NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/128

10:00 a.m., August 4, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
	D. C. Templeman, Temporary
J. de Groote	
M. Finaish	T. Alhaimus
	M. Sugita
	B. Goos
Huang F.	
J. E. Ismael	
A. Kafka	
	M. Foot
H. Lundstrom	
	L. Leonard
E. I. M. Mtei	
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	
	S. de Forges
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

External Relations Department: B. Nowzad. Legal Department: F. P. Gianviti, Director; P. L. Francotte, R. H. Munzberg. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; M. P. Dooley, D. Folkerts-Landau, D. J. Mathieson. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; W. L. Coats, Jr., J. C. Corr, E. Decarli, S. I. Fawzi, R. L. Velutini. Advisors to Executive Directors: W.-R. Bengs, L. P. Ebrill, J. Hospedales, K. Murakami, P. Péterfalvy, I. Puro, R. Valladares, A. Vasudevan. Assistants to Executive Directors: O. S.-M. Bethel, B. Bogdanovic, W. N. Engert, V. Govindarajan, G. K. Hodges, Z. b. Ismail, L. de Montpellier, R. Msadek, A. H. Mustafa, M. Rasyid, D. Saha, B. Tamami, H. van der Burg.

1. SDR - APPROACHES TO INFLUENCING SHARE IN MEMBERS' INTERNATIONAL RESERVES; AND DEVELOPMENT OF VOLUNTARY TRANSFERS AMONG PARTICIPANTS AND PRESCRIBED HOLDERS

The Executive Directors considered staff papers on alternative approaches to influencing the share of SDRs in members' international reserves (SM/86/169, 7/9/86) and on the development of voluntary transfers of SDRs among participants and prescribed holders (SM/86/142, 5/18/86). They also had before them as background information a paper on holding and use of SDRs by Fund members (DM/86/48, 7/28/86).

Mr. Polak made the following statement:

As part of our work program on the SDR, we are dealing today in response to requests by the Interim Committee, with a variety of suggestions intended to "increase its (the SDR's) attraction and usefulness as a component of monetary reserves." The paper on voluntary transfers explores in a modest but important way how the usability, and thereby the usefulness, of SDR holdings can be enhanced. The other paper on today's agenda should help us to address the specific question put to us by the Interim Committee--viz. "the different possibilities of obtaining a more balanced and stable proportion of SDRs in members' reserves," which, incidentally, is a rather narrower subject than "Alternative Approaches to Influencing the Share of SDRs in Members' International Reserves."

I shall first address the activities of the staff to facilitate voluntary transfers. To the extent that those activities have succeeded in creating an active "market" in SDRs, where members and "other holders" can readily buy and sell SDRs against foreign exchange, the attractiveness of the SDR as a reserve asset is enhanced. Tables 5 and 6 of the paper show that the staff has made considerable progress in this direction and that the waiting time to sell SDRs in a voluntary transaction has been reduced to a few days, and indeed to zero in the most recent quarter. The amounts that can be traded on that basis have also increased and are now of an order of magnitude that would accommodate the great majority of uses. I congratulate the staff on their pursuit of these improvements of the SDR, which hold considerable potential in smoothing the operation of the SDR mechanism.

I particularly welcome the fact that in addition to the standing arrangements with some members to sell SDRs, and standing arrangements with some other members to buy SDRs, the Fund now has a standing two-way arrangement with one country to buy and sell SDRs within certain limits. I particularly welcome the willingness on the part of this country to offer this service to the Fund, and I suggest that the staff explore with other members whether they would be willing to assist the SDR system in the same way. I understand that a limited number of volunteers would make it possible to reduce considerably the scope of designation, which would simplify the SDR mechanism for all concerned. Indeed, if some of the largest industrial countries, especially the United States, which has recently sold SDRs in voluntary transactions, were found prepared to stand ready to buy and sell SDRs in substantial amounts, designation might be allowed to atrophy and the existing qualms about the usability of SDRs might, over time, evaporate.

I can generally go along with the presentation, given in Section I of the staff paper of the issues that have arisen over the years concerning the distribution of SDRs and that prompted the Interim Committee to ask the Board to explore corrective measures. In this section, I would highlight only one very useful finding by the staff, namely, that the regulation of SDR holdings in relation to total (or to other) reserves (which is what Section 1(b), Schedule G is concerned with) is less burdensome for members than regulation of SDR holdings in relation to allocations, which was the type of regulation practiced by the Fund under paragraph (a) of the same Schedule. The same point is made once more, and further explained, in the middle paragraph on page 11 of the paper.

It is disappointing, then, that the staff does not stick to this finding and does not explore practical suggestions for regulation under Section 1(b). On the contrary, on the top of page 12, any inherent advantages of this approach over the past system of regulation are brushed away and the impression is even left that any system of regulation in relation to reserves is more burdensome because it involves the Fund in the collection of reserve statistics--hardly a new departure--which are always somewhat lagged and which members might desire to keep confidential.

The question whether the approach that the Interim Committee asked us to explore does or does not hold promise could, I believe, be brought closer to an answer by looking at a concrete example of what regulation of holdings of SDRs in relation to reserves might involve. For that purpose, I have requested the staff to prepare an illustrative table. 1/ It compares for each member, at the end of 1985, two ratios--SDR holdings to net cumulative allocations and SDR holdings to non-gold reserves--with the average ratios for all members on the same date, which were 85 percent 2/ and 5 percent, respectively (SM/86/169, Table 1). It then calculates, in the last column, the amount of SDRs that certain members would have had to acquire on the assumption that members would be encouraged to hold SDRs equal to the average

---

1/ Reproduced in Annex.
2/ The other 15 percent were held by the Fund in the General Department and "Other Holders."

ratio for all members of SDR holdings to non-gold reserves, but not beyond the average ratio of holdings of SDRs to cumulative allocations.

The underlying idea of this table is that insofar as members feel some portfolio disadvantage in holding SDRs, given their present usability and interest rates, rather than foreign exchange, this disadvantage might reasonably be shared on the basis of reserve holdings, for the reasons suggested by the staff on pages 8 and 11. At the same time, regulation would have to take account of the facts that not all SDRs are held by members and that there is a separate mechanism available--the designation system--by which members that are sufficiently strong in terms of their balance of payments and reserve position are obliged to acquire additional holdings of SDRs.

The table does not constitute a proposal for a new rule more or less along the lines implied by Section 1(b), Schedule G. At this stage, the table is, rather, intended to serve the purpose of exploring whether any rule of this kind would be (a) helpful to creditors, some of whom have felt that they were carrying an undue part of whatever operational disadvantages attached to the SDR; (b) bearable on the part of net users of SDRs; and (c) operationally feasible.

On the first point, the table shows that with the particular coefficients used--85 percent and 5 percent, respectively--net users of SDRs would, on the specific date selected (December 31, 1985), have to hold over SDR 2 billion more than they actually did. The corresponding reduction of the SDR holdings of creditors would be in excess of 15 percent of their holdings, which would bring these holdings for many of them below allocation.

The increase in SDR holdings for each net user would be only a few percent of reserves, which presumably would not constitute a major inconvenience for most of them. Any acquisition of SDRs might, however, be too much for countries with very low reserves compared to need, measured for example in terms of weeks of imports; a special dispensation clause could be considered for members in that situation.

When reconstitution was applied under Section 1(a) of Schedule G, some countries maintained their holdings of SDRs at a level far below the indicated average figure of 30 percent--later, 15 percent--of net cumulative allocation. This meant that they were required to acquire very large amounts of SDRs toward the end of the reconstitution period in order to achieve the prescribed average. If members reacted in the same way to a rule that related SDR holdings to reserves, the same difficulties would ensue, since such a rule would also have to be defined in terms of averages over certain periods. In this context, however, the advantage mentioned earlier of a rule based on reserves compared to one based on allocation could prove helpful. Because holding a small proportion of reserves in SDRs should normally be feasible, even if not absolutely optimal, for the great majority of members, such members should be able to manage their reserves under a rule that implied reasonably prompt adjustment of their SDR holdings to, or perhaps rather toward, any agreed target percentage of total reserves. A member that was willing to purchase SDRs on the basis of a rule of this nature could be considered to comply with the objective set out in Section 1(b), Schedule G, even though its actual average ratio might not work out exactly at the specified percentage. I would suggest that if there is sufficient interest in an approach of this nature the staff be asked to explore how such a rule might be defined and how it would operate.

Even though reserve management under the kind of rule described might not in practice cause members additional inconvenience, it would involve some cost for net users of SDRs, in comparison to the present policy of many of them of allowing their SDR holdings to be run down to, and stay at, very low levels. The question to be weighed by these members is whether any drawbacks would be compensated by readiness on the part of the main creditors under the SDR system to agree to adequate new allocations. It is of interest in this connection that the Interim Committee linked the Board's discussion on allocation to its analysis of proposals aiming at a better balance of SDR holdings.

On the section of the staff report relating to economic incentives I can be brief. I do not share the staff's view that the existing tendencies among both creditors and debtors, to prefer at the margin foreign exchange holdings over SDRs as reserv[illegible] should be overcome by an increase in the rate of inte[illegible] the SDR--nor do I share the staff's regret that there [illegible] market mechanism by which the equilibrium rate of inte[illegible] the SDR could be determined.

Central banks are, quite correctly, particular as to the assets that they are willing to hold as part of their reserves, and if certain assets are not quite suitable to the needs of a particular central bank, no reasonable increase in the rate of interest will induce that bank voluntarily to hold such assets. The present interest rate on the SDR, which is equal to the sum of the interest on its five components at the short-term official asset level, is in principle the proper one. I would think that even a modest increase, based on using Euro-interest rates, would on balance have more negative than positive aspects. Fundamentally, any inadequacies of the SDR as a reserve asset will have to be corrected by measures that increase the usability of the SDR--not be compensated by giving the SDR too high a rate of interest. If we do not succeed in bringing about the necessary improvements in the usability of the SDR, then the SDR component of reserves will be doomed to shrink by the continued absence of allocations--unless those members that draw the greatest benefit from allocations are prepared to hold somewhat larger amounts of SDRs than they consider fully optimal, under some sort of rule as discussed in the previous section.

Extending his statement, Mr. Polak stated that he welcomed Austria's willingness to become the first country to stand ready to buy and sell SDRs. His Netherlands authorities would consider exploring with the staff a similar arrangement if a substantial number of other strong currency countries were also willing to participate. It would be useful if the staff could explain in more detail the advantages of such two-way arrangements.

The three tables that he had presented indicated the seriousness of the problem of imbalances in SDR holdings, Mr. Polak indicated. Only two countries, Iceland and Iraq, in the first table, including industrial and capital exporting developing countries, did not hold any SDRs. However, about 70 percent of the capital-importing developing countries with recent debt-servicing problems held no SDRs. Furthermore, a large proportion of capital-importing developing countries without recent debt-servicing problems also held no SDRs. While members with no SDRs were not acting against the rules of the Fund, the Fund's rules were not conducive to encouraging a balanced distribution of SDRs.

Mr. Goos commented that the staff papers had been useful in clarifying certain issues related to the SDR that had been raised in the most recent Interim Committee communiqué. He shared the concerns expressed by the staff and Mr. Polak about the unbalanced distribution of SDR holdings, as it reflected in many cases a permanent transfer of resources that was inconsistent with the spirit of the SDR and, often, with the need for adjustment. Clearly, the distribution of SDRs should be improved. However, that objective should be pursued on its own merits and not, as the staff proposed, as an avenue to overcoming the resistance to a further allocation of SDRs. The adequacy of the supply of global reserves was the only relevant criterion for deciding on the question of an SDR allocation. That criterion had no relevance to the question whether there should be a marginal improvement in the yield on the SDR or an improvement in the characteristics of the SDR compared with those of other reserve assets. Moreover, a more balanced distribution of SDR holdings, desirable as it might be, had no bearing on the assessment of a possible global need.

His authorities' present unwillingness to support an allocation of SDRs did not reflect an unwillingness to hold SDRs, which might be related to the characteristics of the asset, Mr. Goos pointed out. On the contrary, his authorities considered that the SDR was sufficiently attractive and competitive compared with other reserve assets. In fact, an improvement in the characteristics of the SDR, including higher liquidity, would not induce them to increase their SDR holdings within the present limits, as they perceived the SDR to be a reserve instrument rather than a financial asset that had to provide a certain yield and liquidity. Accordingly, they would support an SDR allocation on the basis of the existing characteristics of the SDR, provided that the global need for reserves was clearly established.

