages. It would, for example, tend to be limited in usability, and lack maturity range and anonymity. There were, however, a certain number of steps that could be taken to moderate those limitations.

The staff had suggested that the private use of the SDR would be increased if central banks permitted commercial banks to open SDR-denominated accounts with them, Mr. Prowse noted. In his view, there was no evidence that the private sector needed or indeed wanted such accounts. For the Fund to begin promoting such usage might put the SDR ahead of its present early stage of evolution. It was not evident, for example, that the parceling out of currencies in the particular proportions represented by the private SDR was a perfectly appropriate hedging instrument for commercial purposes except in a very narrow range of cases. The markets themselves would always be able to produce a better hedging instrument for particular cases than the Fund could through a larger fixed SDR basket.

It had to be asked whether in imposing reserve requirements in connection with the SDR, the Fund would be adding to exchange instability, Mr. Prowse said. Obviously, a more significant role for the SDR would require much greater private use; however, the development of private use was an area in which the Fund needed to be accommodating rather than assertive. The pace of development should be determined in the market-place. However, he did not rule out some of the technical improvements that had been discussed in earlier meetings.

Before entering the debate on the relationship between the development of the SDR and stability in the exchange markets, he would await further comments from the staff and from other Executive Directors, Mr. Prowse said.

It was regrettable, Mr. Prowse concluded, that in Chapter 7 of SM/82/107 the staff had not analyzed in greater depth the impact on the SDR of present problems, such as the instability of exchange rates, the weakness of the present dollar-dominated multicurrency reserve system, the difficulties arising from the divergences among the economic policies of major reserve centers, in the general international interest. The most pressing need was for more disciplined domestic policies, and more convergence both in objectives and in policy. Success in that direction would diminish the sources of exchange instability and cut back external deficits to sustainable proportions. It would appear that the SDR did not have a great role to play in achieving those objectives. It was, therefore, of little comfort to consider that if and when there were more stable conditions, the SDR might be capable of more development.

Mr. Senior said that many of the proposals in the staff papers had far-reaching implications and should be the object of further work and discussion. The staff, quite properly, regarded the contention that the

SDR should be the principal financial instrument in the conduct of international economic relations as the central issue for discussion. The SDR had been conceived within the framework of a fixed exchange rate system and the reserve creation mechanism embodied in the gold/dollar standard. Once that system had vanished, the question had arisen concerning what, if any, role the SDR should play in the international monetary system in the post-Bretton Woods era. That question had not yet received a definite answer, and it was to be hoped that some progress in that direction might result from the present discussion. It continued to be the view of his chair that an international monetary system centered on the SDR was the optimum standard for the present decade. A stronger SDR would lead the international monetary system toward a more stable path of reserve creation, thereby facilitating the conduct of trade and financial transactions between countries; and, more important, it would make the attainment of international financial stability easier by distributing the burdens and responsibility of adjustment in a more equitable and symmetrical manner.

To reach a view on the future of the SDR necessarily involved defining the future of the Fund, Mr. Senior continued. Under the Bretton Woods system, the Fund had exercised no direct control over the reserve creation mechanism, although it had retained control over the basic adjustment mechanism of the system and, thereby, had been able to exercise some indirect influence on the growth of reserves and liquidity. With the coming into existence of the floating rate system, the Fund had lost control of adjustment, and its influence on reserve liquidity creation had, in the main, been negligible. The SDR system had originally been devised in the 1960s as a necessary complement in the reserve creation field to the function performed by the Fund in the adjustment field. It was now clear that control over both adjustment and reserve creation in the international monetary system was the very raison d'être for a cooperative, internationally minded body like the Fund. If the Fund was to survive the 1980s, it would have to regain control over the adjustment process and administer it in a symmetrical and equitable manner. The Fund would have to have, at least, some regulatory functions with regard to international liquidity and reserve creation. An SDR system developed along some of the lines proposed by the staff represented one of the few possible courses of action to follow if the Fund was to play its proper role in the international monetary system. One of the most important by-products of the present review of the role of the SDR might be a clear expression of the broad outline of views held by Executive Directors on the future of the Fund.

