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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/78

10:00 a.m., June 24, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
G. K. Arora	
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J. de Groote	J. Prader
	M. Mrakovcic, Temporary
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	A. F. Mohammed
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H. Fukui	
B. Goos	
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G. A. Posthumus	
C. V. Santos	
A. Torres	R. Marino
A. Végh	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
S. W. Tenney, Assistant

Also Present

African Department: C. Brachet. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; G. R. Kincaid. Legal Department: F. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; J. L. Hagan, K. Sono. Middle Eastern Department: S. K. Wajid. Research Department: M. Mussa, Economic Counsellor and Director; M. Goldstein, Deputy Director; F. Larsen, D. J. Mathieson. Secretary's Department: A. Jbili, A. Leipold. Treasurer's Department: D. Williams, Treasurer; D. Gupta, C. A. Hatch, T. M. Tran, M. A. Wattleworth, G. Wittich. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. M. Abbott, P. Bonzom, M. B. Chatah, B. R. Fuleihan, A. R. Ismael, J. M. Jones, Y.-H. Lee, E. Martínez-Alas, M. J. Mojarrad, M. Nakagawa, A. Raza. Assistants to Executive Directors: D. A. Barr, B. Bossone, J. H. Brits, Chen M., J. A. Costa, S. B. Creane, Duan J., N. A. Espenilla, Jr., S. K. Fayyad, O. A. Himani, J. Jonas, K. Langdon, W. Laux, F. Moss, E. H. Pedersen, E. Quattrociocche, L. Rodríguez, P. L. Rubianes, Tin Win.

1. INTERNATIONAL LIQUIDITY AND THE ROLE OF SDR

The Executive Directors considered a staff paper on international liquidity and the role of the SDR mechanism (SM/92/106, 5/27/92).

Mr. Filosa made the following statement:

In the light of the transition to market-oriented economic policies under way in most of the formerly centrally planned economies and the rapidly growing number of developing economies embracing the principles of decentralized decision making, open trade, and free capital movements, the world economy has at once become larger, and the degree of integration has become greater. As a result, the principles inspiring the working of the international monetary system, as well as the responsibility for its orderly functioning, extend to almost all nations on earth.

Great efforts are indeed being made to this effect and, in directing such efforts, the Fund is called upon not only to support strong adjustment programs where needed, but also one of its fundamental duties is to ensure that all possible conditions are in place within the international monetary system to make such transitions as smooth and as least costly as possible.

Three such systemic conditions are: the existence of sufficient international liquidity; its adequate distribution among member countries; and its availability to individual countries at affordable costs. To the extent that these conditions are not fulfilled, and no corrective action is taken, it would become unnecessarily costly for the formerly centrally planned economies to accomplish their transformation and, more important, it would be difficult to achieve the three conditions that are crucial to the well functioning of the international monetary system, namely, orderly exchange rate developments, sufficiently smooth transitions to currency convertibility worldwide, and the rapid elimination of payments and trade restrictions.

Indeed, the collapse of the centrally planned economies following the dismantling of their old economic structures and trade links and the strong economic adjustment and restructuring programs needed in some developing economies facing extreme reserve shortages require these countries to build significant foreign exchange reserve holdings. These reserves, of course, are crucial in allowing the economies to sustain the desired pace of adjustment by absorbing temporary and unanticipated shocks. Among the countries considered, however, the economies in transition have started the transformation process and have joined the international monetary system in conditions of acute shortages of owned reserves; all these countries, moreover, have virtually no access to borrowed reserves.

The need for reserves for these countries, in fact, seems to be becoming most pressing at a time when financial policies in a number of industrial economies must aim at redressing domestic and external imbalances, thus limiting or delaying the provision of reserve currencies through the external current account channel. Nevertheless, the political and economic uncertainties surrounding the transition process in the formerly centrally planned economies and adjustment in the most vulnerable developing countries are such that it is unrealistic to assume that, for at least some years, the needed reserves can be tapped from private sources. Thus, in the circumstances, it appears that the international monetary system does not provide an adequate mechanism to satisfy the demand for reserve holdings of many of its members.

Certainly, it can be expected that once appropriate policies will have been put in place in such countries--once their exportable production will have been integrated into world trade and they have reached a degree of creditworthiness acceptable to private lenders, they will be able to resort, when necessary, to the normal sources of reserves. For the time being, however, such conditions are far from being met, and the only option available to these countries for acquiring the needed reserves is to implement external current account adjustments--i.e., import compression--of such magnitudes as to be politically risky and economically disruptive. The cost of that option must be weighed against the possibility of generating reserves for these countries in ways that could be less costly both for them and the system and against the political and economic costs deriving to these countries and to the system as a whole from the slowdown and eventual failure of the transition and adjustment processes in the countries concerned.

One sensible alternative to import compression is the allocation and redistribution of SDRs to countries facing severe reserve stringencies, as discussed in the staff paper. The liquid resources thus generated would enhance the reserve holdings of these countries. Of course, the redistribution of newly allocated SDRs would have an advantage over a simple allocation by providing reserves precisely to the countries that need them most, thereby reducing the overall size of the allocation necessary to satisfy their reserve needs.

The alternative proposed by the staff would avoid the costs associated with import compression and would make additional reserves available at basically no cost to the system. It would also allow the SDR recipients to promote the elimination of import restrictions and, more generally, avoid policies that would unnecessarily constrain economic activity.

In order to appropriately assess the merit of a new SDR allocation in the present circumstances, it would be necessary to ascertain its consistency with the Fund's criteria governing decisions on SDR allocations. As to the provision in the Articles of Agreement that, in all decisions concerning the allocation and cancellation of SDRs, the Fund "shall seek to meet the long-term global need...to supplement reserve assets in such a manner as will promote the attainment of its purposes...," the two key words are "global" and "long term."

It is clear from the Articles of Agreement that, for the need to be "global," it is not required that all, or nearly all, member countries need to increase their reserves. Rather, what matters is that the actual or projected inadequacy of reserves of a sufficiently large group of countries might have an impact on the performance of the whole system. In the present case, although the shortage is geographically concentrated, it not only involves a large part of the system, but also its persistence might pose a threat to the system's stability and orderly functioning. Moreover, to the extent that the allocation allows the recipient countries to avoid unduly restrictive economic policies, it would have positive spill-over effects for other countries and, in this sense, may be said to have a global impact.

With respect to the "long-term" aspect, an important long-term consideration is in fact implicitly present in the problem at hand. In the absence of a new SDR allocation, the countries concerned might not be able to reach the long-term objective of resorting to normal international reserve sources if they were not able to sustain the necessary transformation and adjustment processes. For such countries, the difficulty of access to international capital markets would indeed be a long-term problem that would run counter to the purposes of the Fund. To redress these problems, much more costly and complex solutions might be needed later. In other words, not satisfying the need of these countries might well have both long-term and global adverse consequences.

Important systemic reasons to favor a new SDR allocation can also be drawn from the discussion that took place during the 1980s at the international level, when the Group of Ten (G-10) assessed the functioning of the international monetary system. At that time, doubts had arisen about the stability and reliability of an international reserve system that was largely based on borrowed reserves from private lenders. As the events following the debt crisis clearly showed, and as the current situation of the economies in transition confirms, borrowed reserves tend to "disappear" or to be unavailable especially when they are most needed. An allocation and redistribution of SDRs would thus be fully in line with the idea of making the system, in particular its most vulnerable members, less dependent on private lenders.

Finally, by increasing the average ratio of SDR holdings to world reserves, a new SDR allocation would reinvigorate the role of the SDR as an international reserve asset and would move the whole system some distance toward the desirable objective of making the reserve supply mechanism independent of the official liabilities of the reserve countries.

An adequate assessment of a new allocation and redistribution of SDRs, of course, requires that the potential risks inherent in their implementation be considered. The major risks related to a new SDR allocation are the risk of generating inflationary pressures and that of lessening the financial discipline of the recipient countries. As to the risk of inflation, to the extent that the allocation of new SDRs is limited to a fraction of the total demand for international reserves and the newly allocated SDRs are added to the reserves of those countries that are willing to undertake Fund-supported programs, it is unlikely that the allocation would result in any significant pressure on real resources. However, if the allocation is seen as a solution to the import-compression alternative, it would, by definition, imply an increase in the domestic spending of the recipient countries, over and above the level of demand that would prevail in those countries in the absence of a new SDR allocation. In this case, inflation could best be avoided by preventing inappropriate spending by the recipient countries.

Instrumental to this effect would be appropriate modalities of implementation of the SDR redistribution. First, with respect to the allocation and redistribution exercise, all members with strong reserve positions should make available to the Fund all the newly allocated SDRs. In fact, all countries with no ongoing Fund arrangements should be "invited" to do so. Indeed, some of the most successful countries with Fund arrangements--in recognition of the extreme need of some fellow members--might decide to lend their newly allocated SDRs; others could decide to retain their allocation, but agree with the Fund to revise upward their international reserve holdings by an amount equal to their allocation. Such an agreement would introduce an element of self-discipline and minimize the impact of the new allocation on global spending. It should be clear, in any event, that the decision to proceed with a new SDR allocation should rest on whether a predetermined minimum of participating countries would intend to enter into a voluntary undertaking to contribute to the redistribution exercise.

I would be in favor of those proposals for redistribution that envisage the Fund as principal of the operation, and I would certainly endorse the idea that the SDR redistribution to individual countries should be effected within the context of Fund-supported programs. This would have the important advantage of not only ensuring that the redistribution would take place with grater uniformity in terms and conditions than under alternative approaches, but it would also guarantee that the redistribution would be rigorously based on balance of payments and macroeconomic policy considerations.

The Fund's involvement as principal would introduce conditionality as an indispensable component of the whole exercise. Through conditionality, of course, it would be possible for the international financial community to exert through the Fund direct control on the degree of financial discipline of the recipient countries. In particular, I would support the idea of including, among the performance criteria of the associated Fund-supported programs, targets for international reserve holdings higher than they would be in the absence of an SDR allocation. I would not, however, propose to resort to any form of SDR reconstitution, as measures of this sort are discriminatory to the SDR as a monetary asset vis-à-vis other liquid assets and, thus, are detrimental to the objective of promoting a larger use of the instrument in the long term.

Finally, a remaining question that merits further analysis is the size of the new allocation. In view of the purpose of the exercise, the determination of the appropriate size would first require an assessment of the willingness of the participants to redistribute their newly allocated SDRs. In fact, once the need for additional reserve holdings of the targeted countries has been identified, it would be necessary to know the potential redistribution pattern to determine the allocation size that would allow the attainment of those holdings.

Mr. Landau made the following statement:

The staff paper makes a clear and very convincing case in favor of a moderate SDR allocation together with some redistribution mechanisms and conditionality. Before dealing with the heart of the matter, I would like to make some general remarks about the context of this discussion.

First, there is an obvious need to build up international reserves and liquidity in certain regions of the world that have only recently been moving toward market-oriented economies. This has been true for Central European countries in the past two years. It is even more the case for members of the Commonwealth of Independent States (CIS), especially if they were to adopt separate currencies.

Second, failure to meet that emerging additional demand for international liquidity could have dire consequences for those countries. Only Hungary has been able up until now to come back to an acceptable level of international reserves through normal market mechanisms. Most of them have already gone through exceptional import compression without being able to restore an acceptable level of international liquidity. They face the prospect of both continued GDP reduction and financial instability if they cannot be provided both with balance of payments assistance, which is beyond the scope of the current discussion, and adequate reserves.

Third, consequences for the rest of the membership from the difficulties met by those countries might be significant in the short or the long run. Apart from the risk emanating from geopolitical instability, donor countries will be under increasing pressure to come up with additional financing; already, the tension generated by the gap between the minimal needs and the aid available is visible.