While he agreed with the staff, at least in theoretical terms, that there was no simple relationship between SDR use and resource transfers or adjustment efforts, it would be a mistake to conclude that the potential repercussions of unconditional liquidity creation on the adjustment process could be disregarded, Mr. Goos commented. In the present global circumstances, an SDR allocation was likely to weaken the adjustment effort.

On the specific measures for influencing the share of SDRs, he could, in principle, consider the reintroduction of the reconstitution requirement, Mr. Goos stated. However, in view of the insufficient support for an SDR allocation, it would probably be unrealistic to pursue that idea any further, particularly as reconstitution could be expected eventually to run into the same difficulties as it had in the past. Mr. Polak and the staff had offered a number of interesting suggestions regarding the regulation of SDR holdings in relation to other reserve assets. Nevertheless, despite Mr. Polak's attempt to invalidate the arguments put forward by the staff against that approach, he could not support such a regulation of SDR holdings. Like the staff, his authorities feared that owing to the widespread difficulties in obtaining timely and accurate reserve statistics, any regulation of SDR/reserve ratios would be prone to manipulation. Further, and more important, the obligation to maintain certain minimum ratios of SDR holdings to reserves would establish a powerful, but unacceptable, incentive to allocate SDRs pari passu with the increase in other reserve assets.

He agreed with the staff that the possibility for SDR holders to engage in voluntary transfers of SDRs enhanced the usability and liquidity of the SDR and, hence, its attractiveness as a reserve asset, which in turn had a beneficial effect on members' attitude toward the SDR, Mr. Goos remarked. Much progress had already been made in that direction, and he joined Mr. Polak in congratulating the staff for its efforts in that respect. The staff should maintain its efforts. However, it was questionable how far the staff should go. He had no difficulties with the proposals to continue assisting members in arranging voluntary transfers and facilitating such transfers by providing information on the intentions of potential buyers and sellers. As that kind of assistance had already reached a stage at which voluntary exchanges of SDRs could be affected without significant delays or other problems, there was no need for additional specific measures. However, he supported Mr. Polak's suggestion that the staff should explore with participants, and perhaps also with other holders, the possibility of entering into standing two-way arrangements to buy and sell SDRs. Beyond that, there was little scope for promoting voluntary transfers of SDRs by enhancing the instrument's attractiveness or usefulness. In particular, the existing range of authorized uses was sufficiently wide to accommodate virtually all requirements. Nevertheless, he would be prepared to consider an extension of that range if the need arose. But he would have difficulties with replacing the existing positive list of authorized transfers with a negative list. In considering the possible ways of enhancing the SDR, the fundamental character of the SDR as a reserve instrument to enable the monetary authorities to meet temporary balance of payments difficulties should be kept in mind. He therefore saw no convincing rationale for promoting the private use of the SDR in order to enhance the usability of the official SDR, particularly as there was no need to add another new instrument to the already worrying proliferation of financial innovations in the international financial markets.

He was very concerned about the staff's suggestion that the further development of voluntary transactions would require, inter alia, the resumption of an allocation of SDRs, Mr. Goos stated. His authorities were disturbed by the repeated attempts of the staff to promote irrelevant criteria for an SDR allocation. Such attempts were bound to undermine the credibility of the staff's assessment of the international liquidity situation and to strengthen a number of Directors' reservations about a resumption of SDR allocations.

Mr. Lundstrom congratulated the staff on its successful efforts to enhance the usability of SDRs by facilitating voluntary transfers and related arrangements. Increasing the possibility for voluntary exchanges of SDRs without the need for representation of balance of payments need or utilization of the designation mechanism was bound to have favorable effects on the development of the SDR and, particularly, on the willingness to hold SDRs. Consequently, he endorsed a further development of arrangements for the purchase and sale of SDRs in transactions by agreement. The standing two-way arrangement with Austria was of special interest in that respect, and the possibility of similar arrangements should be explored further. The staff noted that the growth of voluntary SDR transactions had been largely related to Fund financial activity and that strengthening of the SDR was a precondition for a substantial increase in SDR transactions motivated by a genuine preference to hold the asset. Nevertheless, it was still important to pursue efforts to facilitate voluntary transfers.

On the issue of the share of SDRs in members' international reserves, Mr. Lundstrom went on, the SDR system was best served by being as free from restrictions as possible. He therefore supported the abolition of the reconstitution requirement and the widening of possible types of SDR transactions. The aim should be to make the SDR attractive enough to become "self-contained."

The staff paper confirmed the existence of an imbalance in the distribution of SDR holdings, which was harmful to the system, Mr. Lundstrom noted. Most net users of SDRs ran down their holdings to minimal levels. Consequently, other holders ended up with a higher share of SDRs in their reserves than they would prefer. In addition, the net use of SDRs was proportionately greater than the net use of other reserves, an indication that SDRs were considered less attractive to hold. That situation had several disadvantages. The objective established in the Articles of Agreement that the SDR should become the principal reserve asset in the international monetary system could be questioned if SDRs flowed largely in one direction. In those circumstances, the SDR assumed the character of a vehicle for the transfer of real resources, which could be interpreted as a de facto link between the allocation and the transfer of resources. That perception was harmful to the monetary role of the SDR and served as an argument against any new allocation. It could also be seen as an indication that such allocations would weaken adjustment efforts.

On the approaches to achieving a more balanced distribution of SDR holdings, Mr. Lundstrom continued, his authorities favored the combination of regulations and incentives. Generally, incentives seemed to be more conducive to the long-term development of the SDR system. But in the present situation, calling for rapid results, the regulation approach should also be actively pursued. He would prefer a type of regulation that aimed at maintaining a country's SDR holdings above a certain ratio to its total reserves. A reserve-based regulation seemed more compatible with the basic SDR concept than the reconstitution requirement. Moreover, it did not run the same risk of requiring large SDR acquisitions on the part of countries experiencing balance of payments difficulties. The administrative problems of such a system should not be overemphasized but would have to be studied before a final choice of methods were made. The question of increasing the SDR's attractiveness concerned its liquidity and usability rather than its yield, although there was a close connection between liquidity and yield.

In a broader perspective, the general uncertainties surrounding the future of the SDR had an obvious negative impact on members' willingness to hold SDRs, making it all the more important that the present comprehensive review of the SDR system should lead to a narrowing of differences of views that still existed and, finally, to proposals based on a broad consensus, Mr. Lundstrom remarked.

In his statement, Mr. Polak had questioned whether the costs of a reserve-related SDR holdings regulation might be compensated by the prospects that such a regulation would break the deadlock on agreement on a new allocation, Mr. Lundstrom recalled. Would the type of reserve-based regulation outlined by Mr. Polak make it easier for those members opposed to an allocation to agree to a new allocation, provided that the conditions set out in the Articles of Agreement were met? That question should be posed to the Interim Committee, as not all Directors would be able to answer it at the present discussion. The staff should explore that approach further to facilitate the Committee's appraisal of the suggestion.

Mr. Ismael noted that the premise underlying the staff paper on alternative approaches to influencing the share of SDRs in members' international reserves was the concern expressed by some Directors that although SDRs had been allocated to augment members' reserves, certain groups of members had been unwilling to hold SDRs as part of their reserves because the SDR was considered an unattractive reserve asset, as reflected in the low ratio of SDR holdings to total reserves. Contrary to that view, staff studies and other available evidence suggested that there were more important reasons explaining the low SDR holdings of capital-importing countries. He would cite five factors to show that the decline in SDR holdings had been related to the transaction needs of those members rather than to the lack of attractiveness of the SDR as a reserve asset. First, the reduction in SDR holdings reflected the extensive use of reserves, including SDRs, in financing large current account deficits. Second, extensive use of SDRs reflected significant transfers to the Fund by capital-importing countries to discharge repurchase obligations and to pay charges that were very large compared with previous years. It was also noteworthy that in 1984-85 capital-importing countries had acquired substantial amounts of SDRs in order to stabilize their SDR holdings, despite substantial debt service payments to the Fund. Third, the bulk of net SDR use in 1982-85 had been concentrated in a small number of countries that were market borrowers. Fourth, most capital-importing countries were also indebted to the Fund and therefore had to make use of SDRs in discharging their obligations to the Fund. Fifth, SDR allocations had failed to keep pace with the growth in other reserve assets, a factor explaining, to some extent, the decline in the ratio of SDRs to total reserves.

On the alternative approaches to influencing the share of SDRs, his authorities were opposed to any form of regulation of SDR holdings, which would be a step backward and would adversely affect the monetary character of the SDR, Mr. Ismael commented. Regulation would introduce inflexibility in the use of SDRs, reduce the attractiveness of the SDR as an asset, and force members to hold SDRs in amounts that were different from the desired amounts. Furthermore, any form of reconstitution was inappropriate as it did not take into account the balance of payments situation of a member.

With respect to the modality of implementing a reconstitution requirement, the staff clearly indicated the disadvantages of defining a minimum level of SDR holdings, both in terms of net cumulative allocations and in terms of total reserve holdings, Mr. Ismael observed. Mr. Polak favored a reconstitution rule based on reserves rather than on cumulative allocations. However, Mr. Polak's preference could pose special problems to some countries in his own constituency, which had a policy of maintaining high levels of reserves in order to give confidence to the market participants. In one case, a member's holdings amounted to 400 percent of cumulative allocations. If the reconstitution rule were based on reserves, that member would be required to increase its holdings of SDRs by more than 800 percent in order to achieve a 5 percent target in the ratio of SDRs to reserves. He was opposed to the adoption of any reconstitution rule, but if a rule were to be adopted, he would prefer that it be based on both allocations and total reserve holdings.

He disagreed with the staff regarding the improvement in incentives to hold SDRs, Mr. Ismael indicated. SDR interest rates were already at market levels, and the SDR maintained a more stable value than other reserve currencies. He agreed with Mr. Polak that even a modest increase in the SDR interest rate would, on balance, have a more negative than positive effect. The inadequacies of the SDR as a reserve asset would have to be rectified by measures that increased the usability of the SDR.

He had no difficulty with the staff paper on voluntary transfers of SDRs among participants and prescribed holders, Mr. Ismael remarked. He endorsed the objective of improving the usability and liquidity of SDRs and could support further action to promote the voluntary transfer of SDRs. The staff should continue to assist members in arranging desired transactions and to develop information that would facilitate transactions between buyers and sellers. He agreed with the staff and Mr. Polak that industrial countries, particularly the United States, should follow Austria's example by entering into a two-way arrangement to buy and sell SDRs in order to enhance the liquidity of the SDR and make designation redundant. Prospects for the development of voluntary transfers could be adversely affected by the failure to make a further allocation of SDRs. If use of the SDR was to become widespread, an objective laid down in the Articles of Agreement, serious efforts should be made to reach a consensus on a further allocation.

Mr. de Groote observed that the staff papers presented conclusions that were somewhat different from those explicitly assumed by the Board during its previous discussions of the SDR. The background paper (DM/86/48) read in conjunction with the staff report on approaches to influencing the share of SDRs in members' international reserves reinforced his conviction that the SDR had satisfactorily fulfilled its role as an international reserve asset and his opposition to the notion that the permanent retention of SDRs in countries' reserves would be essential to the nature of that asset. The ownership and spending of reserves should be viewed as two different aspects of the use of any reserve asset. Why were reserves accumulated, if not to be used in times of crisis or to finance deficits? SDRs were not issued to be permanently registered in the books of members' central banks but to be used as instruments to smooth balance of payments misalignments and to improve the liquidity and stability of the international monetary system as a whole. Most of the 12 countries that accounted for 70 percent of total net SDR use by capital importers in 1982-85 had experienced important payments imbalances and grave liquidity problems during the period. It was encouraging that those countries had used their SDR holdings to finance their adjustment process. It was also satisfying that those countries had used their SDR reserves more intensively than other reserves, a fact that indicated the great utility and liquidity of the SDR in the adjustment process and reinforced the central role of the Fund. Indeed, 8 of those 12 countries had outstanding Fund credit, and 2 others had been the beneficiaries of resources available under the Fund's special facilities. It would have been somewhat paradoxical if those countries, which had received SDRs from the General Account as part of their financing arrangement, had not used the SDRs they had in their own account. Those countries had been unable to reconstitute their SDR reserves because they still faced important repayment obligations to the Fund. However, they had shown some willingness to stabilize their SDR holdings in 1984-85 and the other capital-importing countries had substantially increased their SDR holdings during the same period. That trend indicated a general agreement that the SDR was a truly effective reserve asset, to be used during acute payments crises and in support of important adjustment efforts, and to be reaccumulated thereafter. As stressed by Mr. Ismael, the more or less prolonged use of SDRs reflected the relative degree of reserve needs and the seriousness of payments imbalances, as could be expected from reserve use in general.