The different possibilities for enlarging the functions of the SDR within the Fund were extremely interesting and deserved further elaboration, Mr. Senior commented. He attached particular importance to the possibility of extending Fund credit to members in the form of newly issued SDRs rather than through the exchange of members' currencies as under the present Articles. Once SDRs were created through Fund lending, the relationship between that form of SDR creation and SDR allocations would have to be clarified. It might be worth exploring in more detail the characteristics of such a system and the requirement to make it workable in the medium term. To envisage such a system made clear the neutrality of the SDR with respect to the provision of conditional and unconditional liquidity. As the staff had pointed out, the proportion in which the two types of liquidity were provided might be controlled through the choice of allocation or the extension of Fund credit of SDRs as alternative means of issuing SDRs.

He supported those measures aimed at bringing the interest rate on the official SDR more in line with rates on competing assets, as well as increasing the frequency of payment of interest and charges, Mr. Senior said. Such improvements in the financial characteristics of the SDR would broaden its use and acceptability by private transactors. He believed that the liquidity of the SDR would be considerably improved if, in addition, current control mechanisms were relaxed.

The question of whether an international environment characterized by stability in prices and exchange rates was more favorable or not for the evolution of the SDR was misplaced, Mr. Senior argued. The real question was whether a developed SDR system might contribute to a more stable international economy. The major issue was whether there were alternative international monetary standards based on the SDR, which might be more efficient than the current system in attaining external equilibria in members' economies. Even assuming agreement on the need for a more developed SDR system, the progress of the instrument would depend on the confidence placed in it by the international financial community. The development of the SDR depended, in the last resort, on its acceptability as a generalized means of payment by the agents operating within the international community. Stop-and-go policies with regard to SDR creation had not benefited the asset.

One of the main requirements for a means of payment to evolve was the certainty that it would be accepted in discharge of any sort of obligation present or future, Mr. Senior commented. The SDR would be more widely held and more actively used if there were some degree of certainty regarding its future. Since the inception of floating exchange rates, the Fund had issued mixed signals on the probable role to be played by the SDR in the international monetary system. If the SDR was to be converted into a central asset in the system in compliance with the Articles of Agreement, definite and steady action should be taken to that effect; otherwise the Articles of Agreement should be changed to define the real role, if any, of the SDR more clearly.

Mr. Kafka said that he regarded the present seminar discussion as one in a series. The staff papers outlined the history of the SDR and contained some reflections about its future. The present discussion was timely in that the SDR was in a deep crisis and might not survive for much longer in any practical sense. The Executive Board could not give up seeking means to ensure its survival.

In discussing a substitution account, the staff had pointed out that there was no dollar overhang at present and that there had been no destructive reserve shifts, Mr. Kafka noted. Even when those problems had existed, the world appeared to have learned to live with them in a multicurrency reserve system. Nevertheless, the idea of substitution merited a wider justification than the dollar overhang. Substitution could be applied not only to currencies other than the dollar, but also to other types of debt.

In discussing why the SDR had not become a medium of exchange, the staff had remarked that it could not be said that the number of parties holding accounts with the Fund was small, Mr. Kafka commented. It suggested that if central banks allowed commercial banks to open SDR accounts with them, the SDR could function like a medium of exchange. That idea had been put before the Committee of Twenty in the form of the Sangster proposal. The staff considered that there were still too many Fund-imposed restrictions on SDR use. He believed that the Fund could do more to stimulate SDR use, but he recalled that during discussions of the Sangster proposal some warnings had been expressed against the "SDRization" of national economies, and about the risk of difficulties similar to those arising from the "dollarization" of certain economies. That problem merited further exploration.