In fact, the need for additional liquidity has been recognized, in the case of some countries, and met with some new and sometimes unorthodox solutions. In the case of Poland, official development assistance (ODA) funds have been mobilized to constitute a zloty stabilization fund, operating as a second line of reserve. In the case of Russia, activation of the General Arrangements to Borrow (GAB) is contemplated for the same purpose, which was not exactly the same as that envisaged when this agreement was put into place.

In this framework, the question is not whether or not an SDR allocation is needed, but how an SDR allocation would compare with other means or tools as the best way to provide international liquidity and reserves to those countries in need.

The case developed in the staff paper rests on six main arguments, all of which seem valid.

Recognition of a long-term global need does not imply that all countries face shortages of international reserves. It is sufficient that countries whose needs are recognized present a risk of a systemic nature for the rest of the world, which is currently the case for a significant number of new members.

Once global need is recognized, the decision to allocate SDRs should not depend on finding that this need cannot be met through other means; the fact that reserves could be acquired--or borrowed--on the market is not sufficient reason to exclude an SDR allocation.

In any case, the possibilities of getting reserves through market and official credit arrangements might be very limited in the future for the countries most in need. The imperative of fiscal consolidation in industrial countries will limit the possibilities of official credits, and there are certainly better uses for this type of resource. In addition, there might be some erosion in the capacity of international financial and capital markets to finance reserve accumulation where it is most needed. The staff underlines the risk of "contagion" effects, which would cut off the supply of funds for some countries. More generally, creditworthiness of newcomers to the international economic and financial scene takes a long time to establish or re-establish. Thus, it cannot be taken for granted that good policies will also be rewarded by capital inflows in sufficient amounts to cover both balance of payments financing and reserve accumulation. In the case of Hungary, only an unexpected surge of foreign direct investment has led to an increase of reserves.

The cost of holding borrowed reserves can be very high for those countries whose international creditworthiness is fragile. Table 8 of SM/92/106 strikingly illustrates the significant amount of resources that those countries have to allocate for that purpose.

Some of the risks mentioned in previous discussions on SDR allocations might not be as prevalent at the present stage as they were in the past. I am referring, in particular, to the inflationary risks associated with the expansion of international liquidity.

On the global scale, and especially in the industrial world, inflation pressures are currently lower than they have been at any time in the past 20 years. The risk of fueling inflation through an SDR allocation could be contained through incentives to hold the corresponding reserves rather than spending them. This point is clearly underlined in the staff paper. Moreover, the inflationary risks could be further reduced by calibrating a possible SDR allocation to make it smaller than the prospective increase in the demand for global reserves.

Apart from an SDR allocation, and excluding the possibility of borrowing in international markets, the only means for new members to get needed international reserves is from the General Resources Account (GRA). Compared with an SDR allocation, the constitution of reserves through the GRA seems to present two important drawbacks. First, GRA resources are more temporary, owing to the short-term character of Fund financing. Second, such an arrangement would put additional pressure on the general resources of the Fund in a period of prospective high utilization. Thus, we wonder whether those resources might best be used for other purposes, such as catalyzing balance of payments financing for program countries. This raises the question of how best to use the panoply of tools available for the various aims currently under consideration. Excluding an SDR allocation would be somehow penalizing.

In light of the above-mentioned considerations, we support both the thrust of the staff paper and the proposals that have been put forward, in particular by Mr. Hashimoto. We certainly consider that a moderate SDR allocation would be appropriate during the sixth basic period. We also favor the institution of a redistribution mechanism that would allow those countries with the greatest need to constitute or reconstitute their reserves to benefit selectively from this allocation. Some mechanism was proposed, in a different context, by Mr. de Maulde on behalf of France, and his proposals are still valid. Their great merit is that the Fund is not put at risk by the redistribution mechanism. Nevertheless, we are certainly prepared to consider other possible proposals. We would also be prepared to study the possibility of making this redistribution mechanism conditional to ensure that it would be used both to support an adequate economic program and meet the original purpose of holding--rather than spending--the redistributed SDRs.

We are not unduly concerned about the problem of prolonged net users of SDRs. As the staff paper clearly notes, at the present level of remuneration, the SDR does not seem to lead to a transfer of real resources. The problem of prolonged use should be seen as a symptom of underlying imbalances or inappropriate policies, which have to be tackled by proper means, i.e., by proper conditionality. However, if it is necessary to make the proposals acceptable for other members of the Board, we would be prepared to consider some reconstitution requirements after a sufficiently long period.

The staff paper mentions only briefly the possibility of a "hardened" SDR in the future. This question has been raised on many previous occasions by the U.K. chair. We would certainly be interested in further elaboration of this proposal. Obviously, at the present stage, the SDR is sufficiently attractive. Indeed, large holders of SDRs do not enter as frequently as needed in voluntary transactions. Nevertheless, while that subject is beyond the scope of the current discussion, a hardened SDR could play a certain role as an anchor in the functioning of the international monetary system in the future.

While we would insist that the Fund be in a position to come as quickly as possible to an operational decision for an allocation of SDRs, we understand the priority that should be given to implementing the quota increase under the Ninth General Review of Quotas. Nothing should be done to place that process in danger. As I have indicated, the possibilities offered by an SDR allocation should come in addition to--not as a substitute for--the much-needed and much-delayed increase in the Fund's ordinary resources.

Mr. de Groote made the following statement:

The concise staff paper currently under consideration covers most of the topics relevant to an SDR allocation. At first sight, the staff's presentation of these topics seems logical, as it assesses the global need for an SDR allocation, the inflationary potential of an allocation, the problem of prolonged net use, and the potential of a retransfer of such an allocation to the Fund for conditional use.

Nevertheless, I differ from this presentation, which is less logical than it first appears. Indeed, the retransfer issue should be settled first, rather than last, because it radically affects the answers to all the other questions; the global need for reserves and the inflationary risk of an allocation must both be assessed differently depending on whether or not the retransfer is taken into account. The retransfer of SDRs would eliminate the unconditionality related to the use of SDRs and limit the size of the allocation to be considered, since the retransferred SDRs would be used only for specific purposes and would be directed only where such resources are really needed. For this reason, future consideration of SDR allocations should begin with the retransfer issue and only then examine the other issues, instead of taking the retransfer as a codicil to be considered after all issues have been settled. Such a reordering would break the present vicious circularity of Board discussions on this topic.

As to the most crucial issue, namely, the adequate provision of international liquidity and the contribution of the SDR to this goal, two questions arise. First, are current reserve levels adequate? Second, can an SDR allocation make a useful addition to future reserve needs? While Table 1 of SM/92/106 could lead to the superficial conclusion that the ratio of non-gold reserves to imports at the beginning of the 1990s is rather healthy compared with the situation prevailing 10 or 20 years ago, closer examination reveals interesting findings, on which I will comment at some length.

First, as the staff notes, the rise in the overall ratio is largely accounted for by the industrial countries, whose ratios of reserves to imports increased by 5 points between 1985 and 1987, as a result of de facto changes in the exchange rate system following the Plaza and Louvre agreements. For this reason, the current level of the industrial country ratios should be considered historically normal, lying between the level of the early

1970s, when a fixed exchange rate system was in place, and the level of the late 1970s and early 1980s, when exchange rates were operating under a more or less generalized floating system. If the restoration of the higher liquidity level of the past resulted from changes in the system, or more precisely, from changes in what the monetary authorities regarded as their reserve needs under a system of more stable exchange rates, renewed efforts to increase stability in the exchange rates of the major currencies will further increase the usefulness of a buildup in reserves.

Second, the slight increase that occurred between the 1970s and end-1991 in the reserve ratio for the developing countries generally and for some of the subgroups was entirely due to a sudden increase in the ratio in 1991. The subsequent changes show that the sizable increase in the ratio in 1991 can be attributed to declining import values for developing countries' imports. Indeed, the figures in the most recent World Economic Outlook indicate that in 1991 unit values of developing country imports decreased generally by more than 3 percent, the steepest decline since 1986 which, as Table 1 shows, was also the most recent year in which these countries' reserves-to-import ratios rose significantly. This clearly shows that a more relevant pattern could be obtained for the developing countries by comparing the period between 1987 and 1990 with the 1970s.

Third, between the 1970s and the late 1980s many things have changed, and have caused developing countries' demand for international reserves to change as well. Generalized floating has been abandoned in favor of greater emphasis on stable exchange rate policies, with the aim of enhancing the credibility of sound monetary and fiscal policies pursued as a corollary to policies of more stable rates. Therefore, developing countries may well have a need to maintain higher reserve levels to support their exchange rate commitments and, hence, the credibility of their monetary and fiscal policies. As a result of the debt crisis of the 1980s, developing countries must expect to rely less on private international capital markets to replenish their reserve stocks. While this is obviously the case for the countries that have recently had difficulty servicing their debts, it is no less true for others. There is ample evidence of a contagion effect from debt-problem countries to those countries that service their debt regularly as, for instance, in the case of Hungary. Prudence on the part of the indebted countries calls on them to build up more owned reserves than they would have needed had there been no debt crisis. The world has also changed, in that new countries have emerged to join the international community and have begun to engage in international trade, requiring them to hold reserves. The column on Eastern European countries in Table 1 gives figures for only five countries, which is a rather small sampling of all the countries currently engaging in market-oriented reforms in the central and extreme eastern parts of Europe. Finally, to the extent that the role of gold in central bank reserves has been weakening over the past two decades, an unchanged ratio of non-gold reserves to imports actually represents a deterioration in the availability of reserves.

These considerations show that, although the ratio of reserves to imports has remained stable or even slightly increased over the past 15 years, this does not necessarily indicate that all is for the best. Indeed, the staff has convincingly demonstrated that several groups of countries were able to rebuild their reserves-to-import ratios only at the cost of import compression and very low economic growth rates. Table 5 of SM/92/106 confirms that this situation is global in scope. The countries in Groups I and II managed to double their reserve holdings between 1985 and 1990 and were, therefore, able to maintain their import levels without pulling down their reserves-to-import ratios. In contrast, the countries in Groups III and IV managed to increase their reserves by no more than 50 percent during the same period, and some did not increase them at all. To keep their reserves-to-import levels constant, these countries had to accept slower growth or no growth in their imports.

The World Economic Outlook provides some estimates on the world demand for savings resulting from the massive destruction of capital stocks in the Middle East and the formerly centrally planned economies of Eastern Europe and the former U.S.S.R. In addition, there is the need to restructure the economies of developing countries elsewhere to avoid future unproductive spending patterns. To meet this massive ex ante excess demand for world savings, it will be necessary to rebuild a large capital stock, which will ultimately have to come from domestic savings. In principle, to finance the needed increase in investment relative to consumption, countries could choose between spending their reserves or borrowing in order to keep their reserve ratios relatively stable. Unfortunately, such a choice is available only in theory, as most of the countries involved either lack reserves altogether or cannot attract private capital flows at the present stage. The need to reconstitute reserves is preventing a large number of countries from investing the amounts necessary to maintain satisfactory income growth. As neither official bilateral nor multilateral credit arrangements are likely alternative sources of international liquidity for these countries, an SDR allocation offers a way to help them restore appropriate reserve levels and enable them to use their current account surpluses for other purposes, such as investment. In doing so, an allocation would serve precisely the purposes for which reserves to hold are demanded, namely, allowing the country that owns them to maintain appropriate import and income levels and facilitating access to the financial markets. To avoid subjecting those countries to destructive levels of import compression or trade and payments restrictions--which would be counter to the aims of the Fund as stated by the Articles of Agreement--we have an obligation to give very serious consideration to the whole allocation approach.

As Mr Landau pointed out in a different context, only in the case of Russia has there been evidence of a political willingness on the part of industrial countries to underpin a country's adjustment efforts by providing international reserves so as to make the exchange rate policy credible. This is a fair assessment of the G-10 decision in principle to activate the GAB in order to finance the ruble stabilization fund. Other countries have similar systemic problems, but these have not been addressed or could not be addressed in the same way. This is an additional argument for the approach recommended by management.