A second important conclusion reached by the staff was that increased use of the SDR depended in the first instance on the Fund's own activities, Mr. de Groote noted. Even the development of voluntary transfers was a corollary of the Fund's activities. Hence, an increase in the use of the SDR would best be served by a general expansion of the Fund's activities, which could be effectively achieved in three ways: an increase in the Fund's quotas, a new SDR allocation used to finance the Fund's operations, and the development of a set of flexible and market-oriented operations and mechanisms in SDRs. An increase in the Fund's quotas would enhance the importance of the SDR in the international monetary system, even if the quantity of SDRs remains constant. A new SDR allocation would not only increase the share of SDRs in total international reserves, but also, if achieved according to some propositions previously discussed by the Board, greatly foster the use of the SDR in the adjustment of the international financial markets. Additional two-way arrangements between the Fund and its members, such as that between the Fund and Austria, to buy and sell SDRs would strengthen considerably the use of the SDR. The flexible form of those arrangements and the importance of the transaction range, which could eventually be increased above 25 percent of the net cumulative allocation--the limit established between Austria and the Fund--could lead to a situation where the Fund would act as a clearing house for the buying and selling SDR operations of central banks. Those first steps toward more market-oriented SDR operations could help to persuade the international financial community of the advantages of holding the SDR for portfolio diversification and of the possibilities for foreign exchange market stabilization. He was confident that other members of his constituency would consider entering into two-way arrangements with the Fund in the near future if there was broad acceptance of that approach by a number of countries. He welcomed Mr. Polak's indication that his Netherlands authorities shared that view. The second step toward more market-oriented SDR operations could be completed by opening the official SDR to the international private markets, for example, by issuing some kind of certificate representing SDR holdings with the Fund or with designated official holders that could be offered and traded on the markets. Such a system would not require a change in the Articles of Agreement.

The development of those market mechanisms would clearly reinforce the use of the SDR on the basis of economic incentives rather than of regulations, Mr. de Groote considered. He agreed with the staff that regulations on the net use of SDRs would tend to reduce the attractiveness of holding SDRs, other things being equal. The use of the SDR was already regulated to such an extent that any effort to increase its use should be directed to opening and broadening the real market and eliminating any new regulations. In that context, Mr. Polak's proposal to increase the use of SDRs by forcing countries to hold them did not seem to be useful. While his proposal would require that some countries reconstituted their SDR reserves, it would not enhance the use of the SDR as a real reserve asset or the willingness to hold the SDR. Mr. Polak even entertained some hesitation about the validity of a regulation approach by proposing a somewhat contradictory system: the repatriation rule, which he noted would be relatively constraining, but he considered that the willingness to purchase SDRs on the basis of that rule would be sufficient to meet that constraint. In order to make the SDR the principal reserve asset of the international monetary system, the Board should abandon the pursuit of that sort of hybrid regulatory system and devote its attention to the further elaboration of market mechanisms based on sound economic incentives.

Mr. Zecchini stated that he welcomed the analysis of the staff, which had been appropriately supplemented by the tables requested by Mr. Polak. The latter represented quantitative simulations of the current impact of alternative proposals and, as they were essential for the Board's assessment, should have been included in the staff papers. In general, the staff should be encouraged to present a more detailed analysis, with numerical projections of the likely effects of any proposals.

There were two reasons for influencing members' attitude with respect to SDR holdings, Mr. Zecchini considered. First, the present distribution of SDR holdings among groups of countries was very uneven. In 1982-85, the group of capital-importing countries tended to use SDRs more intensively than other reserve assets, compared with other groups of countries. Within that group, the market borrowers had also been responsible for the largest use of SDRs, perhaps indicating the convenience of resorting first to those assets when in need. However, the group of large net holders of SDRs did not at the same time build up their SDR stock to an equivalent amount, thereby indicating some unwillingness to accumulate those assets. Second, some major countries clearly opposed increasing the existing stock of SDRs on the grounds that the uneven distribution of those assets and the unidirectional flow of SDRs implied a permanent resource transfer, and indicated a weakening of the economic adjustment effort of the users.

It was too early to assert that the present uneven distribution of SDRs was either permanent or long term, Mr. Zecchini noted. However, there were signs of a reversal of the positions outlined in the background paper (DM/86/48), where it was stated that in 1984-85 SDR acquisitions increased to some extent, owing to members' efforts to rebuild SDR stocks from previous low levels, thereby indicating some spontaneous reconstitution.

The question of an SDR allocation could not be solved positively unless the divergent preferences of the two groups--net holders and net users--were harmonized and made consistent with the interest of stability in the international monetary system, Mr. Zecchini remarked.

Given the present differences of view, any allocation based solely on quotas could not avoid the emergence of excess SDR supply for some countries or permanent excess demand for others, Mr. Zecchini considered. Excess supply was not related exclusively to members' perception of a consequent weakening of the adjustment effort, leading to the undesirable result of a more uneven distribution of SDRs. Excess supply also reflected the inadequate development of demand for SDRs by some countries. Demand weakness was related largely to the characteristics of the SDR compared with those of other major reserve assets. In spite of recent progress in increasing voluntary transfers, it could not be denied that the market for SDRs was still thin, that its usability for the purposes required by central banks was still constrained, that its yield was not fully competitive with that of other assets, and that its liquidity was less than desirable. Those factors, while discouraging net holders from building up their stocks of SDRs, encouraged net users to spend their SDRs before other reserve assets. The lower cost involved in SDR use compared with that for other assets or for borrowing in the capital markets represented a particular inducement to spend SDRs.

However, as the staff rightly pointed out, there was no simple relationship between net SDR use and the adjustment effort, Mr. Zecchini commented. It all depended on the specific purposes to which those resources were devoted. Limiting the extended use of SDRs neither neutralized the impact of allocations on the adjustment effort nor assured that the impact would be favorable from the point of view of the international economic system. However, in the absence of an allocation it was possible that rigidities would be introduced in the international monetary system, leading to its destabilization. The only viable solution was to reach middle point between satisfying some countries' excess demand for SDRs and reducing other countries' excess supply without altering the methods of quota-based allocations and of designations. He was willing to discuss the two approaches proposed by the staff only as a way to reach the broad consensus necessary for a new SDR allocation. In general, the two approaches of regulations and incentives were both valid and relevant for the solution of that problem.

On the regulation approach, his Italian authorities could favor a reconstitution provision based on the maintenance over a specified period of a minimum required average share of SDRs in total non-gold reserves, Mr. Zecchini indicated. That approach had several advantages over the cumulative allocation approach. In particular, it allowed a country to maintain its level of SDR holdings in line with the evolution of its balance of payments situation and its reserve buildup. In addition, it would avoid the actual freezing of SDR use in the reconstitution process. Moreover, the difficulties in obtaining timely and comprehensive information on reserves were surmountable with specific procedures for ex post monitoring and reconstitution adjustments. It should also be recalled that the minimum required SDR share should be adjusted for the change in the relationship between total SDR allocations and the growth of the supply of other non-gold reserves.

The economic incentive approach also had its merits, Mr. Zecchini considered. The rate of return on the SDR had an effect on the demand for SDRs, and any increase in that rate was likely to increase the desired SDR holdings, thereby reducing excess supply and encouraging members to hold that asset. However, neither the regulation approach nor the economic incentive approach alone could affect the distribution of SDRs among members. More regulations controlling the use of SDRs would reduce the attractiveness of any further allocations for most groups of countries, while increasing the rate of remuneration on the SDR would reduce its attractiveness for some groups. Therefore, a viable solution was to combine the two approaches and add a new element, a cost disincentive. Such an approach would involve setting up a minimum average share of SDRs in non-gold reserves for a specified period. If a member's share dropped below that level, the country would have to pay interest on the SDR use at a penalty rate, which could, for instance, be the five-year SDR rate. If, in the subsequent period, the share of SDRs in non-gold reserves remained below the minimum, the remuneration rate would be increased above the five-year SDR rate.

The main advantage of that approach lay in the fact that it penalized the extensive user of SDRs through the cost of the resources rather than by constraining SDR usability or, de facto, availability, Mr. Zecchini pointed out. The latter constraints ran somewhat against the objective of making the SDR as liquid and unconditional as the other major reserve assets. The penalty rates would aim, first, at eliminating any existing element of concessionality in the SDR rate and, in a later period, if prolonged net use persisted, at raising the cost of SDR use above that of alternative reserve assets. Clearly, the period of monitoring the minimum share, the subsequent periods, and the penalty rates, should be designed in such a way as to promote the desired degree and speed of reconstitution of the SDR position. That approach would also greatly enhance the willingness of net holders to add to their SDR holdings. The success of that system depended on its intrinsic rationale and also on the fact that it was part of a larger package, which should be a commitment to allocate a significant amount of SDRs over a number of years in order to stabilize the SDR share in global non-gold reserves and to improve the liquidity of the SDR through measures aimed at expanding the SDR market and its usability. Without those two components, even a mere reconstitution provision could not save the SDR from the meager existence for which it was heading.

Mr. Kafka stated that the staff should be congratulated for its success in creating a market in SDRs. Particularly commendable was its success in concluding standing arrangements to buy, to sell, and, most important, to buy and sell SDRs. He encouraged the staff to intensify its efforts in all those areas and to increase the number and size of the two-way agreements. He strongly supported the idea of replacing the positive list of prescribed operations with a negative one.

The official SDR was apparently not as attractive as other non-gold reserve assets, Mr. Kafka observed. Consequently, there was a desire on the part of those members that expected to be on average holders of SDRs in excess of their cumulative allocations to promote a more balanced distribution of SDRs in order to equalize any net disadvantage. He agreed with the staff's discussion on the nature and causes of those advantages and disadvantages, although the political immunity of the SDR was not absolute.

The economic incentive approach for eliminating any net disadvantages for the average holder of SDRs was preferable over the regulation approach, Mr. Kafka considered. He agreed with Mr. Polak that the attractiveness of the SDR should not be strengthened by changing the SDR interest rate. There were other ways in which the SDR could be made more attractive. Considerable progress had been made in that respect, but much remained to be done. He agreed that there were considerable advantages in making the SDR usable in market intervention. Mr. Sangster had made a suggestion on that point at a recent meeting of the Group of Twenty.

The regulation approach was more questionable, as it would reduce the attractiveness of the SDR compared with other reserve assets by restricting the freedom not to hold SDRs, Mr. Kafka noted. Nevertheless, in an effort to reach consensus on an allocation, it might be worthwhile exploring regulatory techniques. The drawbacks of the reconstitution approach had been appropriately described by the staff and Mr. Polak. Nonetheless, achieving balance in relation to cumulative allocations seemed, at first sight, a natural objective if the aim was to allay the fears of those members who wished to avoid becoming consistently saddled with the SDRs that had been allocated to other members. While the advantages of balancing SDRs in relation to other reserves could not be denied, those who chose to hold large reserves, in both absolute terms and in relation to other economic indicators such as GDP, could perhaps object to that method of balancing holdings. Mr. Ismael's idea of using a combined approach merited further exploration. Any regulatory changes should be introduced simultaneously with the next allocation of SDRs. However, every effort should be spent, irrespective of an allocation, to increase the attractiveness of the SDR other than by changing its interest rate. An allocation of SDRs was long overdue. It would present only advantages and pose no threat to the Fund.

Mr. Yao commented that the staff papers illustrated the concern expressed by many Directors about the uneven distribution of SDR holdings. On the one hand, there was a group of countries that were net users of SDRs and, on the other hand, there was a group of countries that did not want to hold SDRs in excess of their cumulative allocation. As a result, the Fund had become a large holder of SDRs and the role of the SDR in the international monetary system had become less important. The staff also pointed out that although there had been an increase in SDR-denominated transactions in recent years, those transactions had been largely Fund related. The overall impression given by the staff was that the SDR was not perceived as a very attractive reserve asset.

