INTERNATIONAL MONETARY FUND

Minutes of Executive Board Seminar 82/6

3:00 p.m., July 2, 1982

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

Executive Directors	Alternate Executive Directors
	A. Yasseri, Temporary
	E. M. Ainley, Temporary
	S. E. Conrado, Temporary
	L. E. J. Coene, Temporary
	A. Le Lorier
	T. A. Connors, Temporary
	T. Alhaimus
T. Hirao	T. Yamashita
J. C. Iarezza	R. T. Salazar
R. K. Joyce	
A. Kafka	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
	F. Sangare
	G. Winkelmann
	C. P. Caranicas
	A. B. Diao, Temporary
	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
	T. de Vries
	B. Legarda
J. Sigurdsson	
	Tai Q.

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

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Also Present

Asian Department: R. C. Baban. Exchange and Trade Relations Department: K. B. Dillon. External Relations Department: P. de Fontnouvelle. Legal Department: G. P. Nicoletopoulos, Director; R. C. Effros, Ph. Lachman, 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; 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. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, M. A. Janjua, K. V. Jännäri, G. Jauregui, P. Kohnert, P. D. Peroz, F. Yeo T. Y. Assistants to Executive Directors: R. J. J. Costa, A. Halevi, J. M. Jones, M. J. Kooymans, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, E. Portas, D. V. Pritchett, J. Reddy, D. I. S. Shaw, H. Suzuki, A. A. Yousef.

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

The Executive Directors continued from the previous discussion (EB/Seminar/82/5, 7/2/82) their consideration of 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 the evolution of the SDR outside the Fund (SM/82/93, 5/10/82) as well as a survey of the relationship between special drawing rights and plans for reform of the international monetary system (DM/82/23, 4/14/82).

Mr. Sigurdsson remarked that the retrospective survey of developments and discussions that had been referred to in the staff papers provided a valuable framework for consideration of the way in which the role of the SDR could usefully be broadened. On the other hand, based on the outline that had been submitted to the Board in December 1981, he had expected more definite proposals for action than had been incorporated in the main staff paper under discussion.

Taking up the issues suggested for discussion in Chapter VIII of SM/82/107, Mr. Sigurdsson noted, first, that his chair continued to support efforts to give substance to the objective of making the SDR the principal reserve asset of the international monetary system. Still, he recognized that those efforts must be related realistically to the evolution of international liquidity, and he joined Mr. Hirao in asking the staff to comment on the questions raised by Mr. Erb and Mr. Polak in their exchange of memoranda in late 1981 on the concept of international liquidity. With respect to the second discussion item, the twin objectives defined for the SDR of facilitating trade and transactions among countries and safeguarding international financial stability both seemed appropriate.

The third question was that of increasing the Fund's use of SDRs in its own activities, Mr. Sigurdsson observed. Additional use would bring the characteristics of the SDR closer to that of other currencies and would help the Fund to move away from the somewhat artificial and cumbersome method of allocation and cancellation. He would be interested in seeing a more detailed study of the ideas developed in the staff paper on issuing SDRs for conditional Fund lending in support of adjustment programs, although he noted that the effect on liquidity of SDR creation through that mechanism would have to be carefully analyzed. On the fourth point, he agreed with the staff that the "correct" balance between conditional and unconditional liquidity created by the Fund would depend on world economic conditions. The appropriate proportions should thus be determined from time to time rather than rigorously fixed.

The fifth issue for discussion was particularly important, Mr. Sigurdsson continued. Recent improvements in the characteristics of the SDR had, as noted by the staff, "set the SDR on a course that led from the protected administrative environment of its creation to the threshold of the open market." That course should be maintained, and the suggestions in SM/82/92 for further improvements in the SDR should be followed with the aim of creating a situation in which designation procedures and acceptance limits would no longer be needed. He agreed with Mr. Anson that a financially more attractive SDR was a prerequisite for any increase in SDR transactions by public and private entities, and he looked forward to specific proposals directed toward that goal. He also agreed with the idea (point 6) that the existence of international banking in and of itself should improve rather than worsen the prospects for purely international money.

Under points 7 and 8 of the suggested topics for discussion, the staff had contended that stability of prices and exchange rates would provide a more favorable climate for the evolution of the SDR than conditions of instability, Mr. Sigurdsson observed. Like Mr. de Vries and Mr. Prowse, he considered that hypothesis unproven. While he found the staff's analysis to be interesting and agreed that private transactors would presumably always be in a position to define more precise "hedges" than the SDR could provide for their particular needs, their actions did not seem to be inherently related to the presence of instability but rather to the specific nature of the individual transactions. The staff seemed to be suggesting that, if all were well in the world, the SDR could have a better existence. In his view, the SDR deserved better; the Fund should not wait for the perfect solution but should actively adopt a more pragmatic approach and work toward improvement.

He agreed entirely with the thoughts expressed in points 9 and 10, Mr. Sigurdsson commented. A financially attractive SDR should be developed, and the establishment of the SDR system should not be made dependent on more temporary requirements. Moreover, care should be taken not to close the door on any of the options for the development of the role of the SDR even though the opportunity for exercising them might not be particularly favorable at present. In that connection, he joined Mr. Anson in stressing that Directors should not lose sight of the general concept of a substitution mechanism.