The Fund's Legal Department should be able to provide some means of making a gradual transformation of the Fund into an institution fully based on SDRs, Mr. Kafka remarked, without a further reform of the Articles of Agreement. He did not share the fears voiced by Mr. Erb that moving the Fund in that direction would lead to a loss of control over international reserve creation. Indeed, there was no control at the moment, and, if more SDRs were created, less reserve borrowing would emerge. However, he shared some of Mr. Anson's doubts about the advantages of moving toward a Fund fully based on SDRs.

The staff's reflections on the SDR in a world of stable currencies and prices was interesting, Mr. Kafka said. He found the concept of a "hard" SDR rather frightening, however; combined with SDRization of national economies, would a hard SDR not ensure long-term stagnation? In any event, stability would not be the death of the SDR, which had other merits than providing a hedge against currency fluctuations.

He would have preferred to have seen Part II of SM/82/107 organized more aggressively around three functions of the SDR and the relations among them, namely, the SDR as a hedge, the SDR as a supplement to international reserves, and the SDR as world money to be held and used by private parties, Mr. Kafka concluded. The present discussion was but a stage in a wider discussion, with which the Executive Board should press ahead as rapidly as possible. He agreed strongly with Mr. Nimatallah that international monetary reform and the role of the Fund in it had once again to be thought of actively. The place for such considerations was within the Fund; he hoped that the Executive Board would not be caught short by others in that endeavor.

Mr Hirao remarked that, since its introduction into the international monetary system, the SDR had evolved steadily and grown more attractive as a reserve asset. The SDR had been improved and had changed as the international monetary system had changed from the Bretton Woods arrangements to the present open-ended multiple currency system. The improvements, which had contributed greatly to enhancing the attractiveness of the SDR, included the simplification of the valuation basket, the raising of the interest rate to the full combined interest market rate, and the abrogation of the reconstitution requirement. More recently, the simplification of the valuation basket had sharply stimulated private dealings in SDR-denominated assets and a rapid growth of the "SDR family." Indeed, the SDR, as a unit of account, had now come to play a much more central role than ever before. Although the use of the SDR to denominate international assets had remained limited in the private sector--because such use had virtually begun only 18 months before--there seemed to be favorable prospects for an appreciable increase in the future. The main prerequisite of that increase would be stability in the value of the SDR, and confidence in it as a reserve asset. In consequence, the steady evolution of the SDR as a more attractive reserve asset was important not only for its own sake, but also as a means of strengthening the whole "SDR family."

While it was important to maintain the basic principles regarding valuation and other fundamentals, there seemed to be a number of areas in which further improvements could be pursued, Mr. Hirao observed. Such improvements could perhaps be introduced in a gradual manner, in line with institutional developments in the financial market of the member countries. The same applied to the evolution of the SDR outside the Fund. He believed that an evolution of the SDR responding to developments in the financial market would best serve the SDR's long-term interests. He endorsed, therefore, the steady and pragmatic approach to enhancing the role of the SDR.

The staff had recognized two important changes that had taken place since the inception of the SDR, Mr. Hirao noted. First was the emergence of flexible exchange rates. The abandonment of the fixed rate system had required a reappraisal of the role of the SDR, because it had relieved the monetary authorities, to some extent, from relying heavily on external reserve assets in the adjustment process. Second was the rapid growth of international capital markets. Increased reliance on borrowing in those markets had reduced the need for owned reserves. Such changes made necessary a review of the concept of "international liquidity." In that regard, the memoranda prepared by Mr. Erb (EBD/81/326, 6/16/81) and by Mr. Polak (EBD/82/2, 1/6/82) seemed to provide interesting issues for future discussions. Mr. Erb had made the point that the concept of international liquidity had become quite ambiguous in light of the evolution of international financial relations during the previous decade. Mr. Polak had raised pertinent points about the measurement of the need for international reserves. He hoped that the staff might present further views on those two stimulating memoranda. A complete rethinking about the need for international liquidity would be necessary for a better understanding of the working of the present international monetary system and of the role of the SDR within it.