Many other countries may be confronted in the years ahead with financing problems that bear some analytical resemblance to the debt problem. In the case of the debt problem, it was finally accepted that debt forgiveness can be part of a package of credible adjustment to get the process under way and sustain it. Similarly, an SDR allocation would enable certain countries to alter the composition of their reserve stocks in such a way as to permit a resumption of investment and create a virtuous circle in which income growth would feed savings, which would then support further investment and further reserve reconstitution.

Evidence of a need to consider an SDR allocation still leaves open the question of whether such an allocation is compatible with the requirement of the existence of a long-term global need, as prescribed by the Articles of Agreement. The staff paper provides a very interesting contribution to the debate on the correct interpretation of the global-need requirement--a debate that forms a very complex chapter in the history of economic exegesis, by noting that SDRs redistributed through Fund-supported programs could help to satisfy reserve needs on a short- to medium-term basis. I agree with that observation. I also support Mr. Filosa's argument that the requirement for a long-term liquidity need can be satisfied to the extent that countries benefiting from the retransfer of an SDR allocation will, through the allocation, be enabled to attain their long-term goal of spontaneous access to normal international reserve sources. Thus, allocation becomes a key to spontaneous access to the markets.

When the term "long-term global need" originated--the draft corresponding to Section 1(a) of Article XVIII contained no reference to a global need. The draft indicated that, in all its decisions on allocations and cancellations of SDRs, the Fund should promote the attainment of its purposes, and should therefore seek to avoid economic stagnation and deflation as well as excess demand and inflation. After reviewing this draft, the Deputies of the G-10 expressed the view that:

"With respect to activation conditions, Article XXIV, Section 1, there was no disagreement with the present structure of that Article, but a few points of drafting or clarification were made. One of these was that by singling out as the only specific item the avoidance of deflation and inflation, the impression might be created that the SDR plan aimed at cyclical variations, which, of course, everybody agrees is not the objective. Therefore, the suggestion was made that one ought to introduce words to the effect that the aim was to meet the long-term need for reserves, and also make clear that the reference was to questions of deflation/inflation and not to individual countries."

Thus, it is clear that the present Articles of Agreement make reference to the notion of global need only to avoid the possibility that an SDR plan could be used to offset cyclical variations. Understandably, the G-10 Deputies wanted to avoid such an interpretation. Therefore, they chose, at the suggestion of one member, to adopt the notion of global need, simply to avoid the risk that an SDR allocation would be used for cyclical balance of payments financing.

In addition, the Managing Director's proposal for an allocation for the third basic period gives a clear interpretation of the notion of global need. He argued that, with greater exchange rate flexibility, countries might have been expected to make do with much smaller reserves. Moreover, important changes have taken place in world financial markets in the past decade, and most countries can obtain reserves by making use of international money and capital markets. In that connection, he stated that:

"Experience shows, however, that countries want to increase their reserves as the level of their international transactions rises, and such increases can be expected to continue in the coming years. While it is true that most countries have a means to satisfy their need for reserves when international capital markets are as free as they are today, the decision to allocate SDRs does not depend on a finding that the long-term global need cannot be met except by allocation. A characteristic of a system in which countries add to their gross reserves as their international indebtedness increases is that they are faced with the need for periodic refinancing. This difficulty does not arise when additions to net reserves are made through allocation of special drawing rights."

Another important element of the interpretation of the criterion of global need can be drawn from the very purpose of the SDR system. The Ossola Group which met in 1964 and 1965, was the first G-10 working party charged with studying the creation of international reserves. That working group experienced the same kind of situation that so often arises during discussions on the creation of new mechanisms or new systems. At the outset of such discussions, there seems to be agreement on an objective. However, as the discussion progressed to the examination of specific mechanisms, the group lost track of the final goal, owing to divergent views on details and mechanisms which completely obscured the original sense of direction.

Still, the general purpose of the Ossola Group is clear, and an interesting shift of emphasis can be observed. Initially, the Committee appeared to be influenced by some ideas that were popular during that era, such as that there could be a major danger of liquidity destruction if the United States had a massive current account surplus. That was seen as a clear and present danger in the early 1960s by the then Managing Director of the Fund, who not only explained to the media, but also to the President of the United States that the world was running the risk of a major deflationary slowdown, owing to the liquidity shortage that an imminent U.S. surplus would entail. After further consideration of this possibility, it was agreed that in the event that such a surplus ever occurred, the Fund should have a mechanism for offsetting it. Thereafter, the main focus of the Ossola Group discussion gradually shifted to other matters. In the end, the main themes were to improve the composition of international liquidity and find a substitute for gold by creating a new reserve asset, the SDR, in a rational way.

Another question is whether the increased SDR reserves will not lead to a spending spree and end by pushing up world inflation rates. First, this will not happen if the allocation is sufficiently limited in size. Second, it certainly would not lead to such a spending spree, if the allocation occurs, as it would at present, during a period of capacity underutilization in the world economy. Finally, such a spending spree absolutely would not occur if the retransferred SDRs are made available only on the condition of appropriate macroeconomic policies.

One major objection to an allocation is related to the prolonged use made by some groups of beneficiary countries. It is indeed an important finding that developing countries as a group have become prolonged net users. It is important to examine the reason this has occurred, even though prolonged use has sometimes even obliged them to go out and borrow international currency reserves at a higher cost. In a previous discussion, this fact was perceived as calling into question the validity of the whole mechanism as it stands at present. The demand for SDRs comes from countries that judge the risk-return composition of the SDR to be favorable. The developing countries supplying the SDRs became prolonged users because, hard pressed at times to use reserves to avoid further import compression, they felt they could, in this way, avoid paying the additional risk premium carried by other forms of reserves. As the staff paper points out, an SDR allocation might turn out to increase the risk premium that countries have to pay on the funds that they borrow in private markets, which would offset their apparent resource savings from the allocation. In this case, the need for attaching conditionality to the use of SDRs becomes evident. This objective can only be attained after the retransfer of the allocation to the Fund. Such conditionality would make the markets more confident about the macroeconomic policies of countries that were previously unwilling or unable to undertake needed adjustment policies because sufficient reserves were not available to them at market cost. It is true that such countries would obtain cheaper resources, owing to their conditional use of retransferred SDRs. This gain can be perfectly explained by the disappearance of the previous risk premium attached to the long-term creditworthiness of those countries, since they would be acting under Fund-supported programs. This again provides a clear analogy with the experience of the indebted countries.

The merits of a conditional use of retransferred SDRs do not mean that there is no longer a case for an allocation of SDRs that are not conditionally used afterward, because there is still the obligation of Fund members to make the SDR the principal reserve asset of the international monetary system. By the 1992 Annual Meetings, there will be more than 30 Fund members that have never been allocated SDRs, since they joined the Fund after 1982. The share of the SDR in the total of world reserves continues to decline, and a small allocation would do little beyond restoring the previous world distribution of reserves. Therefore, the motivation for an SDR allocation should not be seen from the perspective of supplementing world liquidity. The change in the composition of reserves is a valid objective in itself.

I have long advocated the link between allocation, post-allocation redistribution, and conditional use. Therefore, I strongly support the staff's presentation of such a system as the best possible guarantee for effective use of an SDR allocation of limited size. Indeed, unlike a general increase in quotas, a limited SDR allocation, which is subsequently retransferred to the Fund, could provide the Fund with additional resources to serve various purposes according to circumstances. For example, such resources could be used to finance an enlarged access policy for developing countries faced with severe external shocks; to underpin structural adjustment policies in formerly centrally planned economies; and--this could turn out to become the most important use--to bolster an exchange rate stabilization policy for the currencies of the major industrial countries, or rather, the major currency centers. Increasing the general quotas of our membership sufficiently to enable each country's adjustment problems to be met solely by financing from its own quota share, would require an enormous capital increase for the Fund. Realistically, this cannot even be considered; in this connection, Directors will recall the small quotas allocated to most of the republics of the former U.S.S.R.

It is still too early to discuss mechanisms for SDR retransfer in any detail. By the same token, the time is not yet ripe to decide how large the allocation should be for the sixth basic period. However, it is time to reach an agreement in principle on the usefulness of an SDR allocation in the coming years subject to appropriate conditionality on its use. Starting from this basic option, a lot of the earlier criticisms on the consequences of it could become void.

Mr. Mirakhor asked whether Mr. Filosa had meant to indicate, with respect to conditionality, that a post-allocation redistribution of SDRs should be directed only toward those countries with Fund-supported programs. He also wondered whether Mr. de Groote agreed with that interpretation of how conditionality should be applied.

Such an interpretation of conditionality could be counterproductive in the effort to create an additional buildup of reserves that would enhance the credibility of developing countries' exchange rate policies, Mr. Mirakhor noted. In considering how conditionality should be incorporated into a post-allocation redistribution of SDRs, it was important to bear in mind that many developing countries had put economic adjustment programs in place without financial support from the Fund. Other countries that had already completed arrangements with the Fund were still struggling to enhance their exchange rate policies. Those countries should not be excluded from a post-allocation redistribution of SDRs.

Mr. de Groote considered that, in line with Mr. Mirakhor's comments, the Fund would need to establish a facility that would direct the redistribution of SDRs to countries that did have arrangements with the Fund--because they did not suffer from major balance of payments or macroeconomic imbalances--but, nevertheless, needed to reconstitute their reserves. In dealing with such countries, the Fund should note the virtuous behavior those countries had demonstrated by restraining imports and lend them the SDRs needed to reconstitute their reserves and achieve spontaneous access to market sources of finance.

Mr. Filosa stated that he agreed with Mr. de Groote that there were a variety of means that could be used to incorporate conditionality into a post-allocation redistribution of SDRs. For that reason, he had purposely not included any suggestions on appropriate modalities for redistribution in his opening statement. That was a matter that the Board would need to examine in detail at a later stage.

In that connection, however, Mr. Mirakhor was correct to point out that some countries that did not have Fund-supported programs needed to reconstitute their reserves, Mr. Filosa commented. At the same time, some countries that had arrangements with the Fund had adequate reserves positions.

Mr. Posthumus made the following statement:

The staff paper currently under consideration suggests that there has not been a "generalized" or "global" reserve shortage during the past decade. In addition, it does not make the case that the growing global need for additional reserves, estimated at SDR 300 billion, cannot be met by the usual sources of growth of international reserves. Nevertheless, the staff argues for a new SDR allocation. While all the arguments both for and against such an allocation and the measures that could be taken to offset possible objections have been presented persuasively, even emotionally, and certainly in a way that seems politically attractive, I do not consider that any central bank would argue a case for monetary expansion based of the needs of specific sectors of an economy or of specific groups of the population. As far as SDR creation is concerned, the Fund should behave like a central bank. I am not convinced of the merits of the case for a moderate new SDR allocation, and it is disappointing that such a proposal has been made.

According to the Articles of Agreement, SDRs may only be created when a long-term global need can be established. It is doubtful whether the proposal currently under consideration is in accordance with this principle. First, the question is whether there is a long-term need. The experience of Mexico and Venezuela shows that when macroeconomic conditions in countries with reserve shortages improve, access to international financial markets can be rapidly regained. Second, the need for additional reserves is not global. The majority of member countries earn their reserves or are able to borrow them without difficulties from the private markets. When access to these markets is restrained, contagion effects are the exception rather than the rule and certainly do not constitute a valid reason for an SDR allocation. Third, it is doubtful whether there is a major reserve shortage in the countries without access to financial markets. The ratio of reserves to imports plus debt-service payments has risen for all groups of developing countries, while imports remained more or less at the same level; the most spectacular increase in reserves has occurred with respect to the Eastern European countries, although this increase is distributed quite unevenly. It is clear that several members of the Fund, including the states of the former U.S.S.R., face severe reserve stringencies. Import compression and other policies to secure reserves would be injurious to their economies. However, it is also necessary to argue the case for export expansion, which means that industrial countries should accelerate the opening up of their markets. In addition, the Fund could provide larger access in specific cases, depending on a country's policies.