In conclusion, Mr. Sigurdsson commented, it might be useful if the staff could provide a sharply focused comparative study of the characteristics and implications of the three broad methods for creating or generating SDRs, namely, allocation, substitution, and issuance through the Fund's financial operations.

Mr. Joyce remarked that the staff paper was a timely and well-balanced presentation of the events surrounding the introduction of the SDR and its evolution through the 1970s, and he had read with interest the provocative comments in Part II, which looked toward further opportunities for broadening the role of the SDR and for finding ways in which it might be adapted to meet changing needs. In that connection, he agreed with the staff that it was useful to try to assess possible future developments in the international monetary system with a view to identifying ways in which the SDR might ideally evolve over the longer term.

He had few comments on Part I of the staff paper, Mr. Joyce continued, although he had found it interesting that, with changing circumstances in the world, there had come about a basic evolution in thinking with respect to the role of the SDR. It was of course understandable in the circumstances that attitudes about the need for an enhanced role for the SDR had been modified in recent years, since the world was perhaps currently somewhat wiser and more realistic about the progress that could be made. Nonetheless, he hoped that the commitment to the development of the SDR would remain firm. Certainly, all the countries that he represented continued to support the further evolution of the SDR as a reserve asset. They believed that, even if it was not possible in present circumstances to make dramatic progress, the Fund should not hesitate to examine further ways of improving the quality of the SDR as a reserve instrument or even of making further changes in the system itself.

He was not so much in agreement with the staff that the SDR might win greater acceptance in more stable economic circumstances, Mr. Joyce said. Indeed, it might be argued that the return of exchange rate stability would reduce the desire to denominate assets and liabilities in a composite unit of account such as the SDR. He was inclined to share the view of Mr. de Vries and others that the acceptance of the SDR had less to do with stability or instability than with whether or not the qualities of the instrument had matured sufficiently to make it attractive on its own without the scaffolding of designation and acceptance limits.

Clearly, the SDR had a long way to go before it became an important reserve asset or began to play a major role in the private markets, Mr. Joyce remarked. While the Fund should do what it could to encourage the use of the SDR in private markets, the immediate priority should be to find ways of increasing the role of the SDR in the activities of the Fund itself and in dealings between the monetary authorities of members.

He had no trouble in principle with the suggestion that members might be asked to make part of their payment of any quota increase in SDRs, Mr. Joyce said; indeed, he had supported that suggestion in earlier discussions. However, he recognized that, if the proportion were to go as high as 25 per cent, existing stocks of SDRs in the system might be inadequate. If new allocations were required to make up the difference, they might be of a magnitude far greater than any annual allocations thus far considered and certainly larger than the sort of modest allocation of SDRs that his authorities had been supporting. As the Minister of one of his countries had said in Helsinki, an SDR allocation of such a magnitude and for such purposes would be difficult to justify on liquidity grounds. He was also concerned that the need for prior agreement to proceed with the staff suggestions could easily lead to greater pressures for exceptionally large quota increases as well as to greater resistance to selective quota increases.

Like others, he found interesting the suggestion that Fund credit might be extended to members in the form of newly issued SDRs, with provision for cancellation of repayment or repurchase, Mr. Joyce commented.

He was not yet clear about all the implications that such a change would have for the operations of the Fund and its liquidity or even for global liquidity in the international monetary system; nonetheless, the suggestion merited further investigation and discussion.

He did not accept the suggestion on page 56 of the paper that, if the major countries succeeded in stabilizing their domestic price levels and bringing about more stable international conditions, they and others might then return to a system of fixed parities and SDR pegs, Mr. Joyce remarked. Whatever problems had been faced in the previous few years, he saw no reason for believing that the world would currently be in any better position if it had operated under a fixed-rate system. Nor was it clear that, even with much more stable conditions, the world would now be better off if it shackled itself with a system of fixed parities, thus losing the degree of flexibility available under floating rates. It was not the floating rate system that had been at fault in recent years; it was the world's failure to manage the system and to ensure coordination of economic policies by the main players. It was for that reason that he welcomed the proposals that had emerged from the Versailles summit meeting encouraging more active consultations among key countries on international economic questions.

Mr. Sangare remarked that the matter of the SDR had engaged the particular attention of most Executive Directors since January 1982, when the fourth basic period had begun without a new allocation. He hoped that the staff papers under discussion and the views that they elicited would go some way toward clarifying what role the SDR should play in the international monetary system. The staff had lucidly described the events leading up to the establishment of the SDR and its evolution since that time, and had pondered on its possible future.

The staff had rightly perceived that the SDR was the appropriate principal instrument to be used in the conduct of international financial relations, Mr. Sangare continued. That idea logically flowed from the Articles of Agreement, which envisaged that the SDR would develop into the principal reserve asset of the system. However, that laudable objective could not be achieved unless conscious efforts were made gradually to adapt the SDR, which at present was the only international financial instrument created through the fiat of the entire international community. If properly developed, the SDR could offer the best approach to safeguarding international financial stability and, provided that there was an adequate supply of the asset, to facilitating the conduct of trade and financial transactions.