There could well be some incompatibility between the two main objectives of the present SDR system, Mr. Hirao continued. The first objective was that the SDR should be made the principal reserve asset in the international monetary system. The second objective was that the SDR should be created and allocated for supplementing reserves when there was a global need. As to the first objective, it was of vital importance to maintain and enhance confidence in the SDR. For that purpose, strict discipline would need to be observed when a decision was made on a new allocation of SDRs. On the other hand, in order to attain the second objective, additional SDRs would need to be created through new allocations when there was a long-term global need for additional liquidity. However, the assessment of global liquidity need had become more complex and ambiguous for the reasons stated by Mr. Erb. That situation was likely to continue, unless some convincing solutions to current problems were offered.

The staff had suggested that the Fund's operations could be based largely or entirely on the SDR, and that Fund credit could be extended to members in the form of newly issued SDRs, Mr. Hirao noted. The idea was an interesting one and perhaps deserved further consideration. It would probably enhance the use of SDRs, as well as perhaps helping to maintain an appropriate balance between conditional and unconditional liquidity. On the other hand, the scheme would most likely involve the considerable task of amending the present Articles of Agreement. Furthermore, the suggested system, in which members would not be obliged to pay in their currencies or SDRs at the time of the quota increases, might affect the character of the Fund as a quota-based cooperative institution. The liquidity and income positions of the Fund would also need to be examined, since they would probably be quite different from those under the present system.

The staff contended that stability of prices and exchange rates provided a more favorable climate for the evolution of the SDR than did conditions of instability, Mr. Hirao observed. He tended to agree with that analysis; however, it might be argued that with the advent of the flexible exchange rate system, the currency composition of reserve portfolios had been diversified, leading to increased use of the SDR. A number of factors other than exchange stability might also influence the evolution of the SDR.

Mr. Caranicas remarked that the present review of a number of fundamental and complex issues regarding the SDR was necessary to obtain a better perspective of possible future developments. While Part I of SM/82/107, which dealt with the evolution of the SDR and its adaptation to the changing needs of the international community, provided a useful historical survey, it was perhaps rather too long in comparison with the second, and most interesting, part of the paper, on possible future developments. Overall, however, the paper established an excellent framework in which to ponder past developments and their implications for the SDR. Too often, given the complexities of the questions involved, the debate tended to lose sight of previous developments and deliberations. It had been argued in the past that the present situation did not appear conducive to radical change in the international monetary system, or non-system. A few of the proposals and considerations contained in the staff papers did however appear to be feasible under the current Articles of Agreement and deserved close scrutiny by the Executive Board.

The objective of making the SDR the principal asset of the system derived its rationale from two of the principal characteristics of the asset: namely, its multilateral and cooperative nature, and the stabilizing role that it played by being based on a basket of currencies, Mr. Caranicas continued. One of the major elements necessary to fulfill that role was for it to gain widespread acceptance among both official and commercial entities as a medium of transaction. In that connection it would seem important that the Fund should act as a promoter of that enhanced role. The discussion on possible improvements in the use of SDRs at EBM/82/78 (6/7/82) represented a step in the right direction.

He had been favorably impressed by the proposal that 25 per cent of the subscription payment for a future increase in quotas should be paid in SDRs, and that a special allocation of SDRs should be made to make such payments possible, Mr. Caranicas remarked. The main objection that might be advanced against the proposal was that it might increase unconditional liquidity. However, if it was still felt that current world conditions did not warrant such an increase, ways could be explored to sterilize it. It might be possible, for example, to change the definition of the reserve tranche, so that it would not include the part generated by the allocation of SDRs. In that way the Fund would be able to expand the use of SDRs, without increasing the amount of unconditional liquidity in the system. A movement toward basing all Fund drawings on SDRs would undoubtedly strengthen the role of the asset, once again without increasing unconditional liquidity. In that respect, he agreed with the staff that SDRs per se were "neutral," as far as the distribution of world liquidity between conditional and unconditional components was concerned. However, since the present Articles of Agreement were incompatible with the introduction of a radically new Fund asset, he wondered whether it would be realistic to expect implementation of such a broad-ranging reform in the foreseeable future, particularly at a time when a general review of quotas was under way. However, he had an open mind on the issue and would be ready to proceed with a discussion of it should the Executive Board so wish.