Lending SDRs to countries with poor credit ratings, which can only be done on a voluntary basis, and reintroducing a reconstitution requirement do not enhance the image of the SDR as a genuine reserve asset, and are therefore not in keeping with the agreed goal to promote the SDR as such. Essentially, post-allocation lending of SDRs with conditionality attached boils down to an inappropriate substitute for the Fund's credit facilities. The proposed penalty charge on prolonged use of SDRs would require an amendment of the Articles of Agreement, while raising the SDR interest rate to a level above market interest rates would give the SDR an artificial character.

The proposed post-allocation redistribution is meant specifically to benefit the small low-income developing countries and the countries in Eastern Europe and the former U.S.S.R. According to the staff, these countries were forced to compress their imports because of reserve shortages. However, it is plausible that this import compression is due to insufficient export earnings connected with severe macroeconomic instability and structural problems, high debt-service obligations, and limited currency convertibility. The international trade activities of these countries are probably more restricted by a shortage of balance of payments financing than a shortage of reserves "to hold." If the availability of external financing proves limited, this will probably be the result of poor creditworthiness, which requires proper adjustment of policies. Existing Fund credit arrangements are the obvious means to facilitate such policies. Insofar as an expected deterioration of the liquidity ratio of the Fund points to a possible lack of resources to finance these credits in the near future, a rapid implementation of the quota increase under the Ninth Review and a quick start with the Tenth General Review of Quotas are required, not an SDR allocation.

Finally, the Articles of Agreement stipulate that the SDR should be made the principal reserve asset in the international monetary system. An SDR allocation when there is no long-term global need would not serve the purpose. A post-allocation redistribution, and limiting the use of SDRs for other purposes than reserve buildup would affect the use of SDRs as a reserve asset, because the purpose of reserves is to be readily usable. Therefore, in the circumstances, the only thing the Fund can do is to preserve the SDR mechanism by regular, limited allocations. These should certainly not be so large as to compete with increases in Fund quotas, which continue to be the regular and preferred way to finance the Fund.

Mr. Peretz made the following statement:

As previous speakers have accepted, the case for a classical SDR allocation would have to rest on sufficient evidence of a long-term global liquidity shortage, as required under the terms of Article XVIII, Section 1(a). While Mr. de Groote's comments on the history of the Articles of Agreement are interesting, we must adhere to the present wording of the Articles of Agreement. The case for an SDR allocation on that basis has not yet been made. Indeed, it is increasingly difficult, although not impossible, to envisage circumstances in which there would be a long-term global liquidity shortage of the kind envisaged when the Articles of Agreement were agreed--or circumstances of the kind that existed when previous SDR allocations were made. Removal of capital restrictions, the end of the debt crisis, and the development of efficient global capital markets make a systemic threat to the world monetary system from inadequate international liquidity somewhat unlikely.

To answer the question posed by the staff paper, namely, whether an initial SDR allocation should be followed by a subsequent conditional redistribution, highlights an internal inconsistency. If a redistribution is needed, can there actually have been a global shortage? If not, it follows that there would have been insufficient grounds for the initial allocation.

This highlights the need to distinguish between severe financing shortages in some areas of the world and a systemic threat to the world monetary system. While some countries face severe liquidity shortages, it is not clear that their needs would best be served by the creation of extra global liquidity. In addition, it is not clear that such regional shortages of liquidity necessarily reflect any market failure.

There is little analysis in the staff paper on the potential supply of liquidity in terms of access to capital markets. I suspect that demand may have been overestimated as well. I doubt whether the level of global reserves will remain at the historically high level of 1991. Demand for reserves depends on a wide range of factors, including interest rate and current account volatility, the holding cost of borrowed reserves--which has been a major factor when it has been profitable for the United Kingdom to hold reserves--and ease of access to capital. The trend toward privatization in many countries could also reduce the demand for official reserves. We should not simply extrapolate past levels of reserves to estimate future demand.

One special factor is the need to shift from barter agreements to multilateral trade in Eastern Europe and the states of the former U.S.S.R. However, it is difficult to see how a general SDR allocation could be specifically targeted to these countries. For the poorer developing countries, the demand for reserves largely results from high debt-service levels, and the problems of those countries would be better served by strong adjustment at home and, where appropriate, greater debt relief from abroad.

It is not at all clear that an SDR allocation is the right or most efficient way of providing liquidity to those countries facing particularly acute liquidity shortages. However the scheme operated, the initial allocation of SDRs to members could not be made subject to conditionality. That means there would always be a high risk, on the basis of past experience, that this would result in some countries in a delay in needed policy adjustment.

I accept that the impact of a modest SDR allocation on industrial countries' macroeconomic policies and on global inflation would be limited. Our estimates imply that an allocation of SDR 30 billion largely redistributed to developing countries would result in a rise of world interest rates of about 25 basis points. The more significant danger, as noted in the staff paper, is that it might result in a weakening of policy in some recipient countries or a delay in needed macroeconomic adjustment.

One issue, already addressed by Mr. Landau, that I had hoped would be fully covered in the staff paper, but was not, is the role of the SDR as a unit of account and reserve asset. It would have been helpful to have a reasonably full analysis of possible ways to improve the quality of the SDR as a unit of account and reserve asset, in particular by hardening the SDR. The SDR is relatively illiquid and little used in the private market. Many countries find it unattractive as a reserve asset. I wonder whether more could be done to make it more attractive to hold and to turn it into a better, more inflation-proof, unit of account. Mr. de Groote noted. This is quite closely related to one of the main themes of the inventors of the SDR, who were looking to create an asset to substitute for gold that could act as a world unit of account. I would like to repeat my request for more work on these issues, which are potentially more important than whether or not to have a modest allocation of SDRs.

The question seems to boil down to whether an SDR allocation can be justified as a prudent means of providing finance for particular countries suffering acute liquidity shortages. This is not what SDR allocations were intended for; indeed, the essential character of a general SDR allocation makes it in many ways unsuitable for use as a conditional form of credit. We should certainly not be contemplating this method of financing conditional credit for member countries unless the usual means of redistributing credit through ordinary resources were for some reason unavailable. If the Fund needs extra resources, the best route is to augment ordinary resources through a quota increase, as we are already doing.

Mr. Landau said that he agreed with other Directors on the need to examine the laws of the Fund with respect to SDR allocations. However, it was common practice--at least in France--to look at the way laws were created to determine how they should be interpreted. It was generally accepted by the Board, from a legal perspective, that a "long-term global need" should not be seen as a situation in which only some countries needed to enhance their reserves. However, if the needs of those countries represented a systemic threat, a global need could be seen to exist. Also from a legal perspective, there was no need to justify an SDR allocation in comparison with other means that could be used to build up reserves.

As Mr. Posthumus had indicated, it was important for the Eastern and Central European countries to expand exports, Mr. Landau commented. However, even with that expansion, those countries would need balance of payments financing, because they would have a legitimate desire to increase imports as their exports grew. In addition, they would have problems with respect to their reserves positions. While the Fund had other tools, such as the GRA and the GAB, at its disposal to address those needs, an SDR allocation and redistribution would still be needed to help integrate those countries into the international financial system.

Mr. Clark made the following statement:

The staff paper currently under consideration raises a number of very important issues related to a proposed SDR allocation. The staff argues that such an allocation can be justified on two grounds. First, an SDR allocation would provide additional reserves for countries with strong liquidity needs; and second, an SDR allocation might reduce the costs of holding reserves for some countries, particularly those with limited access to capital markets. While I would not dispute either of those propositions, neither is germane to the main issue under consideration. The main question is whether or not there is a long-term global need to supplement existing reserve assets.

From the various measures of international liquidity, we agree with the staff that there is no convincing evidence indicating a "generalized reserve shortage" during the past decade. The sources of international liquidity have been altered by the diminished role of official bilateral and multilateral credit arrangements and the growing importance of private international financial markets. However, we agree with Mr. Peretz and

Mr. Posthumus that it is not evident that the system will be unable to continue to meet the increased demands for reserves arising from the expansion of world trade in the absence of an SDR allocation.

It cannot be concluded that there is necessarily a "maldistribution" of reserves on the basis of several groups of countries having lower than average ratios of reserves to imports. The market has functioned, as one would hope and expect, with no evidence of market failure that might justify a fresh allocation of SDRs. Creditworthy countries have been able to acquire reserves at reasonable cost, while less creditworthy countries have had to borrow at higher rates of interest, or in some cases, have been denied access to international capital markets. The fact that some countries have been forced to compress imports and take other measures to cope with a shortage of reserves is not a sign of market failure, but an example of market discipline. We continue to consider that creditworthy countries will be able to meet their demands for liquidity through traditional sources. If some countries are capital constrained, this is likely to reflect inadequate domestic policies and poor track records of debt servicing. The adjustment efforts of these countries would not present a systemic threat. As the staff notes, "under appropriate policies, many countries should be able to earn increased reserves by expanding exports and by encouraging inflows of private investment."

Nevertheless, contagion effects arising from developments in neighboring countries or countries with similar economies do raise plausible examples of market failure. In this respect, some comfort can be drawn from developments in capital markets. Countries that have undertaken serious and sustained reforms have regained limited but growing market access, suggesting that contagion effects are not persistent and will diminish as uncertainty declines. Recent capital market developments also suggest that contagion effects may be symmetric, in that countries less advanced in terms of implementing economic reforms may be regaining market access at a quicker pace than would otherwise be warranted, owing to events in neighboring countries. In any event, an SDR allocation is too broad a tool to be used to address problems of contagion.

In the absence of any fresh and convincing evidence of a long-term global need to justify an SDR allocation, the staff argues that since the sustainability and success of economic stabilization and reform in the formally centrally planned economies and other developing countries is far from assured, an SDR allocation might "brighten the prospects." While this statement is emotionally appealing, it is not necessarily sound economics or a convincing rationale for an SDR allocation. As recognized by the staff, an allocation of SDRs may allow countries with inappropriate economic policies to run larger balance of payments deficits and delay needed adjustments. Moreover, it should be noted that reserve stringency for Russia and the ruble area is being addressed by the establishment of the Ruble Stabilization Fund financed by the GAB. Thus, any systemic threat that might develop as a result of difficulties in Russia is being addressed in a manner other than that of an SDR allocation.

Nevertheless, we agree that there may be good reasons to provide such countries with greater conditional Fund lending in the context of Fund programs in order to ease the adjustment burden if the prospects for success were enhanced as a result. However, an SDR allocation linked in some fashion to relending by industrial countries under appropriate Fund conditionality is neither the only nor necessarily the best approach. Indeed, similar proposals made in the 1980s in connection with the debt crisis were consistently rejected by most of the industrial countries on the grounds that such solutions were not costless, but represented a transfer of risk. Moreover, such schemes, if seen as desirable on their own merits, could be put in effect without an SDR allocation. These alternatives could include industrial countries increasing their bilateral lending to such countries by linking financing to Fund programs; the Fund increasing the size of its loans within the context of existing access limits; or the Fund re-examining its access limits with a view to raising them, which would require implementation of the quota increase under the Ninth Review. All of these options, including an SDR allocation, would involve industrial countries assuming greater exposure to the former centrally planned economies, and other recipient countries, either directly or indirectly through the Fund. We would argue that an SDR allocation is the least transparent of the options available.

It should be noted that in Canada, and perhaps many other countries, any relending of an SDR allocation would require parliamentary approval, which can be a painstakingly long process. More important, any such scheme would result in at least some portion of the relending of an SDR allocation being charged against the aid budget, and thus, implies a reduction elsewhere in Canada's ODA program, in order to maintain spending limits. Thus, an SDR allocation might compete with funds set aside for lending under the enhanced structural adjustment facility.

As to the appropriate size of an allocation of SDRs and the concern that developing countries might spend the new allocations rather than hold them, as we do not support an allocation of SDRs, we have only academic interest in these issues. However, it should be noted that, while various options such as reconstitution requirements and penalty charges on extended use are feasible, such measures could act to ensure that the SDR would never become the principal reserve asset.