He agreed with the staff that international financial relations, to the extent that they were conducted through the Fund, could be simplified by basing the Fund's activities largely or wholly on the SDR with Fund credit to members in the form of newly issued SDRs instead of in members' currencies as at present, Mr. Sangare noted. SDRs issued in that connection would complement those issued and allocated directly to members on other occasions, and the concern about SDR allocations increasing members' unconditional liquidity would thereby be reduced. The proportion in which unconditional and conditional SDRs should be provided depended on developments in the international monetary system, although specific guidelines for their creation should be established so that further allocations could not be blocked at the whim of a few members. For example, agreement might be reached on the share of SDRs in total reserve growth annually as a way of preventing any accretion to global reserves from taking the form of an unmitigated growth in the supply of national currencies or private capital markets from becoming major suppliers of reserves, all at the expense of new SDR creation.

He could fully support the idea of further improvements in the characteristics of the SDR along the lines suggested in the paper, Mr. Sangare continued. While such improvements would further enhance the prospects of SDR-denominated instruments, the primary objective should be to promote the attractiveness of the official SDR rather than the commercial SDR. Of course, what happened to the official SDR could affect the fortunes of the private SDR, although it was difficult to see how improvements in the SDR could bring about the desired objective of making it the principal reserve asset in the international monetary system if the quantity of SDRs in existence remained at the present low level. He hoped that the exchange of views on the role of the SDR in the international monetary system would help Directors to appreciate the need for further SDR allocations. Finally, the fact that the SDR had been established at a time when par values had existed did not mean that it had no role to play in the current situation of floating exchange rates. If anything, the SDR as a currency "cocktail" became more relevant under conditions of instability in foreign exchange markets. Nor was he convinced that currency instability made SDR allocations any less important. Whether or not floating rates reduced the demand for reserves had not been demonstrated by recent experience; certainly, floating rates had not reduced developing countries' demand for reserves.

Mr. Coene remarked that the main line of thinking in the staff paper seemed to be that, since it was difficult under the present system of floating exchange rates and integrated money markets to quantify international liquidity needs, the SDR could play only a limited role; and that only the return of more stable exchange rate relationships involving asset settlement and the possibility of quantifying liquidity needs could expand the official role of the SDR. In the meantime, the characteristics of the SDR should be improved to enhance its use. Supply conditions for international liquidity had changed, making quantitative considerations regarding SDR allocations less relevant; but he wondered whether qualitative considerations--such as the objective of making the volume of international liquidity less dependent on domestic policy and exchange rate considerations--were still not valid and sufficient reasons for a further expansion of the role of the SDR.

The staff had underlined various advantages associated with SDR creation as an addition to reserves, and making the SDR the principal reserve asset of the system could still be a worldwide objective, Mr. Coene continued. The domestic objectives underlying economic policy in particular countries were not necessarily compatible with objectives of the membership as a whole. The drawbacks of the existing system seemed particularly evident in present circumstances, in which conditions in the U.S. financial markets had strong repercussions on the availability of international liquidity. The SDR could not become the principal reserve asset of the system through the pressure of outside forces alone or through development of the commercial SDR; the proportion of SDRs to other reserve assets would have to increase, something that would be achieved by increasing the share of SDRs in international liquidity, either through an allocation of SDRs or through the substitution of SDR-denominated assets for existing reserve assets. Such an arrangement would at least impose a constraint on major reserve currencies, since inappropriate policies would be sanctioned by a transfer from the currency to the SDR.

Even if it could be accepted that the supply of reserves had become elastic and adaptable to a demand determined by prevailing conditions, it was still unclear how an additional supply of SDRs would lead to increased demand, since the cost of using SDRs was similar to the cost of using other reserves, Mr. Coene observed. Hence, only the composition of reserves would change; total volume would be affected only marginally. Of course, allocations need not only provide unconditional liquidity; they could also be used to provide conditional liquidity by financing Fund adjustment programs. The Fund could then adjust the mix between conditional and unconditional liquidity creation as a function of world economic conditions. The case for using such allocations to provide conditional liquidity might be particularly persuasive if there was concern over the inflationary effect of direct allocations. By providing the additional liquidity only in support of an adjustment program, the Fund would be helping countries to achieve more stable economic conditions, which could lead to stability in exchange rates. Since it would be important to avoid the creation of two separate SDRs under such a system, the rate of charge to be applied to drawings should be the SDR interest rate. Certainly, further work on the matter would be worthwhile, within the limits of the existing Articles of Agreement.

The problem of assigning a role to the SDR in a world in which it was difficult to control or separate the creation of national and international liquidity had led to calls for more coordination in economic policy formulation, particularly among the major economies, Mr. Coene noted. While the SDR, as a basket, might be a response to exchange rate instability, it did not remove or address the causes of instability. Moreover, while greater economic coordination remained an important objective, substantial progress in that area was unlikely in the immediate future. It would not therefore be appropriate to arrive at the conclusion that the discussion of the role of the SDR should be suppressed pending the appearance of more appropriate conditions for its further development through allocations, substitution, or conditional lending. The characteristics of the SDR should be improved in ways that would lead to more positive evolution of the asset as a monetary instrument, a more active use of official SDRs, and a further promotion of private SDRs. More active use by the Fund and member countries in a broader market would reduce the need for control mechanisms, such as designation procedures and acceptance limits, and should foster the role of the SDR as the principal reserve asset of the system.