He had some doubts about the wisdom of encouraging central banks to open SDR-denominated accounts with commercial banks in order to facilitate the growth of commercial SDRs, Mr. Caranicas continued. Opening such "domestic substitution accounts" might not be well received by countries maintaining controls on international capital movements; the authorities of such countries might see the opening of such accounts as impairing their control. Opening such accounts might be more feasible in countries that were hosts to major Eurocurrency banks.

The staff offered no conclusion on whether the SDR would have an enhanced or reduced role in a more orderly and stable commercial and financial international environment, Mr. Caranicas noted. Perhaps no definite conclusion could be drawn; but he would have liked to have seen a more in-depth discussion of the relevant issues. There was merit in the argument that unsettled exchange rate conditions made more attractive the development of a currency instrument capable of dampening exchange rate fluctuations. The growth of the SDR, under orderly conditions, might in fact depend on a commitment from the international community to foster its use. Unfortunately, stable market conditions were not yet around the corner, and the question was, therefore, rather academic. Finally, he agreed with the staff that no options with regard to the future role of the SDR should be closed, even though the present international environment was not conducive to full development of the SDR.

Mr. de Maulde remarked that the SDR scheme had been created in an effort to bring about a higher degree of international monetary cooperation and policy coordination, in response to the problem of providing international liquidity that had been perceived in the 1960s and early 1970s. Since that time, the growth of international banking activities and the greater integration of financial markets had provided a solution to that problem. Indeed the succession of events since that period--the changes in valuation of the U.S. dollar, increasing currency flows, the surge of inflation in 1971-73, the upheaval in balance of payments patterns following the first oil shock--had completely changed the preoccupations of the previous period. It was now clear that the SDR scheme could survive only if it could be demonstrated that it could usefully serve a clear and worthwhile purpose other than that of adding to international liquidity.

One of those purposes could be to link the SDR to development, Mr. de Maulde continued. It was clear, however, that there was no consensus on that subject. Another possible purpose for the SDR could be to contribute to a greater stability of exchange rates and, as a consequence, to better trade and financial relations in the world. The comments made by previous speakers about the role of the SDR in the multicurrency monetary system had evoked once again some hope for better cooperation between authorities. More time was needed to reflect on the role of the SDR in that regard.

The general idea that the contribution of the SDR to stability could be enhanced by wider acceptance as a public as well as private financial asset had some appeal, Mr. de Maulde said. A number of limitations continued to prevent the development of the use of the SDR by official or private institutions, and some adaptations could well be envisaged. He hoped that the proposals in SM/82/92 could define the framework for future progress. More progress could also be made in linking the creation of SDRs to Fund credit. The idea of allocating SDRs in a given proportion to future subscription payments in connection with quota increases deserved consideration as well. Such a procedure would obviously remove one of the main objections raised about the decision to allocate new SDRs, since the allocations would be tied to the use of conditional resources, and therefore to the implementation of an adequate degree of adjustment, in borrowing countries. Conversely, he was not convinced of the merits of the proposal to require no payment of SDRs or even foreign currencies to the Fund on the occasion of further quota increases. He feared that the extension of credit by the Fund would be viewed as essentially inflationary; he wondered to what extent such a perception might damage the credibility of the SDR as an international asset. If an inflationary label could be attached to such operations at times of price instability, the Fund might be inhibited in its lending attitude and compelled to restrain its volume of operations.

It could be asked whether the Fund had gone far enough in making the SDR more acceptable to private financial intermediaries, Mr. de Maulde continued. He would advocate caution in that field. Proposals such as those for computing the rate of the SDR on a monthly or even daily basis might be counterproductive at times of extreme variability of interest rates or exchange rates. In fact, he shared the feelings of Mr. Prowse on that subject: the promotion of SDR use by private institutions, desirable as it might be, was largely out of the hands of the Fund itself, and the Fund would probably find it difficult to go much beyond the simplification to the valuation basket introduced in 1980. That simplification had probably been an essential condition of the acceptance of the SDR by private institutions. Experience thus far indicated, however, that the development of the commercial SDR had been disappointingly slow, despite the apparent potential of the instrument in facilitating international transactions and portfolio management.