Mr. Goos made the following statement:

Like Mr. Peretz, Mr. Posthumus, and Mr. Clark, I consider that there is no case for the resumption of SDR allocations that would satisfy the exclusive allocation criteria of the Articles of Agreement, i.e., a long-term global need. The staff paper seems to be little more than another effort to weaken that criteria by enlisting any argument, no matter how alien it might be to the purposes of the SDR system. Statements like "systemic effects on the world monetary system...call for a systemic response" may be appealing, but they can hardly be taken as a serious contribution to the current discussion. For example, nobody would argue that solving the threat to global safety arising from defunct nuclear power plants in one region would require a systemic response in the sense of changing safety standards or nuclear power policies worldwide. Clearly, regional corrective action would bring about the appropriate solution.

Many of the arguments put forward in the staff paper seem to rest on the notion that the SDR could be usefully employed to support global growth and tackle development problems. Those tasks are, of course, inconsistent with the traditional primary tasks of the Fund. Therefore, if the approach outlined in the staff paper was pursued any further, it would be highly appropriate to postpone discussion of the issues currently under consideration until after the forthcoming discussion on the general orientation of the Fund's activities scheduled to take place after the Annual Meetings.

To clarify this chair's position, it might be useful to recall briefly the origins of the SDR and the developments that have taken place since then in the international monetary system: the SDR was created at the time that the fixed exchange rate system was used to counter the perceived threat of a global shortage of international reserves. Since that time, the system of flexible exchange rates between the major currencies and currency blocks has greatly reduced the need for official reserve holdings, while international capital markets have evolved as a bountiful source of liquidity for official borrowers. Moreover, the original assumptions underlying the SDR system, i.e., inappropriately small or disappearing balance of payments deficits of the United States and currency substitution have never materialized. These fundamental considerations clearly suggest that, in the current radically different monetary circumstances, there is simply no case for the resumption of SDR allocations in conformity with the Articles.

It is against this background that my authorities have never accepted the Legal Department's opinion that "an allocation of SDRs could be made even if the need could or would be met in other ways." Clearly, in the current circumstances, this reasoning could always be used to justify SDR allocations--as demonstrated in the staff paper currently under consideration. It is, of course, reasonable to assume that the historical relationship between the volume of world trade and international reserve holdings will not come to an abrupt end, so it is rather safe to expect that the global need for international reserves will continue to grow, albeit to an unknown extent. In economic terms, it makes little sense to ignore that the growing demand for international reserves has been smoothly satisfied in the past without artificial liquidity creation, as evidenced by the lack of any significant resort to "policies injurious to the world economy." The staff failed to demonstrate that future growth in the demand for global liquidity could not be satisfied through the same means as in the past.

Moreover, it appears that the approach used by the staff to estimate the need for future reserve holdings on the basis of an extrapolation of historic trends is seriously flawed. Thus, reserve holdings in relation to imports reached an exceptionally high level for all country groups in 1991. If one applied the average ratio of reserves to imports prevailing over the past two decades for all countries to the 1991 import volumes of those countries, the calculation would yield excess reserve holdings of some $110 billion, which constitutes one third of the need for reserve supplementation projected by the staff. Any serious analysis of the need for official reserve supplementation cannot ignore such considerations.

This is not to deny the general risks facing the world economy resulting from the severe reserve stringencies in a number of countries. However, those risks cannot and must not be tackled by entering into competition between liquidity creation through SDR allocations and the buoyant supply of international liquidity provided by market sources. What is required to overcome the existing reserve stringencies is real adjustment. The creation of additional liquidity most likely would be counterproductive to the extent that it would reduce adjustment incentives for many countries and drive inflation.

The most appropriate means to support real adjustment are, of course, conditional resources, including those provided by the Fund. If those resources are judged to be inadequate, the appropriate solution would lie in further increases of quotas, rather than in obscure redistribution mechanisms for newly allocated SDRs; fundamentally, such mechanisms constitute nothing other than borrowing operations by the Fund with members in a strong balance of payments position in support of conditional lending.

Having said this, I have only a few comments on the proposed issues for discussion.

We consider that the analysis contained in the staff paper on the availability and cost of reserves is largely irrelevant against the existing allocation criteria for SDRs. A priori, high borrowing costs or lack of access to international capital markets have little to do with the level of reserve holdings. Rather, they reflect problems of creditworthiness, which can only be resolved through policy correction to strengthen the confidence of external creditors. The experience of successful reform countries, notably in Latin America, demonstrates the functioning of the international capital markets. If confidence is restored, so will access to external credit sources, and borrowing costs will decline.

While some countries or groups of countries are facing a shortage of reserves, the underlying problems can be resolved and a sustainable balance of payments be restored only through the pursuit of appropriate adjustment and reform policies supported, where appropriate, by conditional financial assistance. SDR allocations motivated by growth considerations with respect to individual groups of countries are inconsistent with the spirit of the SDR and the monetary character of the Fund.

It is a cause for concern that the reasoning put forward by the staff in support of a moderate SDR allocation could be used again in the future to justify another moderate allocation on the grounds of economic problems in other regions. In other words, to follow the approach suggested by the staff would entail a clear risk of the Fund entering into competition of liquidity creation with private sources of financing, which would be bound to become inflationary. Interestingly enough, the staff also acknowledges the inflationary potential of large SDR allocations.

Experience suggests that the reintroduction of the reconstitution requirement could not prevent prolonged net use of SDRs.

Proposals to increase the direct or opportunity costs of using SDRs are somewhat surprising against the background of the staff's reasoning that SDR allocations should help mitigate the high borrowing costs of countries to facilitate their adjustment efforts. Moreover, experience with special charges raises considerable doubts about the effectiveness of such measures.

The proposed use of conditionality is inconsistent with the concept of global need and the related provision of unconditional liquidity. If there is a global need, it would make little sense to withhold in the Fund part of the liquidity created in order to meet that need. In addition, conditionality can ensure that SDRs will actually be held only during the life of Fund arrangements. In this context, I am concerned that the limited control to be achieved under such arrangements might be used as another pretext for prolonged use or further proliferation of Fund arrangements. Moreover, proposals to establish new long-term facilities to control the use of newly created SDRs are totally misguided.

If supported by effective Fund arrangements, the transforming economies should be able to overcome their liquidity constraints in the medium term. Assuming that those constraints would give rise to a long-term global need is tantamount to an expression of mistrust in the ability of the Fund to assist those countries in restoring viability within a reasonable period.

My comments thus far have clarified this chair's position on the Hashimoto Proposal. Liquidity creation can hardly be expected to mobilize the additional capital needed to fill the global savings gap. Moreover, we fail to see a compelling need for the creation of new facilities, in particular, if such facilities were equipped with a lower degree of conditionality.

In conclusion, we cannot support a resumption of SDR allocations at the present stage.

Mr. Al-Jasser remarked that Mr. Goos's comments on developments in the international monetary system over the past two decades implied that there would never be any justification for an allocation of SDRs. Indeed, from that premise, it would be logical to conclude that there was no longer a need for the SDR as a reserve asset, and the Fund should probably seek ways to cancel previously allocated SDRs. He wondered whether Mr. Goos could comment on whether there were any foreseeable circumstances that would justify an allocation of SDRs.

Mr. de Groote commented that, according to Mr. Goos's argument, if countries followed appropriate macroeconomic policies, there would be no need for reserves.

Mr. Filosa recalled that many members of the Board had accepted the Legal Department's practical definition of a "long-term global need." Moreover, even if the Board went along with the comments of Mr. Goos and other Directors on that subject, there would still be a need to make the SDR the principal reserve asset, as prescribed by the Articles.

He agreed with the staff and other speakers that all members did not need to suffer from serious liquidity or reserve deficiencies in order for a long-term global need for reserves to threaten the international monetary system, Mr. Filosa stated. Indeed, central banks often intervened when domestic liquidity crises had the potential to spread. The Fund did not have the same instruments at its disposal as central banks; therefore, the staff was correct to examine ways the Fund could gear its instruments to address problems of global need. Experience showed that there were many cases, where adjustment policies, aid financing, and balance of payments support from the Fund and other international organizations had not been able to solve the independent need to increase reserves to a level that would ensure the implementation of economic policies. For example, the cases of Poland and Russia showed that an extra instrument was needed to make the overall adjustment effort successful.

At the present stage, when the membership of the Fund was expanding, it was important to ensure that new members would be introduced into a smoothly functioning international monetary system, Mr. Filosa continued. Those countries would need to have the strong economic policies and reserves necessary to ensure a smooth transition from the old system. Failure to recognize the needs of those countries was a denial of the purposes of the Fund.

The need to enhance reserves was not relevant to only developing countries or economies in transition, Mr. Filosa went on. Industrial countries also sought to maintain their reserves positions to avoid gyrations in exchange rates; indeed, many countries had tried to fix their exchange rates.

It was important to bear in mind the purpose of the Fund to ensure orderly exchange transactions and promote currency convertibility, Mr. Filosa added. In the absence of sufficient international reserves, the achievement of those goals--particularly the latter--might be possible only over considerable time, Mr. Filosa added. Another important objective of the Fund was to encourage the elimination of trade restrictions. In that connection, it was important to note that the absence of sufficient reserves had forced many countries to continue or even introduce exchange and trade restrictions in the recent past.

In the current circumstances, the Fund needed to have a variety of instruments at its disposal to effectively assist its members, Mr. Filosa considered. The moderate SDR allocation proposed by the staff represented an attempt to make another useful instrument available to the Fund. In that respect, it was important to note that the proposed SDR allocation was not intended as another method of finance; it was designed to encourage all members to maintain sufficient reserve positions, which would provide an important element of confidence in the international community.

The staff proposal was fully consistent with the Articles and with the intended purpose of the adjustment process, Mr. Filosa stated. Such an allocation would promote the stabilization and unification of exchange rates, the achievement of currency convertibility, and the elimination of trade restrictions.

For an increase in Fund quotas to address the problems related to insufficient holdings of reserves, there would be a need to increase all members' access to Fund resources, Mr. Filosa concluded. Obviously, that was not the best solution in light of the political and economic ramifications such a move would entail.

Mr. Dawson noted, with respect to the stabilization fund for Poland and the one envisaged for Russia, that such arrangements entailed more stringent conditionality than arrangements supported by the upper credit tranches. If a lower level of conditionality was to be associated with redistributed SDRs, that could undermine both the monetary and reserve character of the SDR.

Mr. Filosa said that it was not his intention to suggest that the redistribution of SDRs should be subject to lower levels of conditionality. Indeed, such a redistribution should be used to complement other arrangements with the Fund and should be subject to the same conditionality. Moreover, while a redistribution of SDRs could clearly help countries that currently had arrangements with the Fund, some of those countries did not need to receive such SDRs. The redistribution of SDRs would need to be carefully considered on a case-by-case basis in the context of economic programs. Nevertheless, the Fund should have the ability to ensure that the reserves needed to make economic programs successful would be in place.

Mr. Mirakhor stated that he agreed with Mr. Filosa on the need to strengthen both the role of the Fund and the instruments at its disposal. Over the past year, the Fund had taken on increasing responsibilities, and there was a need to provide it with the tools needed to fulfil its new tasks.

Mr. Peretz considered that the logical conclusion to be drawn from Mr. Goos's opening statement was that the Fund should pursue ways, other than allocating SDRs, to strengthen the role of the SDR and make it the principal international reserve asset. In that connection, there was a need to make the SDR an attractive asset that central banks and governments would want to hold in their reserves.

Mr. Filosa stated that he strongly supported Mr. Peretz's suggestion to strengthen the SDR as an asset. That proposal was not inconsistent with the proposal put forward in the staff paper; the two were mutually reinforcing.