Mr. Iarezza said that, like others, he believed that the case for the use of SDRs was as valid at present as it had been at the moment of its creation. There were several reasons why the change from a system based mainly on one reserve currency to a multicurrency reserve system had not lessened the need to continue promoting the SDR. First, as noted by Mr. Anson, it was unclear whether one could even speak of the existence of a multicurrency system, given the key role that the U.S. dollar continued to play. Second, the objective of obtaining a better control and steadier growth of international reserves would be better served through greater reliance on SDRs. Third, a multicurrency reserve system would be vulnerable to shifts among currencies--of the sort witnessed in recent years--in response to varying conditions and policies. Those shifts would raise the risk of instability and, hence, give added impetus to the need for the SDR as an alternative form in which money and reserves might be held in a stable environment.

The second major change that had taken place since the creation of the SDR--namely, the better integration and development of international capital markets--also failed to change his mind about the usefulness of the SDR, Mr. Iarezza continued. Even if such changes provided nonreserve countries with the opportunity to create reserves through increased indebtedness, the effect would be to switch seignorage rights to international banks and leave them with the decisions about costs and the limits of reserve creation. As had been seen in the previous week, those decisions were not always rational; in any case, they did not solve the problem for countries that lacked access to capital markets. Moreover, the integration and development of international capital markets had increased the amount of existing short-term capital and created the potential for overreaction in the face of perceived exchange rate movements, thus increasing the volatility of exchange rates.

The only difference between the present system of international reserves and that in existence when the SDR had been created was that the present system was more demand oriented, Mr. Iarezza remarked. In the circumstances, the effort should be to focus not so much on reserve shortages as on improving the composition of reserves and, in that light, the Fund should continue its efforts toward making the SDR the principal reserve asset of the system. It was important to reaffirm clearly that there was in fact a desire to continue along the path of promoting the SDR as the principal reserve asset of the system. If that were so, he could not share the view of the staff that, in the present system of unstable exchange rates, there was less room for the SDR. A greater reliance on the SDR should help in the effort to move toward a more stable system. Moreover, if the SDR were to be less acceptable in the present environment, an effort should be made to increase its yield, with the ultimate objective of making it totally market oriented.

The staff proposals to use SDRs for payment of quota subscriptions and to base the Fund more fully on SDRs through the issuance of newly created SDRs for conditional lending--coupled with continued SDR allocations and/or the creation of special lines of unconditonal borrowing--should all be explored further, Mr. Iarezza concluded. In the meantime, he supported the statement in the final paragraph of the staff report that "care should be taken not to limit or close options that it might be desirable to exercise more fully when better opportunities to develop the role of the SDR are available." One important way to fulfill the aim of that paragraph would be to reach prompt agreement on a new SDR allocation, or at least to prevent the share of SDRs from being reduced; because if the Fund continued to signal the markets that it was not interested in increasing the importance of the SDR in the system, present and future discussions on the role of the SDR would be purely theoretical. By the time agreement was reached about what to do with the SDR, it might be too late to revive the asset.

Mr. Jayawardena considered it important to bear in mind that the Fund, the World Bank, and the SDR were all shining examples of international cooperation. The SDR had been created to meet the need for increases in international liquidity on a discretionary basis in order to promote stable financial conditions and international trade. It had been designed to prevent countries from undertaking counterproductive policies that were detrimental to the smooth functioning of the system and to promote orderly adjustment and international stability. In that context, the SDR had a crucial role to play, and he was committed to the longer-term objective of making it the principal reserve asset of the system. However, he had been intrigued by the proposals designed to reach that goal by making the SDR similar to money-market instruments, thus widening its acceptance as a medium of exchange. Such an approach tended to ignore the reasons for which the SDR had originally been created and assumed that existing interrelationships among countries and their currencies were stable and intrinsically desirable. The interrelationships among countries and their currencies were not stable, and the staff assumption was therefore unwarranted.

At present, the tendency was to identify widespread inflation and stagnant economic activity as the primary causes of instability, Mr. Jayawardena continued. However, if the problems were more deep-rooted--such as changes in competitive positions among developing countries or continuing problems associated with poverty and adverse trade relations in developing countries--the attempts to promote a wide acceptance of the SDR as a form of international money might turn out to be only a cosmetic treatment of a more basic malaise. Unless such measures were buttressed by moves to improve the characteristics of the SDR as a means of promoting more adjustment--especially in the developing world--the economic problems of the developing countries would become progressively worse, which was likely to create further instability of the sort that would not be eased simply through a greater acceptance of the SDR by the international financial markets.

Turning to some of the specific proposals in the staff paper, Mr. Jayawardena observed that efforts to improve the marketability of the SDR in order to promote its wider acceptance as a reserve asset would require that the terms on which SDRs were made available to countries should be no different from those prevailing in the private financial markets. In the circumstances, countries would be encouraged to finance economic adjustment by going to capital markets because there would be little inducement to approach the Fund and face the rigors of conditionality. To suggest that the flexibility of the current exchange rate system would permit early adjustment and prevent such an occurrence was to assume the problem away. The implications of the efforts to improve the marketability of the SDR should thus be examined further.