Many reasons could be put forward to explain the slow response of the private markets to a wider use of the SDR, Mr. de Maulde considered. In fact, the most important was essentially conjectural in nature. It derived from the strength of the U.S. dollar and even more from the level of remuneration associated with the holding of dollar-denominated assets. The attractiveness of the dollar had seriously reduced the attractiveness of currency diversification provided by a five-currency basket. If such a situation were reversed, it could at least be expected that the advantage of assets providing a degree of stability, such as the SDR, would lead to a rapid expansion in the use of the instrument.

The attractiveness of the proposal that national authorities should play an intermediary role between official and commercial SDRs, and especially that central banks should accept SDR-denominated deposits from commercial banks, would vary depending on specific situations in the countries concerned, the importance of their own currency as a reserve asset, and the importance of foreign assets held abroad by residents, Mr. de Maulde remarked. Tentatively, he suspected that central banks might well find that the inconveniences of such an arrangement could well exceed the possible advantages. In conclusion, he agreed with all efforts designed to improve the liquidity of the SDR. However, like Mr. Anson, he believed that no steps should be taken that might prove incompatible with a future enlarged role for the SDR, although, even at the present time, that future was still ill defined.

Mr. Winkelmann said that he had found the staff's analysis of the history of the SDR to be interesting. He found it difficult to see the SDR serving both as a supplement for reserve creation and as a promoter of stability in international monetary relations. At present national markets were increasingly dependent on international markets; and, vice versa, domestic policies in the United States with regard to the U.S. dollar had a powerful influence on other markets. National and international monetary capital markets were becoming increasingly interlinked, and new instruments involving new maturities were emerging. It seemed, therefore, that the struggle fought in the 1940s and 1950s to establish an instrument that would dominate the international monetary system, while creating stability and providing liquidity, had been lost. The role of the SDR in providing liquidity had also gone, and it would be wrong to conceive of bringing it back by insisting on a fixed relationship between international liquidity and SDR allocation. International monetary flows were increasing so rapidly at present that the need for some international control was becoming ever more apparent. Economic unions such as the European Community had found it extremely difficult to work toward monetary union and or even to establish arrangements for permanent consultation between central banks and the exchange markets.

The question was sometimes posed of whether the international monetary system could function without the SDR, Mr. Winkelmann noted. The answer was of course "yes," but it should be asked in turn why the SDR should be done away with, now that it had been created. In a more stable international monetary situation with stable exchange rates and inflation under control, would the SDR's role as supplier of international liquidity become more important? International liquidity would continue to grow, so that, even when stable international monetary conditions existed, countries would look on the SDR's role as a supplier of liquidity differently from the way in which they had in the 1960s. Nevertheless, the SDR should continue to grow in importance. It played a role not only within the Fund but also in many relationships in the financial field. Perhaps additional roles would be found for the SDR in the future.

The discussions on a substitution account had shown that there had been some interest in it; but that it had proved difficult to create an instrument designed to bring about the mandatory conversion of national currencies serving as international means of exchange into another asset, Mr. Winkelmann recalled. It might be interesting to discuss a substitution account once again and to broaden the frame of reference to include more than one currency and different kinds of debt. A broader substitution account might be more attractive, but it might also give rise to more difficulties. Certainly, questions with regard to the value of the capital invested and interest rates would not be solved easily. If there was no risk for the depositors, there would have to be some risk for the investors. He saw no clear solution to such problems at present.