Like other speakers, he was concerned that the SDR had not filled the role of a reserve asset as intended in the Articles of Agreement, Mr. Yao stated. The unwillingness of some countries to hold SDRs would not only adversely affect its use but might also affect the smooth functioning of the international monetary system. The staff had suggested that the reluctance of some members to hold SDRs be dealt with through regulations and/or economic incentives. He favored a combination of those approaches. In addition to regulations, the provision of economic or financial incentives to potential holders might help to improve the range and usability of the SDR.

On regulations, the proposal for a minimum average requirement was unattractive as it was too similar to the reconstitution rule that had been discarded earlier, Mr. Yao considered. A minimum requirement rule was likely to be too rigid and would ignore balance of payments considerations. It could actually make it unattractive to hold SDRs. Any regulations approved by the Board should be flexible enough to give a country the necessary freedom to use its SDR holdings when the need arose and to rebuild them at its own pace.

On economic incentives, he agreed that the monetary characteristic of the SDR needed to be improved, Mr. Yao indicated. Its stable value and low default risk were important characteristics, but they needed to be enhanced by increasing the liquidity and usability of the SDR. The staff had made some interesting suggestions, which should be explored further, particularly the proposals regarding a market for the SDR. The creation of financial instruments denominated in SDRs and the use of SDRs for foreign exchange market intervention were also worthy of further study. But regulations and economic incentives could not succeed unless there was a larger and more regular allocation of SDRs. The market needed to be assured of the availability of SDRs in order to develop the confidence necessary to encourage its use. In the absence of such a development, all other actions might be inadequate. In the meantime, the staff should continue its efforts to promote the use of SDRs by members.

Mr. Sugita noted that the staff concluded that the rapid growth of voluntary transfers had been based largely on demand for SDRs arising from members' obligations to make payments to the Fund. There was little evidence of an active demand for SDRs that was motivated by preference to hold the asset without reference to the need to use it in transactions with the Fund. The lack of motivation to hold SDRs, together with the more evident problem of prolonged net use of SDRs, was the central concern of the present discussion. While his authorities were interested in improving the attractiveness of the SDR, they felt that the present discussion would not be relevant to a consideration of a new allocation of SDRs, as the long-term global need for reserves had not been established. Furthermore, the abrogation of the reconstitution requirement in

1981 had been agreed upon as a package, which also included an increase in the SDR interest rate to the full market rate. They therefore wondered if under the present circumstances there was sufficient scope for reinstating the reconstitution requirement or increasing further the SDR interest rate, or a combination of those factors, without other concessions.

He would limit himself to a few general observations on the staff paper, Mr. Sugita indicated. While the reconstitution requirement might ensure a balanced distribution of SDRs among members, the stricter the requirement, the less attractive the SDR would be as a reserve asset. Regulations on the net use of SDRs relative to the net use of total reserves did not reduce the difficulties. Mr. Polak's suggestion was interesting, although he was unclear about the extent to which that proposal would contribute to a more balanced distribution of SDRs.

On the economic incentive approach, it could be argued that the prolonged net use of SDRs and, more specifically, the disproportionately greater use of SDRs than other reserves might indicate that the interest rate on the SDR was low, Mr. Sugita considered. Therefore, there might be some room for an increase in the interest rate on the SDR. Broadening and simplifying the use of the SDR by participants and prescribed holders might enhance its attractiveness, helping to ensure more equal distribution of SDRs. Nevertheless, that issue had no direct bearing on the global need for reserve supplementation, on which a new allocation hinged and which should be discussed separately.

Mr. Sengupta commented that the staff papers being discussed were part of a series of studies being conducted by the Fund on the future role of the SDR. The Board had recently considered various proposals relating to the distribution of allocated SDRs and to mechanisms that would ensure that allocated SDRs were reconstituted in some form. Unfortunately, those discussions had been inconclusive. The reconstitution approach, associated with the idea that SDRs could be an overdraft facility, was conditional upon an additional allocation of SDRs. Such a requirement would detract from the liquidity and reserve character of the SDR. However, it had been acceptable as a trade-off to ensure that allocated SDRs were held as reserves and could be drawn upon to meet contingencies rather than spent on goods and services.

The staff paper on voluntary transfers of SDRs included a useful review of the experience of developments in the use of SDRs in transactions and operations among participants and prescribed holders, Mr. Sengupta considered. His main concern was how to improve the usability of the SDR by improving its quality and reducing the rigidities in the present system, especially the regulatory designation mechanism. The staff had rightly observed that increased scope for voluntary transfers of SDRs under the continuous presence of buyers and sellers of SDRs could enhance the liquidity of the asset, thus reducing the need for reliance on the "involuntary" designation mechanism in assuring its liquidity. Such developments would also help participants and prescribed holders. He commended the staff for its efforts in encouraging the increase in voluntary transfers in recent years, which had been due in part to the completion of standing arrangements with members to buy and sell SDRs and to the reduction in the time taken to sell SDRs. However, voluntary transfers had increased largely because of the rise in demand from members that had to make payments to the Fund and was not due to a preference by countries and institutions to hold the asset because of its attractiveness. Although improvements in voluntary transfers of the official SDR, including the completion of two-way arrangements by more countries, could improve its attractiveness, there was a need to study the more fundamental issue of how to make the SDR a fully liquid asset so that it could play a useful part in the international monetary reserve system.

He agreed with Mr. Polak that the present inadequacies of the SDR as a reserve asset did not stem from the inadequate interest rate payable on the SDR but from the restricted usability of the asset, Mr. Sengupta went on. Any further increases in the SDR interest rate might have a negative impact. He disagreed that developing countries generally spent, rather than held, their SDRs. Some countries, particularly the highly indebted countries, had used SDRs to meet their liquidity needs in periods of adjustment to underlying changes--one of the purposes of an allocation. It was for that reason that one of the important criteria for an SDR allocation was the long-term global need for reserves. However, the reserve positions of groups of countries did not appear to be alarming even after the reconstitution provision had been abrogated. The staff paper indicated that the capital-importing developing countries as a group had retained, on average, more than 30 percent of the cumulative allocation of SDRs since 1981, a level that was above that prescribed in the earlier reconstitution provision. However, disaggregating that data, the group of countries with recent debt servicing problems had been able to retain SDR holdings only at about 15-20 percent of the cumulative allocation during the most difficult period, 1982-85. All the other developing countries had retained, on average, over 50 percent of allocated SDRs. In other words, the problem was limited to a comparatively small group of debt-ridden countries and was only temporary in nature, having arisen from the recent debt crisis.

The suggestions of Mr. Polak regarding the application of Schedule G, Section 1(b) of the Articles of Agreement, were interesting, Mr. Sengupta considered. The maintenance of an agreed proportion of SDRs in total reserves was a more reasonable and rational proposal than the present reconstitution method. However, as the staff had indicated, there might be difficulties in putting that principle into practice. The exact mechanism could always be discussed after the practicability of a suggestion was examined. It might be necessary to introduce contingency clauses to take care of special cases with severe balance of payments problems. The proposal had the disadvantage of restricting the liquidity of the SDR, as had been the case with the reconstitution mechanism.

One of the central objections to a further allocation was the fear that SDR allocations could lead to a permanent transfer of resources, a consideration that did not appear to be the case, Mr. Sengupta noted.

What constituted a permanent transfer of resources with regard to SDR allocations? Did the lending of financial resources, which were repaid with interest, constitute such a transfer of resources? Or did grants or concessional lending alone constitute such transfers? The issue needed to be examined further, particularly as the Interim Committee in April 1986 had stressed the monetary character of the SDR, which it considered should not be a means of transferring resources. Future decisions on the SDR could be influenced profoundly by the Board's understanding of that concept. He fully agreed with the staff that for countries with limited access to international capital markets, the failure to allocate SDRs in the face of growth in reserve demand or to allocate sufficient SDRs in the face of a shortfall of reserves in relation to demand, would result in balance of payments adjustment, leading to an outward transfer of real resources. Similarly, allocations to such countries in excess of the growth in reserve demand would have the opposite effect, leading to an inward real resource transfer. He hoped that all Directors could agree on that point.

In sum, there did not appear to be any clear evidence that the net use of SDRs represented a transfer of resources, Mr. Sengupta stated. The track record of the developing countries indicated that they had been holding SDRs, even after the abrogation of the reconstitution provision, at a level that was on average higher than that prescribed by the reconstitution requirement. There was no need at present to increase the SDR rate of interest, as it was unlikely to have any positive impact on the use of the asset. Regulation of net use of SDRs would not improve the monetary character of the SDR. In the short run, the Fund might have to take a number of steps to promote the SDR, including an immediate resumption of an allocation, a broadening of its uses by the Fund, and promoting its use as a unit of account. However, in the long run, if the SDR were to become attractive in its own right, it should become a fully independent monetary reserve asset. For that purpose, the SDR needed the full backing of the international community, particularly of the major currency countries. The logical end to such a situation would be to convert the Fund into a clearing house and to promote the SDR as the principal reserve asset in the international reserve system.

Mr. Foot remarked that he agreed with most of the points made by Mr. Goos. His authorities had reservations about the group of proposals regarding reconstitution. As the staff made clear, those schemes had considerable disadvantages. Although the nature of the problems would depend upon the exact details of the scheme, the proposals would all impose constraints on the use of SDRs and, in that sense, reduce the liquidity of the SDR. The staff made some interesting suggestions on ways in which those problems could be minimized by imposing the reconstitution principle, requiring that the net use of SDR over some period should not be more than proportional to the use of total reserves. Even so, a scheme of that nature would still have a number of disadvantages; in particular, it would encourage countries to hold reserves in a form that was not officially classified as reserves, creating difficulties of monitoring. More generally, any such scheme went against the general objective of improving the attractiveness of the SDR. His authorities considered that the best way to change the distribution of SDRs was to concentrate on improving the attractiveness of the SDR. To that end, two factors should be considered: the appropriateness of the yield of SDR instruments and the degree of liquidity of the SDR as a reserve asset.

It was difficult, a priori, to say whether the current yield on SDRs was above or below the equilibrium rate in the absence of an official market for SDRs, Mr. Foot observed. It was thus difficult to judge whether it was appropriate to move from an SDR interest rate based on yields on official instruments to one using Euromarket rates. With respect to liquidity, the major difficulty for his authorities in holding SDRs at present as part of their reserves was that their relative yield could be justified only, if at all, by a high degree of liquidity, which the SDR did not currently possess. It was central to the function of reserves that they could be realizable at short notice when required. While there had been some changes on that front in recent years, much remained to be done for the SDR so that it could be said to be as liquid as other key currencies. The Board would be considering that question in the near future when it discussed the possibility of allowing SDRs to be used in intervention. His authorities were also interested in the staff's suggestion that it might be possible to consider expanding the use of the SDR to cover all transactions not specifically prohibited by the Articles of Agreement.

He welcomed the steps taken by the staff in recent years, which had contributed to the significant growth in the volume of voluntary transfers of SDRs between members and, thus, had increased the liquidity of the SDR and its attractiveness for all holders, Mr. Foot commented. Nevertheless, constraints on the liquidity of the SDR remained, and some further work by the staff on ways of improving the liquidity of the SDR would be interesting. However, given the considerable amount of work being carried out by the staff on the SDR, no further studies should be undertaken unless there appeared to be good chance of securing consensus on a further allocation.

Mr. Leonard stated that in approaching the present subject, he had tried to put aside in his mind the issue of further allocations of SDRs. He had taken the view that the asset existed, that allocations had been made, and that the question to be addressed was whether the SDR as a reserve asset had shortcomings that needed to be overcome and, if so, how. The staff paper on voluntary transfers set out several positive developments in the use of SDRs that were encouraging for those members who set store by the existence of the SDR and its value as a reserve asset. Particularly welcome were the growth in the number and volume of transactions under standing arrangements to sell SDRs, the somewhat less striking rise in standing arrangements to buy, and the recent agreement on a two-way standing arrangement. Staff efforts to assist members in arranging desired transactions and to provide information on the needs of potential buyers and sellers to facilitate transactions should therefore continue. Nevertheless, the majority of voluntary transactions in SDRs had been related directly or indirectly to transactions with the Fund, and the increase in members' obligations payable to the Fund, while not the only factor, had been the most important factor behind the rise in voluntary transactions. Those facts demonstrated the lingering artificiality of the asset. That so many members held few or no SDRs was also disquieting. A convincing case had yet to be made that apart from the boost that SDR allocations gave to the reserves of members experiencing difficulty in acquiring other forms of reserve asset, the asset had qualities that made it equal or superior to other forms of reserves.