The idea of the Fund creating new SDRs for lending purposes was interesting, Mr. Jayawardena remarked, although it would make the Fund act more like a commercial bank and would dilute the basic characteristic of international cooperation while eroding the Fund's ability to provide unconditional liquidity. Moreover, as noted by Mr. Kharmawan, it had to be remembered which members would bear the difference between charges and interest on the SDR. Finally, experience showed that the generation of international liquidity through conditional resources had been small, even when Fund activities had been considered brisk. An appropriate mix of conditional and unconditional liquidity had to be devised, keeping in mind the special circumstances in which developing countries found themselves.

It was difficult to take the view that, in a period of instability of exchange rates, the function of providing unconditional liquidity should be relatively unimportant or should occupy a secondary place, Mr. Jayawardena commented. The need for enhancing the role of the SDR was more acutely felt during periods of disequilibrium in the developing countries, and to put those countries at the mercy of the private banking system in a period of instability appeared to be an inversion of the entire concept of the SDR as a principal reserve asset. In his view, the Fund--which symbolized action collectively undertaken by the international community--had to mitigate the unwarranted disruption of the progress of real growth in less favored nations.

Mr. Alhaimus remarked that, while the staff had carefully examined the ways in which the SDR might meet the changing needs of the international monetary system, it had not responded fully in a number of areas relating to an active role for the SDR in the system. Those areas included: the role of the SDR in the surveillance of international liquidity; the conditions under which the SDR might become the principal reserve asset and the specific measures needed for that purpose; the issue of the SDR as a vehicle of intervention; and the distribution of international liquidity. The case for promoting the SDR as the principal instrument to be used in the conduct of international financial relations was predicated on the need to correct the inadequacies of the present arrangements.

As many speakers had noted, Mr. Alhaimus said, the present international monetary system was inherently unstable: reserve currencies were exposed to large-scale fluctuations, and the authorities of reserve currency countries had a marked tendency to set their fiscal and monetary policies by reference to what they judged to be the needs of their own domestic economies. Partly because of the central role of reserve currencies, the international adjustment process was lacking in symmetry. Instability in exchange rates and interest rates and the lack of adequate control of international liquidity had been harmful, particularly to the developing countries. Since the breakdown of the Bretton Woods system, the international community had taken only piecemeal measures of the sort that had not amounted to a basic reform of the system.

Given the limitations on its volume and its characteristics, the SDR was far from performing the basic functions usually ascribed to a monetary asset, Mr. Alhaimus continued. National currencies continued to be the centerpiece of the system, and the SDR remained a minor supplement to them. The role of the SDR would depend on the perception of the future direction of the international monetary system, although recent experience, together with the lack of will to introduce basic reforms in the system, indicated that rapid progress toward making the SDR a principal reserve asset might not be feasible. The international monetary system might face a crisis with which it would be difficult to cope unless some adaptations were introduced soon; among the proposals that should be considered were asset settlement and voluntary substitution of SDRs for other assets, including reserve currency holdings.

Beyond the fundamental issues to which he had referred, the idea of allocating the SDR for quota subscriptions or extending Fund credit to members in the form of newly issued SDRs needed careful consideration, Mr. Alhaimus remarked.

The view that conditional credit should be provided during a period of unstable exchange rates while unconditional liquidity ought to be reserved for a stable environment seemed incorrect, Mr. Alhaimus continued. Fund credit to LDCs was generally conditional, although the needs of those countries for credit for adjustment arose in part because of the effects of exchange rate fluctuations caused mainly by the monetary and fiscal policies of developed countries. The instability of exchange rates introduced uncertainties about real earnings for exports and real costs of imports, since both imports and exports were often invoiced in currencies that moved against one another in an unpredictable fashio . The situation tended to create complications in the external debt management of the developing countries, which needed a comparatively high level of reserves during such a period. In those circumstances, providing unconditional liquidity to the LDCs in unstable conditions seemed to be not only appropriate but most desirable. At the same time, the Fund should be taking action to deal with the causes of that instability by applying some sort of "conditionality" or discipline to those countries whose financial policies resulted in harmful exchange rate fluctuations. Such conditionality could take the form of a greater coordination of and surveillance over the national policies of those countries.

Mr. Tai endorsed the view that the SDR, collectively created by the world's leading financial institution, should be used as the principal instrument in the conduct of international financial relations and in the furtherance of international monetary cooperation. The role of the SDR in the international monetary system was threefold. First, in its monetary role, the fate of the SDR was closely related to the state of the world financial situation. It had been developed during a period of exchange rate instability, and so long as that instability continued--and it was apparent in most parts of the world at present--the importance of the SDR's monetary role should be further enhanced.

The second basic role of the SDR was its credit function, which was of great concern in particular to the developing countries, Mr. Tai went on. While it might be argued that the present level of international liquidity and the persistent threat of inflation did not justify any new SDR allocations at present, it was nonetheless true that new allocations would satisfy a portion of the urgent need of most non-oil developing countries for additional liquidity. In his view, the rationale for further allocations at present remained as strong as it had been when the Managing Director had proposed an allocation of SDRs for the third basic period in 1978.