Mr. Goos remarked that he agreed with the conclusions drawn from his opening statement by Mr. Al-Jasser. The current international monetary system was radically different from the system that had prevailed when the SDR was created. That was true particularly with respect to the perceived risk that the United States would achieve a balance of payments surplus large enough to threaten the supply of international liquidity. At the present stage, sufficient sources of international liquidity were clearly available, as shown by the staff paper.

The current problems under consideration were essentially either regional or country specific, and the Fund had the appropriate tools at its disposal to address those problems, Mr. Goos considered.

The staff's assertion that there was no need to consider alternative sources of generating liquidity in determining whether or not a long-term global need was evident was clearly not rational, Mr. Goos stated. In pursuing growth targets for monetary and credit aggregates, central banks needed to consider what was required to achieve those targets and the overall liquidity available; banks then purchased the domestic assets required to increase the supply of money. It would not be rational for central banks to ignore sources of liquidity that could be derived from other sources, such as credit flows into the economy; to do so would risk causing inflation. In addition, it would not be rational to assume that all countries pursued strictly stability-oriented policies, so that whatever liquidity they could mobilize would not affect their monetary policy stance.

In determining whether an SDR allocation would be appropriate, there was a need to assess the situation of all countries, not just the countries that had Fund arrangements, Mr. Goos concluded. Moreover, to allow the number of countries pursuing Fund-supported programs to proliferate would clearly be detrimental to the monetary character of the institution. Therefore, his chair would not support the establishment of additional facilities, in particular long-term facilities.

Mr. Al-Jasser remarked, with respect to Mr. Goos's comments, that Germany probably did not envisage a need for an SDR allocation under any circumstances. Therefore, he wondered whether Mr. Goos would wish to consider canceling existing SDRs, or whether he would consider the proposal put forward by Mr. Peretz and Mr. Posthumus that the Fund should examine ways to improve the quality of the SDR.

Mr. Goos responded that in the current circumstances, which were far different from those prevailing when the SDR had been created, he could not foresee a need to allocate new SDRs. However, it was not possible to accurately predict future developments. The Articles provided for the re-establishment of a fixed exchange rate regime. In the event that the international monetary system began to move toward such a regime, it might be appropriate to resume allocations of SDRs. Nevertheless, as a future return to the parity system was not likely, he would not object to eliminating the SDR system, because it no longer had a role to play in the international monetary system.

As the question of whether or not the Fund should examine ways to improve the quality of the SDR as a reserve asset was not the subject of the current discussion, he would not address it in detail, Mr. Goos said. He would be willing to consider proposals related to that question at a future meeting.

Mr. Posthumus commented that it was impossible to be certain about developments in the international monetary system, especially with respect to the distant future. He agreed with Mr. Goos that, if international capital markets continued to function as at present, there would be no need for a large allocation of SDRs. His proposal was aimed at maintaining the current position of SDRs in international reserves to prevent the SDR system from eroding.

Mr. Jaramillo made the following statement:

The clear and concise staff paper provides a useful guide for discussion. The staff makes a very good case for a new SDR allocation. Aside from the arguments presented in the staff paper, most of which we share, we would like to make the following comments.

We can associate ourselves with the position of the Legal Department and the views expressed by Mr. Filosa and Mr. de Groote on the global need for reserves. As to the requirements of different groups of countries, we would add that for the past several years many developing countries have been reducing trade barriers and liberalizing capital flows. This trend, which is in line with the Fund's objectives as well as its advice to members, calls for an increase of reserve holdings by the countries involved. However, despite improved access for some countries, many Fund members that account for this increase in demand currently have limited access to private international financial markets. As was evident during the debt crisis, markets are slow to distinguish between regional conditions and to react to emerging favorable trends. Consequently, an SDR allocation, coupled with some redistribution mechanism, would lower the costs of building up reserves for the countries that have done much in the recent past in favor of open global trade and financial systems.

Also, during the past few years, demand for reserves must have increased significantly in the states of the former U.S.S.R. and the countries of Eastern Europe, as a result of the disappearance of the payments system associated with their former trading block. Private financial markets will not meet most of these new demands in the short run. Consequently, a new allocation of SDRs, coupled with a redistribution from countries with low net costs of holding reserves to those with high net costs of doing so, would go a long way toward alleviating the need of these countries for additional reserves, enhancing their prospects, and avoiding unnecessary import compression.

We agree with the staff that a moderate SDR allocation is not likely to have global inflationary effects, as the proposed allocation is equivalent to a fraction of the expected increase in the demand for global reserve holdings. As the new reserve assets are to be held by recipients, there does not seem to be any danger of a global surge in spending, even with some sort of redistribution toward reserve-scarce countries.

The argument that an SDR allocation might have the undesirable side effect of inducing some recipient countries to spend more than they otherwise would, is in principle correct. However, the fact that some may act in this fashion is not a strong case against the overall allocation proposal, as the actions of these few would be unlikely to have significant effects worldwide, given the relative economic size of the countries. Whatever the disadvantages of this behavior, they are considerably less costly than the benefits to be gained by most members from a new SDR allocation. In sum, prolonged use of SDRs by some may not be a desirable characteristic of the mechanism, but it is not a case against it. Along these lines, we would not favor a reconstitution requirement, at least in the case of allocated SDRs, as such a requirement could weigh against the SDR as a reserve asset, while doing little to curb undesirable behavior by a few members.

As to the redistribution mechanism, we would prefer to see redistribution carried out through the Fund rather than on a bilateral basis, in order to guarantee uniformity of treatment among members, while acknowledging that the risks for the Fund would be higher. We also prefer this route because, by redistributing the SDRs through the Fund, SDRs are more likely to flow to the countries that need them most. In addition, redistribution should of course be voluntary, and countries with adequate levels of reserves should give up the use of their allocation at least temporarily. The "voluntary" character of such transfers would make such countries more amenable to take the action expected of them.

Mr. Fukui made the following statement:

Let me start by welcoming this opportunity to resume the discussion on SDR issues. Nearly three years have passed since the previous substantive discussion on SDR allocations. The environment of the international financial community has changed dramatically since that time. Despite positive developments in solving debt problems in the developing countries, a strong demand for international liquidity remains in those countries. There is also additional demand for international liquidity from economies in transition. These are all good reasons to take a fresh look at the issue of international liquidity and the SDR. The sixth basic period started at the beginning of 1992. Thus, this is an opportune time to resume discussions on the SDR.

At the same time, however, this is a sensitive issue in relation to the quota increase under the Ninth Review. Needless to say, implementation of that quota increase is the Fund's most urgent priority. Until the quota increase takes effect, the Fund should use caution in proceeding with consideration of the issues related to the SDR system. In that connection, due attention should be paid to how we present this issue to others.

Having said this, the current discussion is our first step toward a more detailed study of international liquidity and the SDR. Therefore, I would like to make some preliminary comments, focusing on the case for a new SDR allocation.

Historically, the case for an SDR allocation has been argued from the standpoint of various interpretations of the conditions for a new allocation as determined in Article XVIII, namely, "the long-term global need to supplement existing reserve assets." There are two dimensions to the interpretation, a quantitative approach and a qualitative approach. Let me comment on both approaches.

First, on the quantitative interpretation, we agree with the staff that "it is difficult to measure the broad concept of international liquidity in a meaningful, quantitative way." Despite all the efforts the staff has made so far, SM/92/106 does not provide a convincing quantitative argument for the scarcity of international liquidity and, thus, for the global need to supplement reserve assets.

Nevertheless, the staff should be encouraged to continue to provide quantitative assessments of the adequacy of non-gold reserves, so long as the Articles require "a long-term and global need" as the condition for SDR allocations. Perhaps the staff could analyze developments in ratios of non-gold reserves to debt outstanding in all countries and/or the ratios of non-gold reserves to merchandise imports plus service imports including debt-service payments.

In this context, the staff's assessment that the ratio of non-gold reserves to merchandise imports was stable or rather rose in the past decade may be taken as a quantitative indication that the level of non-gold reserves was almost adequate, or there was no global need in that period. However, when we take into account the fact that imports in developing countries actually fell in the same period, the implication of this quantitative analysis is not clear. If the level of imports is to some extent dependent on the level of non-gold reserves, the fact that imports fell could indicate that the absolute level of non-gold reserves fell short of supporting the sustainable or adequate expansion of imports. The staff analysis could be examined in this way. In other words, if we could assume hypothetically a level of imports, which was not constrained by the level of non-gold reserves, the ratio of non-gold reserves to merchandise imports would have been lower than it actually was. This suggests that at least a different quantitative analysis could be viable and that the traditional indicators used to assess the adequacy of global reserves in relation to the level of imports are somewhat misleading. I would be interested in considering further study by the staff on this issue.

By introducing the qualitative approach to the case for a new SDR allocation, I intend to widen the scope of the interpretation of the long-term global need. I wonder whether we could understand the long-term and global need more flexibly from the standpoint of whether or not an increase in reserve assets in the form of an SDR allocation would be useful in terms of improving the performance of the world economy. Historically speaking, I understand similar flexibility was shown when the allocation in the third basic period was agreed.

From this standpoint, the staff paper provides an interesting analysis. In particular, I am attracted by the staff's argument that a new allocation of an adequate size will be conducive both to lowering the cost of holding reserves in the developing countries and to better growth performance with increased world trade. If this argument could be further elaborated and strengthened, it could provide a strong qualitative case for a new allocation. Toward this end, I wonder whether the staff could prepare an alternative scenario analysis based on certain assumptions and draw analytical implications of a new SDR allocation of a particular size for world growth prospects, world trade development, world savings and investments balance and so forth. This kind of analysis could be helpful in examining the global implications of a new allocation of SDRs.

The final judgment as to whether a new allocation is warranted in the sixth basic period has to await the results of further study on the case for a new SDR allocation, involving both the quantitative and the qualitative aspects, along the lines mentioned above. However, at the present stage, when the international financial community is facing a new challenge in financing and supporting the reforms in a number of economies in transition, and when the demand for international liquidity seems to be increasing at an unprecedented pace, a new allocation of SDRs could provide an effective means of tackling this challenge.

In addition, maintaining or recovering the share of SDRs in world reserve assets through a new allocation of SDRs is also necessary to enhance the attractiveness of the SDR as a reserve asset. This is also consistent with the spirit of Article XXII, which encourages the Fund to pursue the objective of making the SDR the principal reserve asset in the international monetary system.

For all these reasons, there is a good case for considering sympathetically a new allocation in the present basic period.

With respect to the size of the allocation, I found the staff's hypothetical analysis interesting, although my authorities are not yet in the position to comment on this point. We should be careful to avoid giving the impression that a sizable amount of international liquidity can easily be created. In particular, we should be careful not to send such a signal to the countries in transition, where strong discipline is especially called for. Therefore, we need to give careful and deliberate consideration to the size and the timing of a new SDR allocation.

As to the post-allocation redistribution mechanism, some kind of linkage between the use of allocated SDRs and economic conditionality would effectively alleviate concerns about the side-effects of the SDR allocation, namely, the inflationary risk, on the one hand, and the prolonged net use of SDRs on the other. The proposal made by Mr. Hashimoto is explained in detail in the staff paper, which was based on that notion.

The mechanism to be adopted could be discussed in detail at a later stage. At present, the need for some mechanism to link the use of allocated SDRs to economic conditionality should be stressed. I hope that discussions on this issue will continue in the near future and provide a basis for consensus.

Mr. Végh made the following statement:

The issue of allocating more SDRs has been considered from many different angles. We are currently considering an updated version of the old development link proposal. Let me state from the outset that, to the extent that we really want to make the SDR the main international reserve asset, any generalized constraint imposed on the SDR, whether in the form of a less-than-completely voluntary redistribution mechanism or a strict conditionality on the holding of SDRs, will in the long run be counterproductive. In this context, I share many of the misgivings expressed by Mr. Posthumus, Mr. Peretz, Mr. Goos, and Mr. Clark. However, my conclusions are more moderate than theirs and more in line with the approach taken by the staff.