On ways to influence the share of SDRs in international reserves, he agreed that means for improving the monetary characteristics of the SDR should be explored but would prefer that any steps to influence the share in members' reserves should be by way of economic incentive rather than regulation, Mr. Leonard indicated. The latter approach would be complicated and unattractive, as was evident from experience with the previous reconstitution obligation as well as from the alternative schemes set out in the staff paper. From a long-term viewpoint, there was less chance of the SDR becoming a major reserve asset if it were restricted with complicated regulations.

It was unclear whether an increase in the interest rate on the SDR would have a significant impact on the desire to hold SDRs, Mr. Leonard remarked. That relationship could be established by experimentation. However, initially, it might be better to try to identify the factors that influenced countries in determining whether to hold SDRs in their reserves. Empirical investigations might show which aspects of the SDR were unattractive to holders and what action would be desirable to improve those aspects.

He supported a broadening of the range of uses of the SDR if suitable areas could be identified, Mr. Leonard indicated. Official efforts to broaden the private use of the SDR as a unit of account or otherwise might not help to improve the reserve asset function of the official SDR. The role of the private SDR should grow of its own accord, based on perceived private sector needs, not on the basis of official encouragement.

He did not agree with Mr. Polak that a change in the interest rate on the SDR should be agreed without question, Mr. Leonard stated. A change in the rate should not be used to offset undesirable characteristics, which should, rather, be dealt with directly. The interest rate was just one of several characteristics of the SDR. Marginal changes in that characteristic could be desirable in their own right, and the way should be left open to explore that possibility.

Mr. de Forges commented that the points raised by Mr. Polak were useful. The Board's recent discussion on the post-allocation adjustment in the distribution of SDRs provided a convenient background for consideration of the present issues. The staff had clearly demonstrated the difficulty experienced by a number of countries in acquiring or maintaining a significant, or even minimum, level of reserves. For the SDR to serve its original objective, allowing the harmonious functioning of the international monetary system without excessive reliance on borrowed resources, it was necessary to encourage members to maintain a certain level of SDRs in their reserves. He had no difficulties with the two approaches proposed by the staff. The regulation technique called for the use of a mechanism to require members to hold SDRs and was, by its nature, a restrictive and defensive mechanism. He thus had the same reservations as Mr. Lundstrom, although he could go along with the argument put forward by Mr. Polak. The staff should explore practical suggestions for regulation under Section 1(b) of Schedule G of the Articles of Agreement. Such an approach was more appropriate than one that would require a reinforcement of the rule along the lines of Schedule G, Section 1(a).

The incentive approach was more positive as it encouraged members to hold SDRs, Mr. de Forges noted. He supported all efforts to facilitate the transfer of SDRs and particularly welcomed the decision taken by the Austrian authorities to enter into a two-way arrangement with the Fund. The voluntary holding of SDRs was only possible if they could be transferred easily. Therefore, the Fund should make efforts to promote the SDR. He looked forward to reading further staff studies detailing the precise steps required to make progress in that direction. The expansion of the use of SDRs and an increase in the number of holders would help to improve the attractiveness of that asset.

Given the existing regulations and the fact that there was no open market for the SDR, it was impossible to identify an interest rate that would encourage members to hold SDRs without introducing structural problems, Mr. de Forges considered. He agreed with Mr. Polak that the current interest rate was, in principle, appropriate. Nevertheless, he would welcome staff estimates of the financial burden related to the holding of SDRs. The staff had noted that the composition of reserves that countries chose to hold depended, in part, on the relative yields of alternative reserve assets, and not on the yields in relation to borrowing costs. That observation was particularly pertinent and merited further analysis. Clearly, the incentive approach and the regulation approach were not mutually exclusive. The Fund advocated the liberalization of money markets in every country. It therefore seemed odd that the SDR, the asset allocated by the Fund, was the most regulated of all monetary instruments. Some deregulation of the use of the SDR would be desirable.

Mr. Templeman commented that the discussion of the two papers before the Board should be seen in the context of the broader discussion of the role of the SDR that the Board had embarked on earlier in the year. In assessing the future role of the SDR, his authorities had stressed some fundamental points, including their belief that there was no practical or feasible alternative to the multiple currency system that had evolved since the creation of the SDR, that the need for countries seeking financial resources to stand the test of the market was basically a good policy, and that the SDR should maintain its monetary character and should not become a means for the transfer of real resources. Of course, the international community should be prepared to help countries with debt problems, and the Fund could play a key role with policy advice and financial assistance. He was willing to explore ways to encourage a better distribution of SDR holdings and usage and to consider ways to improve the attractiveness of the SDR within the context of its present role in the system. But that did not mean that any such modifications in the SDR should be presumed to be steps on the way to a fundamental change in the role of the SDR, or as a means of overcoming resistance to a new SDR allocation that did not meet the current criteria spelled out in the Articles of Agreement.

The staff paper contained a clear and frank analysis of some of the concerns that had arisen about the SDR: the prolonged net use of SDRs by some members, the consequent transfer of real resources, the burden on SDR holders of a maldistribution in the pattern of SDR holdings and usage, and the question of a possible undercutting of the adjustment effort arising from prolonged net use of SDRs, Mr. Templeman noted. Prolonged net use of SDRs was inconsistent with the monetary character of the SDR. That view was analogous with the principle that the revolving use of the Fund's general resources was necessary to maintain the monetary character of the institution. That some countries had made prolonged use of SDRs suggested that the SDR, as a readily usable and unconditional international reserve asset, had been perceived by them to be a permanently available source of financing to acquire real resources. He recognized that the use of SDRs need not undercut economic adjustment efforts if they were used temporarily in support of sound economic policies. But he was concerned about the danger that prolonged use could well lead to a delay in economic adjustment. A number of prolonged users of SDRs were countries with doubtful creditworthiness and with limited access to the international financial markets. For such countries, the marginal cost of using SDRs was low and might seem to be an attractive alternative to either running balance of payments surpluses to earn reserves or taking measures that were adequate to restore their international creditworthiness.

He was not persuaded by the argument that the lack of SDR allocations forced countries to earn balance of payments surpluses through excessively restrictive domestic policies, leading to a deflationary bias in world growth. Such a view seemed to reflect a more general outlook, which he did not share, that strong macroeconomic and structural reforms would have adverse effects on economic growth. Indeed, the Baker debt initiative had been specifically designed to emphasize the need for such economic growth as an essential corollary of economic adjustment and structural reform. For qualified countries, Fund financing should be available in support of adjustment programs, and the Fund could also help to mobilize complementary financing from other sources.

The staff report tended to understate the extent to which subsidies were involved in the use of SDRs, Mr. Templeman considered. While the cost of using SDRs needed to be compared, to some extent, with the foregone yield from using other reserve asssets, many countries' reserves were so low that use of non-SDR assets was not a major option and reserves might need to be borrowed. For an uncreditworthy country, access to an interest rate that was otherwise available only to major industrial countries surely represented a substantial subsidy compared with the cost of funds in the international markets, if credit were available at all. Alternatively, the cost to the country in terms of economic adjustment should, in some cases at least, be considered to be higher than the cost of using SDRs. In addition, countries that drew on private capital markets must concern themselves not only with interest payments but also with repayment or refinancing of principal, whereas SDR users needed only to pay charges. Moreover, prolonged users of SDRs, although paying an interest rate tied to short-term funds in private markets, in effect had access to longer-term funds, which might generally be expected to command higher rates in private markets.

For every subsidy there was a corresponding financial burden, Mr. Templeman pointed out. When a user of SDRs sold SDRs to another holder, the financing burden was shifted to the designated recipient. For example, U.S. purchases of SDRs were financed with dollars, which entered into the Treasury's financing needs and had an effect on U.S. financial markets. If only a relatively small group of countries held substantial amounts of SDRs, while many countries were reluctant to increase their exposure further, it was questionable whether a major holder could dispose of a large quantity of SDRs in case of need. In addition, a cost that was not purely financial could arise if the Fund-created resources were, de fa to, used for long-term resource transfer purposes, undermining the support for the Fund as a monetary institution.

Although a more balanced distribution of SDR holdings was warranted and would be consistent with the monetary character of the instrument, it was difficult to determine how best to achieve that objective, Mr. Templeman remarked. He would be cautious about formal new regulations for achieving a better distribution. Reconstitution had not proven to be a very effective vehicle in creating a more balanced pattern of SDR holdings. However, some other form of repayment might be worth exploring. He did not favor the specification of the formal balance between holdings of SDRs and other reserves, an approach mentioned by the staff and spelled out in more detail by Mr. Polak. The adoption of such a scheme would not be justification for turning around his authorities' opposition to a new SDR allocation in the absence of conditions that met the basic allocation criteria laid out in the Articles of Agreement. Furthermore, most countries, including the United States, valued the freedom to control the composition of their reserves. Even if Mr. Polak's proposal that some countries be required to purchase SDRs in order to distribute them were accepted, his limit on the purchase requirements to no more than the average ratio of SDRs to SDR allocations would not permit a significant reduction in the very high SDR holding ratios of some countries, such as the United States. In addition, he did not welcome the implications that a specified SDR/reserve ratio, in the context of a growth in the demand for total reserves, might force a new SDR allocation.

principle, Mr. Templeman went on, he had some sympathy for the economic incentives approach, within existing parameters set for the SDR in the Articles of Agreement and in the Executive Board. However, the idea of exchange market intervention was rather visionary. He also wondered about the extent to which the SDR could play a greater role in the denomination of international trade contracts, as the SDR basket, unlike the European Currency Unit, was not very representative of the trade pattern of particular countries. There might be some other possibilities worthy of further exploration. Without creating a formal requirement, the Board might consider establishing a rule of thumb to limit prolonged use of SDRs, with periodic reviews of the pattern of holdings based on some consensus limits. Some form of making the SDR financially more attractive could also be explored. For example, the SDR basket could be modified to produce a somewhat higher yield, such as by re-examining the maturity of securities included in the basket. He noted that reluctance to hold SDRs might also extend to SDR-denominated assets in general. The possibility of designating prolonged users to hold SDRs might be considered, with less attention given to the relative strength of those countries' balance of payments and reserve positions. Countries with holdings well in excess of common holdings ratios could, perhaps, be given preferential treatment in terms of voluntary transactions if they so desired, in order to reduce more quickly their SDR holdings toward the common ratio. The Fund could also consider purchasing SDRs from such countries.

There might be modest ways to achieve a more balanced pattern of SDR holdings so as to help preserve the monetary character of the asset and support its continued role in the monetary system, Mr. Templeman commented. He was willing to continue exploring that question, but would against any modifications that would result in a fundamental change in the role of the SDR or that was aimed at bypassing the criteria that should be met before a new allocation was justified.

The staff paper on the development of voluntary SDR transfers presented a useful account of the evolution of the use of SDRs and comments on the prospects for further growth of voluntary and total transfers, Mr. Templeman considered. He supported the staff's continuing efforts to facilitate voluntary transfers along the lines described in the report and had no difficulty with the two-way arrangements with individual countries in order to improve the liquidity of the SDR. Exploration of some of the ideas he had mentioned in connection with incentives and rules of thumb to influence the share of SDRs in members' reserve holdings could be helpful in increasing voluntary transfers in the future.

Mr. Weitz noted that voluntary transfers provided an opportunity for holders of SDRs to use their SDRs without having to demonstrate a balance of payments need and helped to diminish the reliance on the designation mechanism. Voluntary transfers of SDRs had increased substantially and had exceeded designated transactions in recent years. The attractiveness of the SDR as a reserve asset was enhanced if there was an active market in SDRs, allowing members and other holders to buy and sell SDRs against foreign exchange. It was encouraging to note that the waiting time to sell SDRs in voluntary transactions had been reduced to a few days. The staff should continue its efforts to assist members in arranging voluntary transactions and to provide information on the desires of potential buyers and sellers with the objective of facilitating such transactions.