Third, it had been the objective of international monetary reform to make the SDR the principal reserve asset in order to eliminate heavy reliance by the international community on one national currency, Mr. Tai concluded. He endorsed the intention of the staff to explore ways of improving the attractiveness of the SDR, with a view to establishing a generally accepted and widely usable financial instrument. However, as total SDRs created by the end of 1981 amounted to less than 6 per cent of members' nongold reserves, it was doubtful whether that objective could be realized through technical improvements in the SDR, without a sufficient increase in the quantity of new SDRs. In addition to new SDR allocations, the extension of Fund credit in the form of newly issued SDRs along the lines suggested in the staff paper seemed worth of further exploration. Finally, the role to be played by the SDR in future seemed likely to be determined not only by economic and technical factors, but also by political considerations.

Mr. Diao remarked that most of the views of his chair on the role of the SDR in the international monetary system had been well expressed by Mr. Nimatallah, Mr. Senior, Mr. Kafka, and others. The main difficulty in making the SDR the principal reserve asset of the system seemed to be a lack of political will. He agreed with Mr. Kharmawan that, if it was not possible to live up to the objective for the SDR laid down in the Articles of Agreement, or if it was determined that that objective was not appropriate to current circumstances, it would be necessary to find one more suitable.

If the SDR was to play a central role in the international monetary system, it would have to be made available in the system in sufficient quantities and be made competitive with other reserve assets, Mr. Diao continued. The Fund should be fully involved in the creation of SDRs as well as in the control of international liquidity.

As pointed out by others, reliance on a single national currency created difficulties for developing countries, particularly in a period of instability in the exchange markets, Mr. Diao remarked. The SDR should be given the leading role among reserve assets, and an effort should be made to increase substantially the ratio of SDRs to reserves other than gold and to enhance the characteristics of the SDR with a view to promoting its competitiveness, along the lines suggested by the staff in SM/82/92 and Correction 1. However, while he subscribed to the principle of making the SDR the principal reserve asset in the system and could readily support actions aimed at doing so, he was concerned about the adverse implications for the income position of the Fund, charges, and the use of the Fund's resources.

The suggestions by the staff regarding the use of the SDR for payments of quota increases and the idea of a Fund fully based on SDRs were both quite interesting and worthy of further study, Mr. Diao commented. Finally, on the question of the link, he did not share the view that the use of the SDR as a means of development finance would be inflationary; on the contrary, it would provide a great opportunity for the transfer of real resources to developing countries.

Mr. Yasseri observed that the aims and objectives associated with the SDR had undergone great changes since its inception. The ultimate role of the SDR of course depended on future developments in the international monetary system. In that connection, he agreed with Mr. Nimatallah, Mr. Joyce, and others that a continued effort should be made to enhance the SDR even though the future trend of the system was not at present clear.

Taking up the issues suggested for discussion, Mr. Yasseri considered that every effort should be made to enhance the role of the SDR as the principal instrument of the international monetary system. The specific suggestions by the staff to promote the asset, including the extension of Fund credit to members in the form of newly issued SDRs, were noteworthy. However, he joined Mr. Sigurdsson in noting that the decision on whether or not greater conditionality should be attached to the SDR should depend on the special world economic circumstances prevailing at any particular time. Some of the practical proposals to promote the SDR did not always lend themselves to theoretical underpinnings in advance; some experiments would sooner or later be necessary to test the proposals and assess their effects.

Many aspects of the international monetary system were interrelated, Mr. Yasseri observed. For example, questions regarding SDR interest rates were linked to the relation of SDR values to those of other currencies and ultimately to the number of SDRs issued or available for transactions. In the circumstances, any future improvements in the SDR should be all embracing. Finally, notwithstanding the desire of his chair to promote private use of the SDR, the supervisory role of the Fund in determining the ultimate characteristics of the asset should not be forgotten.

The Economic Counsellor, commenting first on the reference by Mr. Erb to Professor Triffin's contribution to the analysis of the situation in the 1960s, observed that the staff had referred to Professor Triffin only to indicate that the period was an important one in the history of thought on the international monetary system and to note that his contribution at the time had been influential. He did agree with Mr. Erb that, if a reserve currency country did not manage its economic affairs well, its currency would become less popular as a reserve currency.

He had the impression--perhaps incorrect--that Mr. Erb saw no circumstances in which an issue of SDRs would not be inflationary, the Economic Counsellor continued. The matter had been debated in the Board in some detail only recently, and it had become apparent that there were two aspects to the issue. The first was the somewhat "symbolic" relationship between the creation of SDRs and the problem of inflation; it was difficult to argue with those who felt that the issuance of SDRs would provide a signal that could lead to a higher rate of inflation. Apart from the signal effect, however, the staff continued to be unable to find any significant connection between the issuance of SDRs and the generation of inflation. He had some difficulty in following Mr. Erb's argument that the injection of further SDRs into the system would place the asset in competition with reserve currencies and would thereby in some way result in a further expansion of the domestic money supply in recipient countries, thus leading to inflation.