The development of the commercial SDR should be considered carefully, Mr. Winkelmann advised. He could see no need at the moment to promote the commercial SDR; on the contrary, it might hamper the development of the SDR. The official role of the SDR should first be enlarged. Many possible further improvements of the SDR had been identified. With regard to the proposal that there should be an SDR allocation to permit countries to make subscription payments in part in SDRs at the time of a future quota increase, SDR creation should always be governed by the criterion of global need, as specified in the Articles of Agreement.

If the SDR was to be made the principal reserve asset of the system, an argument could be made for using the SDR more in the Fund's activities, Mr. Winkelmann said. On the other hand, nothing should be done to impair the smooth functioning of the Fund, and no difficulty should be created in relations with central banks. The idea of basing the Fund's operations more on the SDR should be discussed further. Finally, he hoped that the qualities of the SDR would continue to be refined in the future. He looked forward to examining more closely ideas for basing the activities of the Fund more completely on the SDR.

Mr. Kharmawan said that in studying the staff's analysis of the evolving role of the SDR, he had wished for a clearer description of a framework within which the role of the SDR should be considered. Was it the objective of the Fund to promote an international monetary system in which the SDR would be a means of international payment alongside other national currencies? Would there be merit in inserting the SDR for that purpose in the present international monetary system? Would it contribute to a better functioning of the system or not? Was it possible to conceive of an alternative framework in which the SDR could play a more limited, although important, role in the international monetary system? Would it be possible to have a system in which the role of the SDR was limited to being a reserve asset, albeit a better monetary reserve than the existing national currencies? Basic questions about the framework needed to be answered before trying to determine how the SDR could be improved. It was, in fact, difficult to comment on the proposals made by the staff in SM/82/107 without knowing what type of international monetary system was envisaged.

The SDR had been conceived as a means of supplementing a shortage of international liquidity, Mr. Kharmawan recalled. However, by the time that Fund members had finally agreed to create the SDR, international liquidity had been provided through other sources. Might it not have been wiser at the time of the creation of the SDR to have agreed to put the SDR scheme into cold storage and to implement it only at a later date when the need for international liquidity became more apparent? That course of action had not been followed, and in the Second Amendment of the Articles of Agreement it had been stated that SDR allocations should be made to provide more liquidity. At present, however, many countries argued that there was no shortage of liquidity and that SDR allocations were unnecessary. In the circumstances, it was difficult to say in which direction the Fund should proceed. It was for that reason that a frame of reference was needed.

The staff had proposed that SDRs should be created to provide resources to countries asking for Fund assistance, Mr. Kharmawan noted. If that proposal were taken up, would he be correct in understanding that there would be no further need for an operational budget? If there was no operational budget because currencies were not being provided to countries in need of Fund resources, would he be correct in thinking that there would be no reserve positions in the Fund and no remuneration, and that everything would be provided in the form of SDRs? In that case, would countries coming to the Fund for assistance have to pay a higher interest rate on the SDR? If so, what would be the reaction of the debtor countries needing to pay such higher charges? The creditor countries might be willing to accept such a system, because the problem of a difference between providing currency and accepting SDRs would be eliminated. If such a course of action were followed, would it be consistent with promoting the SDR as an international means of payment and with making the SDR play a larger role in the composition of reserves?

The SDR scheme seemed to have much in common with the buffer stock financing facility and the compensatory financing facility, both of which had been accepted by the Fund, but without great enthusiasm, Mr. Kharmawan said. In each case it could be argued that the Fund did not have the courage to say that the facility should be terminated. However, it was essential for the Fund to come to grips with reality and to state whether it was worthwhile continuing to search for the most appropriate role for the SDR. According to the staff, it would be easier to introduce the SDR into the international monetary system in conditions of stability. He wondered, however, whether there would be much acceptance for a new element in the international monetary system if stable conditions prevailed. The general tendency was to make changes designed to make an unstable situation more stable. If the situation had already stabilized, the motivation for change was less strong. Finally, it could be asked whether, if the SDR was really dying, it should be prevented from dying in peace.

The Executive Directors agreed to continue their discussion of the evolving role of the SDR in the international monetary system in the afternoon.

LEO VAN HOUTVEN
Secretary