There was no simple relationship between SDR use and resource transfers or adjustment efforts, Mr. Weitz considered. The net use of SDRs on the part of a member did not necessarily imply a transfer of resources or a relaxation of adjustment efforts; it could merely indicate the use of SDRs to repay borrowed reserves or to exchange SDRs for other reserve assets that were preferred by a member. However, he agreed with the staff that the net use of SDRs in recent years, following the reduction and abolition of the reconstitution requirement, had reflected extreme strains on members' external positions, including their reserve holdings and had been associated with an increase in the use of SDRs to settle members' obligations to the Fund. Although it might be helpful to promote a more balanced distribution of SDR holdings in order to reduce the burden on countries that held SDRs in excess of their cumulative allocation, that subject should not be the main focus of the Board's attention.

The staff had described the regulation approach and the incentive approach to obtaining a more balanced distribution of SDR holdings, Mr. Weitz noted. He did not support the regulation approach for the reasons outlined by Mr. Ismael. As for the economic incentives approach, he disagreed with the staff that countries' preference at the margin for foreign exchange rather than SDRs as reserves could be overcome by an increase in the interest rate on the SDR. He supported Mr. Polak's analysis of the economic incentives approach. In sum, his authorities felt that the steps outlined by the staff were clearly inadequate to promote the SDR. An allocation of SDRs was urgently required to improve the usefulness of the asset and to benefit the international monetary system.

Mr. Suraisry recalled that the Executive Board had been considering for a long time how to enhance the role of the SDR. He welcomed the staff's efforts to facilitate greater use of the SDR by trying to resolve some of the concerns raised by a number of members regarding SDR allocations. He continued to support, in principle, the efforts to facilitate the wider use of SDRs, particularly by enhancing its attractiveness as an asset. Such a development was essential if SDRs were to be a major international reserve asset and if it could help to achieve the majority votes necessary for a resumption of SDR allocations.

On the voluntary transfer of SDRs among participants and prescribed holders, it was encouraging to note the progress in promoting the usability of SDRs, particularly since the second amendment of the Articles of Agreement, Mr. Suraisry commented. The growth in voluntary transactions of SDRs, without the need for representation of balance of payments need or utilization of the designation mechanism, was a noteworthy development. Furthermore, the increased sophistication of transactions arrangements, as evidenced by the two-way arrangement with one country to buy and sell SDRs, was also important. Steady progress of that type was an essential prerequisite for encouraging the longer-term development of the SDR. However, much of the growth in SDR-denominated transactions was related directly or indirectly to Fund activities and did not necessarily constitute a permanent improvement in the usability of SDRs. If the relevant Fund activities were reduced, SDR usage might well decline. Therefore, lasting improvements in the SDR as an asset were called for.

The staff paper on distribution of SDRs presented further possible improvements that could increase the willingness to hold SDRs, Mr. Suraisry considered. Despite the increase in the attractiveness of the SDR, it remained financially less attractive than most other assets. Equally important, there was no well-developed market in which SDRs could be exchanged quickly, an important factor from the reserve management viewpoint. To elaborate, it was often argued that the SDR was not a liquid asset. In particular, as there was no well-developed market for the SDR, its role as a useful reserve asset in the multiple asset portfolio was constrained, despite recent improvements. In the absence of such a market, central banks found it more difficult to align their portfolios in response to changes in their objectives, as well as to changes in market conditions. Since the main objective of holding reserves was to mitigate the effects of sudden changes in a country's external payments position, the existence of markets in which every component of the reserve portfolio could be traded quickly and easily was of paramount importance. Countries found it difficult to react to sudden disturbances in their balance of payments positions if a sizable part of their reserves constituted an asset that was not or might not be, easy to exchange. The development of voluntary transactions of SDRs without designation was important in that respect. However, there was a caveat: when a country sold SDRs through the voluntary transactions mechanism, the Fund, provided that the criteria for designation were met, probably designated more SDRs. He agreed with Mr. Polak that the desirability of an asset depended on more than its nominal yield. However, it should be recognized that the return of an asset and its liquidity, as measured by the existence of a ready market for that asset, were interrelated.

In addition to those economic factors, psychological elements had an important role to play, Mr. Suraisry noted. The absence of an agreement on new SDR allocations created uncertainty about the future role of the SDR. The central banks of major countries were likely to be unwilling to hold SDRs in excess of allocations if the future role of the SDR remained uncertain. The case was even clearer for private market use of SDRs.

With respect to the regulation approach, the reintroduction of a reconstitution provision would be a major drawback as it would require countries to replenish their SDR holdings at a time when they were experiencing serious balance of payments difficulties, Mr. Suraisry pointed out. There were other drawbacks, some of which were mentioned by the staff. However, despite those disadvantages, the regulation approach should not be abandoned. The proposal to target SDR holdings in relation to nongold reserves was, in principle, the most attractive, as it addressed, at least partially, the concern expressed by those members opposed to an SDR allocation that an allocation might result in a permanent transfer of real resources. Further, in contrast to the reconstitution approach, that option would allow countries to rebuild their SDR holdings in line with the growth in their total reserves. However, he shared the staff's concern regarding confidentiality, lags, and the perceived optimality of the resulting portfolio shares. Serious, practical issues needed to be resolved before that option could be implemented. Mr. Polak had taken a first step toward addressing those issues by illustrating some of the practical implications of that type of approach.

The economic incentives option should help to reduce the costs associated with holding SDRs, Mr. Suraisry considered. However, the potential benefits associated with increasing the rate of return on the SDR should not be exaggerated. Enhancing the role of the SDR would require a combination of both improved regulation and more attractive economic incentives. In addition, it was important to encourage use of the SDR by the private market and to increase the supply of SDRs. The development of an active, private market in SDRs would enhance its liquidity, thereby improving its value as a reserve asset. That point should be kept in mind when evaluating the options to enhance official use of the SDR so as to avoid interfering with the growth of private markets. Finally, on the supply side, a resumption of SDR allocations, on a moderate basis, was necessary to increase the existing stock of official SDRs, thereby permitting an increase in the share of SDRs in total reserves.

Mr. Huang commented that there had been encouraging signs of improvement in the usability and attractiveness of the SDR through different SDR transaction arrangements. The increase in the voluntary transfers of SDRs had been made possible largely through the efforts of the staff. He was in broad agreement with the staff analysis.

SDR transactions with the Fund had accounted for a large proportion of the increase in SDR transactions since 1979, and particularly large drawings had occurred during quota payment periods and debt crises, Mr. Huang noted. In 1984 and 1985, the ratio of SDR holdings in terms of cumulative allocations had stabilized at a low level. However, that development indicated the need for additional liquidity and supplementary reserves, and did not represent the permanent transfer of real resources, especially in the context of a debt crisis. Therefore, the running down of SDR holdings by a large number of countries, and particularly by the capital-importing countries, should be regarded as a temporary situation, and would not have a lasting effect on the world economy.

The drawdown of SDRs during a debt crisis would indicate the usefulness of SDRs in meeting the balance of payments needs of members, Mr. Huang remarked. Indeed, the SDR to some extent had played a role, albeit somewhat limited, of providing relief for debtor countries. Voluntary SDR transactions had increased substantially in the past few years implying that there was less dependence on transactions by designation and, more important, indicating that the usability and attractiveness of SDRs had increased. He agreed with Mr. Polak that the characteristics of the SDR would be greatly enhanced if the major industrial countries stood ready to buy and sell SDRs in substantial amounts.

Nevertheless, the system was not perfect, Mr. Huang considered. On the contrary, in view of the existing limitations on SDRs, efforts were still needed to improve the SDR's attractiveness and usability through some kind of regulation. The staff had discussed that issue extensively, including the possibility of introducing a reconstitution requirement linking the use of SDRs to the net use of total non-gold reserves, and had pointed out the merits and disadvantages of the various approaches. Mr. Polak had presented a number of interesting proposals. Nevertheless, a new SDR allocation was clearly needed to facilitate the smooth execution of those proposals.

He had no difficulty in supporting the reconstitution proposal as long as transactions on agreement were not subject to that restriction, Mr. Huang commented. Otherwise, the SDR would lose some of its liquidity and usability characteristics. Voluntary transfers on agreement should be encouraged. On economic incentives, he agreed fully with Mr. Polak that the present interest rate on the SDR was appropriate. Any further increase in charges and interest on the SDR would not add to its attractiveness.

Mr. Mtei remarked that the staff had clearly shown that more effort was needed to enhance the attractiveness of the SDR as a reserve asset. The staff had also demonstrated that those members that had expressed concern about the distribution of SDR holdings had done so because of their perception that countries holding SDRs in excess of their cumulative allocations bore a cost in doing so. In other words, they considered the SDR to be a less attractive asset to hold than other reserve assets. The staff papers gave the impression that there was much ambivalence about the SDR as a reserve asset and its role in the international monetary system.

He agreed that voluntary transactions would help to develop the SDR and improve holders' attitude toward it, Mr. Mtei went on. Such transfers could be facilitated, inter alia, by allowing participants and other holders greater latitude in arranging operations in SDRs and by promoting its use as a unit of account. Unfortunately, largely owing to the uneven distribution of SDR holdings, there seemed to be an attempt to restrict members' use of SDR holdings by reintroducing the reconstitution requirement. Net holdings of SDRs by countries that were heavily indebted could be increased only if the debt situation of those countries improved, not by improving the attractiveness and usability of the SDR. The Fund could be caught in a stalemate with respect to efforts to improve the attractiveness of the SDR unless there was clear political support among the membership for enhancing its usability.

It had been suggested that some form of regulation on the use of SDRs be reintroduced in order to ensure a more even distribution of SDRs and, perhaps, to gain support for a further allocation, Mr. Mtei noted. However, the Fund was generally opposed to restrictions in the market on the grounds that they were inefficient. The arguments in favor of SDR allocations had their own merits that were independent of the issues before the Board at the present meeting.

He welcomed the efforts to be made by the staff to develop a market for SDRs by assisting members in arranging transactions and devising an appropriate information system on the desires of potential buyers and sellers, Mr. Mtei stated. Voluntary transactions had increased rapidly in recent years owing to the staff's efforts and the willingness of some members to enter into standing agreements with the Fund to buy SDRs and of one member to buy and sell SDRs. If other important members were willing to enter such arrangements, the SDR could become more liquid, thereby improving its usability and the willingness of participants to hold the SDR as part of their reserves. However, voluntary transactions remained closely related to the dealings between members and the Fund, an indication that the system of SDR use continued to be deficient.

The concern about the issue of distribution of SDRs arose from the perception that countries holding excess SDRs were subsidizing net users of SDRs, Mr. Mtei noted. However, the staff had pointed out that the present approach for determining the rate of interest for the SDR tended to ensure that the subsidy element to countries that used SDRs to obtain real resources would be relatively small or even nonexistent. Therefore, he saw no need to increase the SDR rate of interest any further. In addition, it was unlikely that an increase in the interest rate would encourage countries to increase their holdings of SDRs, given the present institutional framework. Attention should instead be focused on encouraging voluntary transfers, and major countries should cooperate with the staff in formulating concrete proposals to increase voluntary transfers.

The staff had outlined the advantages and disadvantages of the regulation approach to reducing prolonged net use of SDRs, Mr. Mtei observed. Both approaches would lead to inefficiency and would involve some cost, because participants were likely to be obliged to hold SDRs in amounts that differed from the desired amounts based on the member's particular economic situation. However, it had been argued that regulation of SDR holdings relative to other reserves was better than regulation that restricted the use of SDRs without consideration of the member's balance of payments position. He agreed with the staff that any combination of regulations and incentives should be designed to avoid a situation in which the SDR was used only infrequently in financing payments imbalances. In any event, emphasis should be placed on improving incentives rather than on introducing restrictions.