A number of Directors--including Mr. Anson and Mr. de Vries--had referred to the possibility of substituting SDRs for currencies, whereby a basket of currencies--presumably those in the SDR basket--could be brought to the Fund and exchanged for SDRs, the Economic Counsellor recalled. While the technique would resolve a number of the technical dilemmas that had arisen in the Board prior to the Hamburg meeting of the Interim Committee on the substitution account, it did not resolve them all. In particular, he wondered why countries would want to exchange the basket of currencies for the SDR, particularly given the interest that those currencies could earn. Still, the technique had some potential, and it should not be dismissed without further consideration.

Speakers seemed divided on the importance of stability or instability in the evolution of the SDR, the Economic Counsellor noted. However, speaking personally, he considered that conditions of instability often provided opportunities for radical reform, while evolution was more likely to take place in more stable circumstances. The staff, of course, had been focusing on the evolution of the system, which it had argued would be furthered by stability. The issue had been approached somewhat differently by those who had asked whether, in an ideal and stable situation, the SDR would even be needed. In his view, the SDR would be needed in such circumstances only if the costs associated with its use were less than the costs associated with the use of national currencies.

He wished to take issue, the Economic Counsellor continued, with those who felt that the staff was opposed to making suggestions for improving the SDR until the advent of stability. After all, the paper did include an entire chapter (Chapter VI) that discussed various possible improvements in the asset.

A number of Directors had expressed interest in a further examination of the possibility of financing the Fund's lending through the issuance of SDRs, the Economic Counsellor recalled, and Mr. Kharmawan had asked a number of questions about the implications of such a scheme for certain Fund operations and for the cost of credit. On the assumption that the Fund was totally converted to an SDR basis, there would be no need for a currency budget, reserve positions in the Fund, or the remuneration of those positions; the cost of Fund borrowing would be equivalent to the interest rate on the SDR unless some means were created to reduce that cost. Of course, the staff had not been thinking in terms of such a total transformation. Rather, it had been looking at the possibility of financing all or part of its future lending through the issuance of SDRs.

Mr. Legarda said that he had not been convinced by the Economic Counsellor's endorsement of Mr. Erb's argument that reserve currencies had self-correcting features that would lead a mismanaged currency to repel holders and a well-managed one to attract them. High interest rates of course tended to attract holders, although when political leaders or other officials of large countries went on record as stating that interest rates were unacceptably high and their currencies were overvalued or undervalued, the self-correcting feature of reserve currencies did not seem to work.

The Economic Counsellor replied that the factors influencing the exchange rates were myriad and some--such as those referred to by Mr. Legarda--had an impact mainly in the short term. He continued to believe that, over the longer term, mismanagement would discourage the holding of any currency.

The Deputy Managing Director, returning to Mr. Kharmawan's question about the cost of borrowing from the Fund if the institution became fully based on SDRs, noted that charges would presumably have to be at the SDR rate unless certain costless resources--such as the reserves of the Fund and resources generated by a sale of gold--were retained, in which case charges in the General Resources Account could be significantly lower than the SDR rate.

Mr. Kharmawan replied that, if there was a willingness to reduce charges below the SDR interest rate, one of the objections to being furnished or supplied with SDR resources would be removed. Of course, such subsidies would create two interest rates for the same SDR, which might pose a problem.

On another matter, Mr. Kharmawan wondered whether, if it was decided to provide debtor countries with SDRs, the recipient countries would be able to bring them to the commercial banks and to receive currencies in return. He hoped the staff would consider such a possibility, which would help to broaden the scope of the use of SDRs.

With respect to the suggestions for improving the SDR, Mr. Kharmawan wondered whether there was any purpose in focusing on possible improvements before it was decided whether the SDR would even have a role to play in the system. How could the SDR function in a multicurrency system as a means of payment alongside other currencies, and what characteristics would the SDR need if it was to function as an international means of payment? Those fundamental questions should be dealt with first.

Mr. de Vries observed that the reason why it was possible for the Fund to lend at lower rates than those at which it borrowed was that certain resources were available interest free, a situation that would exist whether the Fund was fully based on the SDR or not. On another matter raised by Mr. Kharmawan, he was not particularly worried about the possibility of there being more than one interest rate for the SDR. After all, there were a number of interest rates for national currencies--such as the three-month rate, the six-month rate, the seven-year rate, and so on. He saw no reason why the same could not be true for the SDR.

The Chairman made the following personal remarks in concluding the Seminar:

> One of the things that struck me in this discussion was the question raised by a number of Directors, namely, whether or not the SDR would be necessary for the functioning of an "ideal international monetary system." My instinctive answer to the question is that one can conceive a stable monetary system without the SDR, or any such composite monetary unit; however, having the SDR as the principal asset of the system would resolve a number of questions that would otherwise not be adequately answered.
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> What are the possible types of international monetary system that could be considered ideal? In Mr. Kharmawan's words, what "framework" do we have in mind? The question has to be answered in historical terms and in terms of the lessons to be derived from the present working, and malfunctioning, of the system. For obvious reasons--on which I need not elaborate now--I think a par value system based on gold would not be an ideal or a practicable system. I do not think it would work. I do not think either that a system in which the dollar was linked to gold--as it was in the Bretton Woods system before the dollar became de facto inconvertible--is now in the realm of probability. I do not see the United States accepting the burden of real convertibility. It is also possible to conceive of a stable par value system based solely on one major currency but, for it to be successful, all members would have to agree to hold the major currency, e.g.

dollars, in their reserves. That would be a Bretton Woods system without the gold linkage. If there was such a dollar system with no link with gold, it would have to be a system where every country was perfectly happy to hold dollars all the time and to accept the creation of a domestic currency to meet the international needs of the system. In any event, such a system would be more a domestic system used internationaly, than a truly international system. I do not think you can call it ideal. And last you can have a floating multicurrency system as we have it now: it has a number of weaknesses, and I do not think you can call it an ideal one.