The case for a new allocation of SDRs should be made on its own merits, rather than on the needs of a group of countries that are encountering difficulties in trying to acquire reserves in the international financial markets. The staff paper presents the case for a new allocation of SDRs on the grounds of developing countries' needs and the health of the world economy at large. At the same time, the staff has made a proposal based on what would do the least harm to the monetary quality of the SDR in the future. However, the staff's approach resembles the development link proposal of the early 1970s. Therefore, it is not entirely on the right track in trying to support a new allocation of SDRs. Moreover, some of the arguments in the staff paper are open to debate.

The benefits to the world economy of a new allocation of SDRs do not seem to be significant, particularly because the SDRs are to be kept as reserves in the countries in need and because the relative weight in world growth and trade of those countries is small. Moreover, the need to minimally supplement the future increase in demand for international reserves with SDRs does not sufficiently justify an allocation of SDRs. To the extent that the international financial markets have been able to provide the required level of reserves in the past, they can be expected to be equally efficient in providing them in the future. The argument that some countries are unable to tap those markets borders on the link proposal, which is not conducive to making the SDR the main reserve asset.

It is not clear that the recipient countries in need of reserves, in particular the republics of the former U.S.S.R., will appreciate receiving reserves that they cannot use or that are subject to strict reconstitution rules and, to the extent that they are used, to a high rate of charge. An SDR allocation, along the lines proposed in the staff paper, to the republics of the former U.S.S.R. could further complicate the administration of those economies at a time when the authorities should be concentrating on the fundamentals. In this respect, I agree with Mr. Landau that it is the quality of economic policy--more than the level of international reserves--that to some extent can delay the adjustment and be a negative element.

A new allocation of SDRs is called for on its own merits. If the SDR is to serve as the main international reserve asset there is a need to ensure that sufficient amounts of SDRs are available. The need to supplement international reserves should not be a cause for concern to the extent that substitution among reserve assets is quite conceivable. The projections presented by the staff on the future increase in demand for international reserves show that a new allocation of SDRs, even a substantial one, would be readily absorbed by the current demand without any need to resort to substitution. To preserve the monetary character of the SDR, no generalized constraints should be imposed on its use.

With respect to the ratio of non-gold reserves to imports, there might be some statistical regularity, but this is a phenomenon of collinearity, rather than a functional relationship. Reserves are associated with central bank intervention in exchange markets where trade in goods and services is a small proportion of total volume of transactions. Furthermore, if we take the two extreme cases of exchange rate systems, namely, pure float and currency board, there is no relationship between reserves and imports. The staff paper makes it clear that the cost of obtaining reserves is related to the quality of economic policy and, thus, to creditworthiness.

While there might be a growing global demand for reserves in the period through 1996, there likely would not be a significant shortage of reserves for most important groups of countries, even in the absence of an SDR allocation.

I agree with previous speakers that prolonged net use of SDRs is undesirable, but the main target should be to have adequate symmetry between providers and users of SDRs and a higher velocity of circulation than at present. In any event, a reconstitution requirement would represent an artificial restriction, which would debase the value of the SDR.

We do not object to the application of conditionality to voluntary redistribution by some countries of their SDR allocation. The Fund could provide its expertise for such application, but without increasing its own risk exposure, which would be high enough as a consequence of credit provided by its own resources and those borrowed in the market.

This chair supports the proposal to allocate SDRs during the sixth basic period. However, such an allocation should be only as large as needed to avoid a declining share of SDRs in total reserves and the extinction of the SDR as a significant reserve asset.

Ms. Mrakovcic made the following statement:

I would like to comment on three general areas: the conclusion we have reached on the issues covered in the staff paper; some of the analytical issues that led to that conclusion; and the questions raised for discussion.

The staff has made a reasonable case for additional conditional Fund lending to certain countries, but has failed to show that such lending should be carried out by way of an SDR allocation. Indeed, the staff suggests that a normal allocation of SDRs would be inappropriate and that the SDR instrument should be modified by post-allocation conditionality. In effect, this would not be an allocation of so-called special drawing rights, but of "not so special drawing rights," because the special attribute of the SDR, namely, that it is unconditional, would have been removed.

The staff paper presents a wide range of views--often conflicting--on a wide range of analytical issues. However, in attempting to pull the threads together, two propositions stand out. First, the problem to be addressed is presented as that of a group of countries that have or will have such a low level of reserves that they will be forced into trade restricting policies. The global dimension is added by the suggestion that this group is sufficiently large to cause systematic effects for the world economy. Second, the solution to this problem is seen as a costless creation of reserves--an SDR allocation--but with those reserves distributed only on the condition that they not be spent.

This restriction is based on the concern that an SDR allocation would facilitate inappropriate spending. This concern is addressed by stipulating that the post-allocation redistribution should be made in association with Fund-supported programs, presumably on the basis that such programs would in fact preclude "inappropriate" spending.

A basic dilemma of this solution, including the requirement that the additional reserves be held, is that--by definition--additional reserves will not ease import compression or other trade restricting policies unless they lead to increased spending. Hence, there is also a requirement by definition that the spending must not be "inappropriate."

The staff proposal, thus, becomes a case for conditional lending. The bulk of the staff paper is devoted to ways in which the SDR might be modified to fulfill this requirement. We could go along with further examination of this issue--including amendments to the Articles--if there were strong support in the Board to do so. However, as the current problems cannot be addressed by merely amending the Articles, the Board's time could be better spent by addressing the issues directly, i.e., by examining the Fund's present policies on access and borrowing.

We take this position not because we see much short-term risk in a modest SDR allocation--although the inflationary risks cannot be altogether discounted--but because, if an SDR allocation can be made at the present stage on the pretext presented in the staff paper, there would be no rational basis for rejecting further allocations in the future. In this respect, it is crucial to note that a modest SDR allocation will not solve the reserve problems of the group of countries currently under consideration.

Against this background, let me very briefly turn to the seven issues for discussion.

With respect to recent movements in holdings of non-gold reserves, it should be noted that over the past decade, reserve-import ratios for all country groups increased substantially without an SDR allocation. Furthermore, the staff paper suggests that there is no correlation between reserves and import compression.

Looking to 1996, it is possible and perhaps even likely that there will be a growing global demand for reserves, but I agree with previous speakers that there is no reason to consider that these demands cannot be met efficiently and without an SDR allocation. While I agree that in the absence of a moderate-sized SDR allocation there is likely to be a significant shortage of reserves for some countries, I equally agree that there is likely to be a significant shortage of reserves for these countries even with an SDR allocation.

I do not consider that the monetary or macroeconomic policies of the major industrial countries would be influenced by a moderate SDR allocation or that prolonged net use of SDRs is clearly undesirable.

I should mention that, while our Australian authorities consider that an SDR allocation is not justified, our Korean and Philippine authorities have indicated that they could support the proposal for a modest SDR allocation--although the Philippine authorities would prefer to retain the special attribute of such allocations, namely, that they are unconditional.

Finally, I wonder whether the staff could comment on how its advice to the target group of countries would differ with and without an SDR allocation.

Mr. J. E. Ismael said that the staff paper provided fresh and useful insight on the adequacy of international liquidity and the desirability of SDR allocations in the sixth basic period, namely, 1992-96. This chair agreed with the staff's analysis and conclusions.

In the absence of an allocation of SDRs, and given the relative stability of reserves-to-imports ratios, a large number of Fund members would no doubt experience a significant shortage of reserves, Mr. Ismael noted. In the circumstances, he agreed with the staff that those countries would be able to maintain minimal levels of reserves only through import compression. The recessionary danger of such a situation was incompatible with the Fund's objective to encourage the expansion of world trade and the growth-oriented adjustment strategy. Moreover, the SDR system would fail to play a useful role in strengthening the international liquidity position of the economies in transition and in supporting their policy reform efforts.

However, for those countries with strong liquidity needs to fully benefit from SDR allocations, a mechanism for post-allocation redistribution of SDRs would be desirable, Mr. Ismael considered. In that connection, mechanisms along the lines of the Belgian or Japanese proposals, which would provide additional support for Fund members implementing economic adjustment programs, would indeed merit consideration.

Finally, as in the past, his chair continued to consider that there is a sufficiently strong case for an allocation of SDRs, and he supported an early allocation of SDRs in the current basic period, Mr. Ismael stated. The range of SDR 6-10 billion for yearly allocations mentioned by the staff seemed to provide a good basis for discussion.

Mr. Torres made the following statement:

> Like other Directors, we broadly agree with the case made by the staff for a new SDR allocation. Moreover, we stand ready to encourage member countries with strong reserve positions to voluntarily make available to the Fund their newly allocated SDRs. Finally, we would endorse a post-allocation redistribution of SDRs by the Fund to members with inadequate reserves, under proper conditionality.
>
> For several years the staff has produced high quality analyses that convincingly support a new SDR allocation. However, in spite of the strong case made by the staff, as well as the widespread recognition by Management and the Board of the importance of maintaining the central role of the SDR in the international monetary system, and the call by the developing countries to resume SDR allocations in view of the important contribution that such an allocation would have in facilitating the adjustment process, several Directors have continued to oppose a new SDR allocation. This leads to the conclusion that the decision to renew SDR allocations is beyond the realm of technical argumentation and debate; it essentially depends on the political willingness of members to give the SDR a greater role in total international liquidity.
>
> The current discussion, hopefully, will promote some changes in traditional positions. This hope is nurtured by the dramatic changes that have taken place in the international economic environment since the previous discussion on SDR allocations. Two additional factors enhance the case for an SDR allocation, namely, the need by the former centrally planned economies in transition to increase substantially their official reserve holdings without further import compression and the budgetary constraints in most leading industrial countries that may limit or delay other actions

to respond to a reserve shortage or to help adjusting countries to transform their economies in an orderly fashion.

The Fund has become almost a truly universal institution, but most of the new members have inadequate reserves and no access to international capital markets at a time when they face tremendous adjustment challenges. Many other Fund members share the same problem; and the problem is of a long-term nature and it has obvious global repercussions.

A moderate allocation of SDRs of an amount to be agreed, but substantially less than the projected growth of world demand for reserves, may be seen as a possible solution, not exclusive from other approaches. By being moderate, an allocation of SDRs will not do any harm to the world economy and can yield benefits for all members. However, we should not underestimate the potential benefits, as the risks of inaction are greater than those of action.

Moreover, a new allocation would enhance the role of the SDR--which is a sufficient condition for a new allocation--and by doing so, it would increase the stability and improve the functioning of the international monetary system.

My authorities would strongly encourage members with strong reserve positions to make available to the Fund all or much of the new SDRs for redistribution to those members with the greatest need for reserves, under proper conditionality, including measures to discourage the net use of SDRs, if this is considered a cause for concern. This voluntary compromise could magnify the benefits of a moderate SDR allocation without weakening adjustment efforts. Under such a scheme, the Fund should bear the risks associated with any use of redistributed SDRs.

Finally, as to the size of the new allocation, I concur with other speakers that we must first determine whether a redistribution scheme is agreeable to members.

Mr. Dawson made the following statement:

The staff paper currently under consideration is an advocacy brief for a moderate-sized new SDR allocation, with much of the allocation to be channeled to countries in very weak balance of payments positions. The staff analysis unnecessarily confuses the separate questions of whether there is a world liquidity requirement that would justify a new SDR allocation and whether an SDR allocation would provide both the opportunity and the mechanism for the richer countries to channel additional resources to poorer countries. The staff paper is also marred by a tendency to confuse SDR allocation issues with questions of balance of payments adjustment, or even foreign aid.

Section IV of the staff paper on the global need for reserves presents a highly persuasive case that the current level of global non-gold reserves is fully adequate for the needs of a well-functioning international economy. In 1991, the ratio of non-gold reserves to merchandise imports for all countries reached its highest levels since 1972.