Mr. Pérez noted that the staff papers had presented some suggestions to increase the liquidity and usefulness of the SDR and enhance its attractiveness as a component of monetary reserves. Mr. Polak had also made a valuable contribution to the present discussion. The paper on voluntary transfers pointed out the effort made by the staff in the past few years to create an active market for the SDR. The staff had suggested ways to increase the number and magnitude of transactions that could enhance the liquidity of the SDR, a key issue if its attractiveness as a reserve asset was to be improved. The dominant factor contributing to the growth of SDR transfers had been the increase in Fund financial activities and the important role of the SDR in Fund transactions and operations. The large number of Fund arrangements agreed upon in the past few years, together with the growing amounts of financing involved, would ensure an active market for the SDR in future years in connection with the settlement of charges and repurchases associated with those arrangements. In addition, given the large external imbalances in a significant number of member countries and the role of the Fund in helping those countries, there would clearly be an active market for the SDR in the near future.

Although the timetable for repurchases and the settlement of charges was, to some extent, limited by the financial constraints felt by countries undertaking Fund arrangements, the staff should, within existing margins, give due regard to an optimal distribution of Fund financing operations to ensure that the number and magnitude of transactions would be properly distributed throughout the year, thus assuring that the market for the SDR would be operative on most working days, Mr. Pérez considered. In that manner, the waiting list for buying or selling SDRs would be reduced, and the concerns of those members holding SDRs about the relative liquidity would be dispelled. In addition to exhausting the possibilities for increasing the liquidity of the SDR through Fund operations, the institution should also try to increase the number of SDR operations and activities outside the Fund, one of the most promising avenues to ensuring an active market for the asset. The use of SDRs for foreign exchange market intervention, a possible activity in the interim exchange rate system, and the use of the SDR as a unit of account in international trade and in designating financing obligations and instruments would increase demand for the asset and its liquidity.

He welcomed the active role taken by the staff in helping members to arrange desired transactions in SDRs, which had resulted in the establishment of a variety of standing, selling, and buying arrangements, Mr. Pérez remarked. In particular, the two-way arrangement agreed with Austria was a positive development, and similar agreements with a few of the largest industrial countries could contribute to reducing the need for designation and increasing the liquidity of the SDR.

The staff paper on approaches to influencing the share of SDRs in members' international reserves dealt with the issue of how to decrease the perceived burden associated with excess holdings of SDRs by some members, Mr. Pérez noted. The staff proposed three lines of action: regulation, economic incentives, and a combination of both. For those members that believed that the SDR should become the principal reserve asset in the system, the only way to enhance the SDR's attractiveness was through economic incentives. Regulation, although necessary at an interim stage, was not a promising approach, as it conveyed the impression that the system had to be forced to accept the allocated SDRs. Nevertheless, it should be recognized that enhancing the SDR through incentives would take time. In the meantime, action was necessary to overcome the problems perceived by some members that prevented a resumption of SDR allocations.

Of the two types of regulations contemplated in Schedule G of the Articles of Agreement, he favored the formulas based on Section 1(b), the regulation of SDR holdings in relation to total reserves, as they took into account the balance of payments situation of the country concerned as well as the amount of reserves at a given point in time, Mr. Pérez indicated. The approach explored by Mr. Polak demonstrated how that could be done. He supported Mr. Polak's request that the staff explore formulas along the lines of his proposal and the ways in which a rule might be defined.

An expansion of the potential uses of the SDR should be the first step with respect to the incentives approach, Mr. Pérez stated. The staff had rightly identified the optimal official rate for the SDR as the interest rate that would be freely determined in a market for official SDRs. Therefore, that market should be expanded and the range of activities for which the SDR might be used widened. However, such developments would take time, and in the meantime, the Fund should study whether a modification of the SDR basket in order to increase its yield could improve the attractiveness of the asset.

Mr. Romuáldez commented that the increase in voluntary transactions of SDRs since the second amendment of the Articles of Agreement had been largely related to an increase in members' transactions with the Fund and to an increase in willingness to use SDRs to make those transactions. Most voluntary transactions had occurred in the period immediately prior to the payment of SDR charges, and during that period the SDR had been relatively more liquid in the sense that those wishing to undertake voluntary transactions had largely been able to do so. The development of standing agreements to buy or sell SDRs had increased the liquidity of the SDR outside those periods and had reduced, albeit to a limited extent, the reliance on the designation process. The decision of one member to enter into a standing agreement to buy and sell SDRs and the increased use of SDRs by members for repurchases were welcome developments that would enhance the liquidity of the SDR and the willingness of members to hold SDRs. He would also welcome the further development by the staff of voluntary transactions in SDRs. He was particularly encouraged to learn from Mr. Polak of the Netherlands views on voluntary transactions. He hoped that the larger industrial countries would respond positively to the Netherlands challenge. A market large enough to enhance effectively the liquidity of the SDR would develop only if there were an active demand for SDRs motivated by a preference to hold the asset without reference to the need to use it in transactions with the Fund.

The staff discussed why a redistribution of SDR holdings, more in line with cumulative allocations, might be desirable in the longer term, Mr. Romuáldez noted. The main reason presented by the staff was that the present SDR system had permitted a sustained net use of SDRs by a significant and growing number of members, resulting in a net transfer of resources from net holders of SDRs to net users of SDRs. That permanent resource transfer had imposed costs on the net holders of SDRs by adversely affecting the liquidity and attractiveness of their SDR holdings. That fact, together with the natural disadvantages of the SDR vis-à-vis the main reserve currencies--perceived costs in terms of the liquidity, operational uses, and reporting requirements--had discouraged members from freely acquiring and holding SDRs. The paper suggested ways to achieve a more even distribution of SDR holdings; by introducing a reconstitution requirement, or economic incentives to increase the attractiveness of the SDR, or some combination of the two. That debate was not new. In 1980, the Board had decided to abandon the reconstitution requirement in favor of increasing the attractiveness of the SDR. The papers currently before the Board addressed basically the same issues.

Reconstitution, in any guise, had a number of drawbacks that had been recognized for some time, Mr. Romuáldez pointed out. It imposed a requirement on the use of SDRs that differentiated the SDR from other reserve assets. It had been argued that development of SDRs might best be served by improving other aspects of the SDR and that reconstitution could affect the SDR's monetary characteristics. Another problem more relevant to today's situation, was that there was no assurance that countries in arrears, on which the main burden of reconstitution would fall, would be able to reconstitute their SDR holdings. Those countries would face a trade-off between building SDR reserves and repaying existing creditors, a fact that would reduce the likely effectiveness of any reconstitution proposal. In its favor, reconstitution would require countries to restore their SDR holdings, at least partially, by reducing the potential for permanent resource transfers and its possible adverse effects on adjustment and the liquidity of the SDR.

He had some doubts about the feasibility of the reconstitution approach based on cumulative allocations owing mainly to the difficulties experienced with that approach in the past, Mr. Romuáldez indicated. The reconstitution requirement in operation prior to 1981 had required a minimum average SDR holding over a period of time. While that requirement gave a country flexibility in its use of SDRs, it had a number of drawbacks. For example, members that made heavy use of SDRs early in the period were required to build up their average holdings to much higher levels than the average minimum requirement later in the period. As a result, a country would be unable to make use of its SDRs in the short run regardless of its policies. Furthermore, members were required to reconstitute their holdings regardless of their balance of payments position. As a result, reconstitution had proved difficult to administer. Circumstances had not changed sufficiently to make that proposal any more workable at present. In fact, owing to the arrears problem, the proposal was perhaps less feasible than it had been at the beginning of the decade.

The staff suggested that reconstitution based on the net use of total non-gold reserves had a number of advantages over the approach just mentioned, Mr. Romuáldez observed. It would prevent the depletion of SDR holdings while other reserves were built up, and countries in extreme need would be able to make full use of SDRs for a longer time. As with reconstitution on allocation, that proposal involved a constraint based on average SDR holdings over time. The proposal seemed more flexible than reconstitution based on allocations. However, the staff implied that an increase in members' overall demand for reserves would require an increase in the supply of SDRs. The staff indicated that as demand for reserves would be expected to grow over time, such regulations would encounter complications unless SDR allocations kept pace with demand for reserves. By using the term "demand" for reserves, he assumed that the staff meant a buildup of reserves, or negative net use of reserves. Some members in his constituency objected strongly to the general proposition that an increase in the demand for reserves should be linked to a need to increase the supply of SDRs. For the most part, members wishing to increase their reserve holdings could do so via access to the capital markets. A criterion for an allocation of SDRs remained a long-term global need for reserve supplementation, a different concept from an increase in members' demand for reserves. Indeed, if members desired to hold higher levels of reserves and if their desire, in general, was satisfied by the capital markets, as it had been over the first half of the decade, there was a diminished need for an allocation.

One way around that difficulty would be to place a maximum limit on the required increase in SDR holdings in response to an increase in total reserve holdings, Mr. Romuáldez went on. Mr. Polak had proposed such a mechanism, by suggesting that countries should reconstitute SDRs to a minimum percentage of reserves but not beyond an average ratio of holdings of SDRs to cumulative allocations. Members would not be required to accumulate SDRs once holdings reached a certain percentage of allocation, and there would be no need for the supply of SDRs to increase in line with an increase in revenue holdings.

In sum, the reconstitution proposals had some serious drawbacks, Mr. Romuáldez considered. A proposal based on total reserves, but which limited the requirement to accumulate SDRs to a percentage of allocation, seemed to have fewer disadvantages than one based on cumulative allocations. However, that proposal would still allow long-term net transfers of resources while a member failed to build up its reserve levels. As such, it failed to address properly one of the major disadvantages of unconditional SDR financing--its potential to undermine adjustment.

Since the second amendment of the Articles of Agreement, there had been a significant improvement in incentives to hold SDRs with the aim of achieving more even distribution of net holdings, Mr. Romuáldez noted. Thus far, judging by the trend in net use of SDRs by members, that approach had met with limited success. The staff proposed a number of additional measures that might improve the attractiveness of the SDR: increasing the SDR interest rate, broadening the uses of the SDR to include foreign exchange intervention, increasing the scope of prescribed holders to include the commercial banks, reducing the reporting requirements on SDRs, and eliminating the requirement to transact at official exchange rates. He agreed with Mr. Polak that the present interest rate on the SDR was, in principle, correct. Furthermore, no reasonable increase in the SDR interest rate was likely to increase members' willingness to hold SDRs. He was also skeptical about the overall impact of the other measures aimed at broadening the use of SDRs, except as a further step in the gradual development of the SDR as a reserve asset. He was not convinced that any economic incentives aimed at increasing members' willingness to hold SDRs would be effective in preventing the type of long-term use of SDRs that had occurred in recent years. Moreover, use of economic incentives to compensate net long-term holders of SDRs would also be inappropriate, as it would imply an acceptance of a long-term transfer of resources via SDRs, a proposition that the Interim Committee had recently opposed.

In sum, increasing the economic incentives of holding SDRs was unlikely to be effective in treating the problem of the long-term net use of SDRs, Mr. Romuáldez commented. Regulation would be the only way to prevent long-term net use of SDRs and to encourage net users to reconstitute their holdings. However, he was not fully confident that regulation would prove effective in achieving that goal. Given the chronic arrears problem and the inherent problems associated with all reconstitution proposals, regulation probably had no greater, and perhaps even less chance of succeeding at present than it had in 1980.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/127 (8/1/86) and EBM/86/128 (8/4/86).

2. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/86/137, Sup. 3, 8/1/86) on the canvass of votes of the Governors' Resolution with respect to remuneration of Executive Directors and their Alternates, which is recorded as follows:

Total affirmative votes		342,968
Total negative votes		452,126
Total votes cast		795,094
Abstentions recorded 1/	84,346	
Other replies 2/	23,241	
Total replies		902,681
Votes of members that did not reply 3/		34,944
Total votes of members		937,625

1/ Australia, Brazil, Chile, Japan, Lebanon, New Zealand.
2/ The Bahamas, India.
3/ Antigua and Barbuda, Burundi, Djibouti, Ecuador, Equatorial Guinea, Ethiopia, Gabon, The Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Haiti, Islamic Republic of Iran, Kuwait, Liberia, Nicaragua, Peru, Qatar, St. Christopher and Nevis, St. Lucia, Sierra Leone, Trinidad and Tobago. The Secretary's communication was not sent to Democratic Kampuchea.

Decision No. 8354-(86/128), adopted
August 1, 1986

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/188 (7/31/86) is approved.