If a gold or a dollar/gold system does not appear optimal or realistic, if a purely dollar system appears inconsistent with the present thinking in a very diversified world, and if one wants to improve the floating multicurrency system which we are now experiencing, then it might be advisable to consider a system like that discussed at length by the Committee of Twenty. Some of the characteristics could be as follows:

First, and most important, it would be a multicurrency system, based on a considerable degree of economic and political convergence, meaning consistency in basic monetary policies and economic policies in the major sectors in the system. Without such consistency, the system could not work smoothly. Such a system would go in the direction of the ideas produced at the recent Versailles meeting of world leaders.

The second element of the system would be some form of agree ment on the type of exchange relationships to be adopted, and on asset settlement. I do not think that the asset settlement question arises only in connection with fixed exchange rates; it crops up in any system where some form of intervention is allowed. I do not think that we will move toward a fixed exchange par value system, and I think it would be unwise to move towards one because of the considerable drawbacks and rigidities evident in the past. Even with significant convergence between members, some discrepancies in basic policies would be inevitable. The convergence exercise is greatly limited by the fact that national policies could never be expected to fit perfectly into the same macroeconomic policy mold, whatever structure was adopted. Even with a considerable basic convergence of policies, there would probably be differences in inflation rates and, hence, variations in exchange rates. But there would probably also be some forms of authorized interventions in the exchange markets as at present.

It is essential in any system to have an understanding of how exchange rate relationships should be conducted. I think we have answered a considerable number of questions on that issue since 1974/75. We have a set of pragmatic and theoritical answers to the question of how exchange rates should behave in a world of floating rates, but we would also need a more systematic answer to the fundamental question of asset settlement. It has always been a very difficult question. It was discussed, but not resolved in 1974; however, it should be addressed. In an ideal system, a country with a deficit should settle its debts in a manner that satisfies its creditors. Two ways of doing so have been tried: there is the dollar system or the multicurrency system under which the rest of the world agrees to accept a number of major currencies in settlement of debts. These systems have a number of weaknesses.

Therefore, if a gold linkage for reserve currency settlement is not acceptable--and I don't believe it is--and if some form of internationally based asset settlement system is desired--to the extent the system would imply a degree of intervention--there would be a need for an international instrument, acceptable by all and issued by an international central bank or monetary fund, run collectively by the members of the system. And that is the essence of a SDR system. The SDR can be defined in many ways: it can have 16 currencies, or 5, or any agreed number; that is not of major importance. But, fundamentally, a system such as the one I am referring to would have to issue an international currency in which ultimate settlements would eventually take place.

I believe that such changes--if they ever take place--would take a long time, because there is hardly more sympathy than there was in 1974 for all the obligations stemming from the principle of asset settlement. After 1974, the oil crisis provided an opportunity for dropping such matters. We will always have good reasons for forgetting about the nagging questions on the future of the international monetary system; but if we want to reflect usefully on these matters, we shall not be able to evade them.

With hindsight, it becomes thus apparent that the creators of the SDR were profoundly right in saying that the SDR should become the principal asset of the system. If one believes that the international monetary system should be evolving along the lines I have described, because the world has become more complex--more "multipolar"--than it was in 1944, then we should be striving toward reaching a consensus in favor of such a system.

But, if it is ever achieved, it will still take a long time. I do not believe that these reforms happen just because some experts find them to be desirable. These things never happen that way because they entail much readjustment in the countries involved. Even the relatively modest proposals for a substitution account failed at the last moment because it was felt that they went too far or did not fit with the immediate problems of the day; so the much more fundamental questions that we have been discussing with respect to the SDR will no doubt give rise to many hesitations.

In the meantime, we should proceed pragmatically and continue to improve the characteristics of what should become one day the principal reserve asset of the system. I profoundly agree with what Mr. Anson said, namely "in a step-by-step way, let us look not at the things we might do in 20 years--but the things we might do now, as long as they are consistent with a certain view of the evolution of the system."

These are purely personal comments. I do not think the time has yet come for the sort of reassessment that Mr. Kharmawan, very logically, was asking for. I do not think that the time has come, because there is insufficient political consensus for the sorts of decisions that would have to be taken to establish a new system.

I believe that we should be looking at a number of ways to improve the characteristics of the SDR: for example, the possible enlargement of the use of the Fund of its own instrument, further practical measures to increase the attractiveness of the SDR. All the questions that you have raised today should be taken into account in future staff papers and Board discussions. In fact, a paper is being prepared that will identify possible future steps, and we shall try to go forward little by little.

This is not a summing up of the discussion; it is my personal informal contribution to the seminar.

LEO VAN HOUTVEN
Secretary