Reserve ratios are not only at the high end of recent experience, but also the distribution of reserves among major subcategories of countries has improved over the past decade. For industrial countries there was a bulge in reserves around 1987--probably associated with currency intervention in connection with the Louvre agreements, as the staff suggests. This reserve buildup has gradually been scaled back, but the reserve ratios for the industrial countries still appear to be at the comfortable end of historical experience.

The developing countries encompass a very heterogeneous group, but the data in Table 1 show there has been a persistent, if choppy, increase in the reserve ratio of the developing countries as a group since the debt crisis emerged. A similar, but even stronger, pattern is evident among the debt-burdened countries as a group which, in 1991, achieved the highest reserve ratios reported in the past 20 years. Even sub-Saharan Africa has shown a systematic improvement in its reserve ratio since the early 1980s, as have the countries of Eastern Europe. I wonder whether the staff could comment on whether there is any discontinuity of data in Chart 3 of SM/92/106. As the staff emphasizes, small, low-income countries stand out as a group whose reserve ratios are relatively low and not improving.

While close examination of individual countries, or even clusters of countries, reveals cases of painful import compression to restore depleted reserves, the broad sweep of the data clearly supports the view that over the past decade the international financial system has generated and rationally distributed the rising level of reserves needed to support an expanding level of trade.

The staff paper contends that, notwithstanding the aggregate pattern of comfortable reserve ratios, the low reserve ratios in a large number of small, low-income countries with limited access to international capital markets is evidence of a regional inadequacy of reserves and that this has adverse global consequences. It is argued that growth in these countries is constrained by an inadequate level of reserves and hence their contribution to world activity is thereby truncated. We do not find this argument persuasive. The discouraging economic problems besetting these countries are undeniable, but low levels of reserves are more a symptom of their economic difficulties than an independent constraint on their freedom of action.

The ability of many creditworthy countries, including many developing countries, to tap private markets reinforces the impression that there is neither a current global shortage of liquidity nor a prospective shortage. However, the sources of international liquidity have been changing. The staff notes the downward trend of the ratio of official resources to non-gold reserves as indicating a growing reliance on obtaining reserves from private financial markets. This, in itself, should not be seen as a negative development or one that requires a corrective response from the Fund. Beyond this, however, the staff suggests that there is some malfunctioning in the system since some countries have experienced abrupt changes in the cost and availability of liquidity from private markets, owing to either adverse macroeconomic developments or contagion effects. In general, we do not see the role of the Fund as smoothing out fluctuations in the cost of liquidity or equalizing such costs across countries with varying degrees of creditworthiness. Even so, if there is a problem, a generalized provision of unconditional liquidity would not seem to be the proper solution. These market dislocations are precisely the sort of cases that call for the traditional role of the Fund to support appropriate policy responses to adverse internal and external developments.

The staff makes a good deal of the proposition that, for many reserve-poor countries that lack access to capital markets, the marginal cost of acquiring reserves can easily be in excess of 30 percent. From this, it concludes that, as SDRs can be provided at low or no cost, the efficient way to augment reserve holdings for these countries is to issue additional SDRs to them. The only trouble with this analysis is that under the circumstances postulated, the additional reserves are more likely to be spent than to be held. No matter how additional reserves are acquired or what was paid for them, the opportunity cost of continuing to hold them is the value of additional resources that could be commanded by spending them, not the artificially low cost they incur when SDRs are assigned through a redistribution process. Certainly the systematic tendency of many low-income countries to spend their SDR allocations indicates that these countries view SDRs as a low-cost means of acquiring real resources.

Some of the major problems of prolonged use were corrected by moving to market-based interest rates for the SDR. However, we continue to consider that a subsidy element remains, and we are also concerned about the consistency of prolonged use with the monetary character of this asset. This issue merits consideration in its own right, separate from the debate on a new SDR allocation.

There are serious deficiencies in all of the proposals for a post-allocation redistribution of SDRs. While costless to create, once issued, SDRs are valuable to the recipient countries. All redistribution schemes necessarily require the donor countries to give or lend valuable rights to recipient countries. Such a choice may be wise or foolish, but there is an element of aid in all the redistribution schemes that cannot be dodged by stressing, as the staff does, that SDRs have a zero cost of production. Even if we agreed with the desirability of a post-allocation redistribution, which we do not, any post-allocation redistribution scheme would be viewed in the United States as a credit to the Fund that would require explicit congressional approval.

Introducing conditionality considerations into a post-allocation redistribution of SDRs confuses the purposes and policies of the Fund. As a quota-based institution, it would be inappropriate to link access to Fund resources to new allocations of SDRs. In essence, such a procedure would constitute a means of expanding quota-based lending beyond the limits established by the size of quotas themselves. Therefore, it would be a means to circumvent prior decisions on the appropriate magnitude of Fund financing. Moreover, SDRs were designed to be unconditional liquidity. Redistributions based on policy conditionality would undermine this basic feature of the SDR.

No case has been made that there is a global liquidity need such as to justify an additional allocation of SDRs at this time. Reserve shortages in a number of small low-income countries and in Eastern Europe and the former U.S.S.R. are symptoms of poor economic circumstances, rather than systemic problems to be dealt with through SDR allocations. Proposals to issue SDRs and then reallocate them to needy countries should be seen as either aid proposals or proposals to bypass traditional quota-based lending by the Fund, rather than systemic reforms. We see no merit to such proposals. Even if we did, as a practical matter, we would be reluctant to support such proposals, owing to the difficult legislative requirements in the United States. The declining share of SDRs in global reserves should be borne in mind, but that factor is not an adequate basis for a new allocation of SDRs.

Mr. Landau asked Mr. Dawson whether a move to redistribute SDRs would require congressional approval in the United States if the redistribution was designed to take place on a bilateral basis between countries and the Fund was not directly involved in a legal sense.

Mr. Dawson replied that the U.S. Congress would need to approve any allocation of SDRs that was geared toward a specific purpose. As the proposal for an SDR allocation currently under consideration was clearly intended to achieve specific aims, it would require legislative approval.

Mr. Solheim made the following statement:

> The staff paper presents a thorough discussion of the various issues related to international liquidity and the SDR mechanism, and it makes a case for a moderate allocation of SDRs. Although the global level of reserves will have to increase over the medium term in line with the growth of international trade, we are not convinced that there exists--as required by the Fund's criteria--a long-term global need for supplementing international reserves through a new SDR allocation. In particular, the ratification process for the quota increase under the Ninth Review is now at a critical juncture, and we should be careful not to endanger the current quota increase.
>
> As documented in the staff paper, various groups of countries have consistently suffered from insufficient levels of foreign reserves. This has particularly been the case for countries which, due to varying reasons, have lost their access to international capital markets. Even though accumulation of reserves for these countries may entail substantial country specific costs, there have been no major systemic effects on the international monetary system.
>
> The countries currently most in need of a higher average level of reserve holdings are the republics of the CIS, the Baltic countries, and many of the developing countries and Eastern Europe. The nature of their problems often, however, vary substantially from country to country, and the problems should, therefore, be handled selectively, i.e., through conditional lending from international organizations and bilateral creditors. Accordingly, reserve shortage problems reflecting individual or regional factors should not be dealt with by general means, and should not determine the question of a new SDR allocation. Furthermore, a general rise in the demand for Fund resources should not be met by an SDR allocation, but should be handled through a general augmentation of the level of Fund resources.
>
> On the assumption of a prudent monetary and foreign exchange policy in the major industrial countries, a moderate SDR allocation may not entail inflationary pressures. If a major part of the allocated SDRs is not retained by the recipient country, but used to finance a larger current account deficit than would have occurred in the absence of an allocation, upward pressure on world prices and real interest rates cannot be ruled out.

In the case of an SDR allocation, consideration should be given to introducing measures that will reduce the prolonged net use of SDRs; for instance, the conditionality associated with Fund programs could be used to ensure that holdings of SDRs are rebuilt or its use limited. Some form of appropriate reconstitution requirements may also merit consideration, although, if enforced, the attractiveness of SDRs as a reserve asset would be reduced. Introduction of, for example, penalty rates on prolonged users should, however, be avoided, as this would require amendment of the Fund's Articles of Agreement.

An argument of particular relevance for a moderate SDR allocation is to give countries that have entered the Fund since the most recent SDR allocation a specific SDR allotment, thus allowing them to participate in the SDR mechanism. To give only the new members SDR allotments would, however, require a redistribution on a voluntary basis between existing members of the SDR mechanism, or require a change in the Articles of Agreement. We do not consider the latter alternative suitable.

All the proposed schemes for a redistribution of a new SDR allocation entail a number of difficulties and problems. If it is decided to implement a moderate SDR allocation, both the Hashimoto Proposal and the Erb Proposal encompass elements that may deserve a more thorough examination. The merit of the post-allocation redistribution schemes is that they target the needs of specific groups of countries and combine this with appropriate Fund conditionality. The main question remains, however, whether the SDR mechanism is the relevant instrument in this regard, and whether the need for additional reserves is not better dealt with through other means.

In conclusion, this chair is of the view that the question of a new SDR allocation is not urgent, and a cautious approach should be followed on this issue. Although, at present, we are not convinced that a legislative case exists for a new SDR allocation, we are open to return to the issue when the quota increase under the Ninth Review is in place. Once the quota increase is implemented, the question of an increase in quotas under the Tenth Review and its likely timing, as well as other ways of strengthening the position of countries facing severe reserve stringencies, should also be carefully explored.

The Executive Directors agreed to continue the 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/92/77 (6/19/92) and EBM/92/78 (6/24/92).

2. DEBT AND DEBT-SERVICE REDUCTION OPERATIONS - EARLY REPURCHASE EXPECTATIONS - AMENDMENT

a. The initial paragraph of Decision No. 9331-(89/167), adopted December 19, 1989, as amended, shall be amended to read as follows:

"In the context of the guidelines on the role of the Fund in the debt strategy, the Fund adopts the following decision on expectations of early repurchase by members with respect to (i) purchases of additional resources under stand-by or extended arrangements either for interest support or for collateralization of principal in reduced interest par bond exchanges and (ii) purchases of amounts set aside under such arrangements to support operations involving debt reduction."

b. Paragraph 1 of Section A of Decision No. 9331-(89/167), adopted December 19, 1989, as amended, shall be amended to read as follows:

"Whenever the Fund approves a member's request for (i) purchases of amounts set aside to support operations involving debt reduction under a stand-by or extended arrangement, or (ii) additional resources under a stand-by or extended arrangement either for interest support or for collateralization of principal in reduced interest par bond exchanges, pursuant to the Fund's guidelines on the role of the Fund in the debt strategy, the Fund shall specify in the decision approving the request the purposes for which, and the period of time within which, such set-aside amounts or additional resources can be used."

Decision No. 10056-(92/78), adopted
June 23, 1992

3. JORDAN - STAND-BY ARRANGEMENT - REVIEW OF EXTERNAL FINANCING

The Fund decides that the first review on the financing of the program contemplated in paragraph 4(e) of the stand-by arrangement for Jordan is completed.

Decision No. 10057-(92/78), adopted
June 23, 1992

4. REPUBLIC OF THE MARSHALL ISLANDS - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from May 21, 1992, the Republic of the Marshall Islands has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

Decision No. 10058-(92/78), adopted
June 22, 1992

5. SURINAME - 1992 INTERIM ARTICLE IV CONSULTATION

The Fund notes the staff report for the 1992 interim Article IV consultation with Suriname (SM/92/115) and declares the consultation completed.

Decision No. 10059-(92/78), adopted
June 22, 1992

6. UNITED NATIONS - COMMITTEE ON CONTRIBUTIONS - RELEASE OF INFORMATION

The Executive Board approves the release of certain information on the states of the former U.S.S.R. to the UN Committee on Contributions, as set forth in EBD/92/126 (6/22/92).

Adopted June 23, 1992

7. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAM/92/28 (6/22/92) is approved.

APPROVED: March 5, 1993

LEO VAN HOUTVEN
Secretary