APPROVED: April 21, 1987

JOSEPH W. LANG, JR.
Acting Secretary

SDR Holdings, Cumulative Allocations, and Reserves

Participants	SDR Holdings1/ (1)	Cumulative Allocations1/ (2)	Non-Gold Reserves1/ (3)	Col. (1) / Col. (2) (4)	Col. (1) / Col. (3) (5)	Col. (1) - 0.85xCol. (2) (6)	Col. (1) - 0.05xCol. (3) (7)
	(SDR millions)						(SDR millions)
Industrial Countries							
UNITED STATES	6,639	4,900	29,220	1.36	0.227	2,475	5,178
UNITED KINGDOM	1,030	1,913	11,707	0.54	0.088	-596	444
AUSTRIA	191	179	4,340	1.07	0.044	39	-26
BELGIUM-LUXEMBOURG	345	502	4,414	0.69	0.078	-81	125
DENMARK	179	179	4,942	1.00	0.036	27	-68
FRANCE	819	1,080	24,206	0.76	0.034	-98	-391
GERMANY	1,408	1,211	40,403	1.16	0.035	379	-612
ITALY	297	702	14,125	0.42	0.021	-300	-409
NETHERLANDS	569	530	9,816	1.07	0.058	119	79
NORWAY	258	168	12,670	1.54	0.020	115	-375
SWEDEN	224	247	5,274	0.91	0.043	15	-39
CANADA	198	779	2,278	0.25	0.087	-464	84
JAPAN	1,926	892	24,325	2.16	0.079	1,168	710
FINLAND	156	143	3,414	1.10	0.046	35	-14
ICELAND	--	16	187	0.02	0.002	-14	-9
IRELAND	99	87	2,676	1.13	0.037	25	-35
SPAIN	254	299	10,174	0.85	0.025	--	-254
AUSTRALIA	283	471	5,251	0.60	0.054	-117	20
NEW ZEALAND	6	141	1,453	0.04	0.004	-114	-67
TOTAL	14,884	14,438	210,875	1.03	0.071	2,614	4,340
Capital Exporting Developing Countries							
IRAN, I.R. OF	328	244	6,350	1.34	0.052	121	11
IRAQ	--	68	5,614	--	--	-58	-281
KUWAIT	104	27	4,981	3.90	0.021	82	-145
OMAN	11	6	993	1.74	0.011	6	-39
QATAR	19	13	406	1.47	0.046	8	-1
SAUDI ARABIA	529	196	22,764	2.70	0.023	363	-609
UNITED ARAB EMIRATES	68	39	2,917	1.76	0.023	35	-78
LIBYA	156	59	5,375	2.66	0.029	106	-113
TOTAL	1,215	651	49,399	1.87	0.025	662	-1,255

(Continued). SDR Holdings, Cumulative Allocations, and Reserves

Participants	SDR Holdings1/ (1)	Cumulative Allocations1/ (2)	Non-Gold Reserves1/ (3)	Col. (1) / Col. (2) (4)	Col. (1) / Col. (3) (5)	Col. (1) - 0.85xCol. (2) (6)	Col. (1) - 0.05xCol. (3) (7)	Minimum Additional Holdings (8)
	(SDR millions)					(SDR millions)		
Capital Importing Developing Countries with Recent Debt-Servicing Problems								
YUGOSLAVIA	--	155	997	--	--	-132	-50	50
SOUTH AFRICA	1	220	286	--	0.002	-187	-14	14
ARGENTINA	--	318	2,236	--	--	-271	-112	112
BOLIVIA	--	27	182	--	--	-23	-9	9
BRAZIL	1	359	9,654	--	--	-304	-482	304
CHILE	--	122	2,230	--	--	-103	-111	103
COSTA RICA	--	24	461	--	--	-20	-23	20
DOMINICAN REPUBLIC	29	32	310	0.91	0.093	2	13	--
ECUADOR	26	33	654	0.80	0.040	-2	-7	2
EL SALVADOR	--	25	164	--	--	-21	-8	8
GUATEMALA	--	28	274	--	--	-24	-14	14
HAITI	--	14	6	--	0.002	-12	--	--
HONDURAS	--	19	96	--	--	-16	-5	5
MEXICO	--	290	4,467	--	--	-246	-223	223
NICARAGUA	--	19	426	--	--	-17	-21	17
PANAMA	12	26	89	0.44	0.131	-11	7	--
PARAGUAY	39	14	498	2.83	0.078	27	14	--
PERU	--	91	1,663	--	--	-78	-83	78
URUGUAY	13	50	159	0.27	0.084	-29	5	--
VENEZUELA	451	317	9,332	1.42	0.048	182	-15	--
ANTIGUA AND BARBUDA	--	--	15	*	--	--	-1	--
GRENADA	--	1	19	0.01	0.001	-1	-1	1
GUYANA	--	15	3	--	--	-12	--	--
BELIZE	--	--	13	*	--	--	-1	*
JAMAICA	--	41	147	--	--	-35	-7	7
ST. LUCIA	--	1	12	--	--	-1	-1	1
SURINAME	1	8	21	0.10	0.036	-6	--	--
EGYPT	--	136	721	--	--	-115	-36	36
YEMEN ARAB REP.	23	6	270	3.76	0.086	18	10	--
KAMPUCHEA, DEM.	--	15	*	--	*	-13	*	*
PHILIPPINES	35	117	560	0.30	0.063	-64	7	--
VIET NAM	--	48	137	--	--	-41	-7	7
CENTRAL AFRICAN REP.	2	9	54	0.17	0.029	-6	-1	1
CHAD	4	9	46	0.37	0.077	-4	1	--
CONGO	2	10	3	0.16	0.538	-7	1	--
ZAIRE	--	86	173	--	0.001	-73	-8	8
BENIN	--	9	4	--	0.003	-8	--	--
GAMBIA, THE	--	5	2	--	--	-4	--	--
GHANA	17	63	436	0.27	0.040	-36	-5	5
GUINEA-BISSAU	--	1	*	--	*	-1	*	*
GUINEA	--	18	*	--	*	-15	*	*
COTE D'IVOIRE	--	38	4	--	0.016	-32	--	--
LIBERIA	--	21	1	--	--	-18	--	--
MADAGASCAR	--	19	55	--	0.001	-16	-3	3
MALAWI	--	11	41	--	--	-9	-2	2
MALI	2	16	20	0.10	0.080	-12	1	--
MAURITANIA	4	10	54	0.40	0.073	-4	1	--
MOROCCO	--	86	105	--	0.001	-73	-5	5
MOZAMBIQUE	--	--	*	*	*	--	*	*
NIGER	--	9	124	--	--	-8	-6	6
NIGERIA	1	157	1,518	0.01	0.001	-133	-75	75
SENEGAL	--	24	5	--	0.011	-21	--	--
SIERRA LEONE	--	17	10	--	--	-15	--	--
SOMALIA	--	14	2	--	--	-12	--	--
SUDAN	--	52	11	--	--	-44	-1	1
TANZANIA	--	31	15	--	--	-27	-1	1
TOGO	--	11	270	0.01	--	-9	-13	9
UGANDA	--	29	13	--	0.002	-25	-1	1
ZAMBIA	--	68	182	--	--	-58	-9	9
WESTERN SAMOA	--	1	13	0.01	0.001	-1	-1	1
ROMANIA	--	76	181	--	--	-65	-9	9
TOTAL	662	3,472	39,443	0.19	0.017	-2,289	-1,310	1,146

(Concluded). SDR Holdings, Cumulative Allocations, and Reserves

Participants	SDR Holdings1/ (1)	Cumulative Allocations1/ (2)	Non-Gold Reserves1/ (3)	Col. (1) / Col. (2) (4)	Col. (1) / Col. (3) (5)	Col. (1) - 0.85xCol. (2) (6)	Col. (1) - 0.05xCol. (3) (7)	Minimum Additional Holdings (8)
	(SDR Millions)					(SDR millions)		
Capital Importing Developing Countries Without Recent Debt-Servicing Problems								
GREECE	--	104	790	--	--	-88	-39	39
MALTA	40	11	899	3.51	0.044	30	-5	--
PORTUGAL	16	53	1,270	0.29	0.012	-30	-48	30
TURKEY	--	112	961	--	--	-95	-48	48
COLOMBIA	--	114	1,452	--	--	-97	-73	73
BAHAMAS, THE	--	10	176	0.03	0.002	-8	-8	8
BARBADOS	--	8	127	--	--	-7	-6	6
DOMINICA	--	1	3	--	--	-1	--	--
ST. CHRISTOPHER & NEV.	--	--	*	*	*	--	*	*
ST. VINCENT	--	--	13	--	--	--	-1	--
TRINIDAD AND TOBAGO	108	46	1,027	2.33	0.105	68	56	--
BAHRAIN	14	6	1,511	2.20	0.009	8	-62	--
CYPRUS	--	19	542	0.01	--	-16	-27	16
ISRAEL	--	106	3,350	--	--	-90	-167	90
JORDAN	22	17	385	1.30	0.057	8	3	--
LEBANON	2	4	978	0.40	0.002	-2	-47	2
YEMEN, P.D. REP.	2	23	181	0.10	0.013	-17	-7	7
SYRIAN ARAB REP.	3	37	181	0.08	0.015	-28	-6	6
AFGHANISTAN	12	27	269	0.47	0.046	-10	-1	1
BANGLADESH	12	47	306	0.25	0.039	-28	-3	3
BHUTAN	--	--	*	*	*	--	*	*
BURMA	--	43	31	--	0.001	-37	-2	2
SRI LANKA	--	71	411	--	--	-60	-20	20
INDIA	306	681	5,845	0.45	0.052	-273	14	--
INDONESIA	51	239	4,529	0.21	0.011	-152	-175	152
KOREA	36	73	2,612	0.50	0.014	-26	-94	26
LAOS, P.D. REP.	--	9	--	--	0.833	-8	--	--
MALAYSIA	105	139	4,472	0.76	0.024	-13	-118	13
MALDIVES	--	--	4	0.07	0.005	--	--	--
NEPAL	--	8	51	--	0.001	-7	-3	3
PAKISTAN	24	170	735	0.14	0.033	-120	-13	13
SINGAPORE	66	16	11,695	4.00	0.006	52	-519	--
THAILAND	1	85	1,994	0.02	0.001	-71	-98	71
DJIBOUTI	--	1	*	0.31	*	-1	*	*
ALGERIA	126	129	2,566	0.98	0.049	16	-3	--
BOTSWANA	10	4	713	2.22	0.014	6	-26	--
BURUNDI	--	14	27	0.01	0.004	-12	-1	1
CAMEROON	4	24	9	0.17	0.452	-17	4	--
CAPE VERDE	--	1	*	0.16	*	--	*	*
COMOROS	--	1	*	0.29	*	--	*	*
EQUATORIAL GUINEA	3	6	*	0.53	*	-2	*	*
ETHIOPIA	--	11	135	0.02	0.001	-9	-7	7
GABON	2	14	248	0.15	0.008	-10	-10	10
KENYA	1	37	356	0.02	0.002	-31	-17	17
LESOTHO	1	4	40	0.26	0.025	-2	-1	1
MAURITIUS	--	16	27	--	0.001	-13	-1	1
ZIMBABWE	13	10	85	1.29	0.155	5	9	--
RWANDA	8	14	103	0.60	0.079	-3	3	--
SAO TOME & PRINCIPE	--	1	*	0.06	*	--	*	*
SEYCHELLES	--	--	8	0.02	0.001	--	--	--
SWAZILAND	--	6	76	0.04	0.003	-5	-4	4
TUNISIA	--	34	212	0.01	0.002	-29	-10	10
BURKINA FASO	6	9	127	0.60	0.044	-2	-1	1
SOLOMON ISLANDS	1	1	33	1.18	0.023	--	-1	--
FIJI	5	7	119	0.74	0.043	-1	-1	1
VANUATU	--	--	10	*	0.016	--	--	--
PAPUA NEW GUINEA	6	9	376	0.63	0.016	-2	-13	2
TONGA	--	--	*	*	*	--	*	*
CHINA, PEOPLE'S REP.	440	237	11,588	1.86	0.038	238	-140	--
HUNGARY	--	--	2,840	*	--	--	-142	--
TOTAL	1,448	2,872	66,658	0.50	0.022	-993	-1,889	684
TOTAL MINIMUM ADDITIONAL HOLDINGS FOR ALL COUNTRIES								2,363

*Data not available or ratio undefined.

1/ At the end of 1985.