INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/79

3:15 p.m., June 24, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
G. K. Arora	
Che P.	Wei B.
	K. Langdon, Temporary
	J. M. Abbott, Temporary
J. de Groote	
	M. Mrakovcic, Temporary
R. Filosa	
	A. F. Mohammed
	J. A. Solheim
H. Fukui	
B. Goos	
J. E. Ismael	T. Sirivedhin
	J. C. Jaramillo
	P. Bonzom, Temporary
A. Mirakhor	O. Kabbaj
	L. J. Mwananshiku
D. Peretz	
G. A. Posthumus	
	A. R. Ismael, Temporary
A. Torres	R. Marino
A. Végh	A. G. Zoccali

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

Also Present

European I Department: M. C. Deppler, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; G. R. Kincaid. Legal Department: F. Gianviti, 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; D. J. Mathieson. Secretary's Department: J. W. Lang, Deputy Secretary; A. Jbili, A. Leipold. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; C. A. Hatch, T. M. Tran, M. A. Wattleworth. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: M. B. Chatah, L. Dicks-Mireaux, B. R. Fuleihan, J. M. Jones, 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, Duan J., N. A. Espenilla, S. K. Fayyad, M. Galán, O. A. Himani, J. Jonas, W. Laux, E. H. Pedersen, P. L. Rubianes, Tin Win.

1. INTERNATIONAL LIQUIDITY AND ROLE OF THE SDR

The Executive Directors continued from EBM/92/78 (6/24/92) their consideration of a staff paper on international liquidity and the role of the SDR mechanism (SM/92/106, 5/27/92).

Mr. Al-Jasser made the following statement:

This chair, like Mr. Fukui's, has been supportive of a modest SDR allocation. The staff paper, which presents the case in favor of an SDR allocation, reinforces my support for such an allocation, particularly in light of recent developments. The crucial importance of adequate reserves for sustainable structural adjustment is evidenced by the cumulative experience of developing countries over the past decade as well as by the recent experience of members who have joined the Fund over the past two years. The world economy will benefit from a modest SDR allocation that reduces the need of many countries for excessive import compression and other growth-constraining policies. Hence, global growth could be enhanced without creating unnecessary excess demand and inflationary pressures. Moreover, an allocation would enhance the role of the SDR as an important reserve asset, which is its raison d'etre.

As the staff paper indicates, any assessment of the long-term global need for reserves should incorporate an expansion of the concept of international liquidity to include the availability of external borrowing from private creditors. Hence, strictly speaking, it is difficult to argue that a generalized reserve shortage exists. Nevertheless, the current distribution of international reserves and liquidity raises major concerns. Indeed, many developing countries and formerly centrally planned economies have very low ratios of non-gold reserves to imports and extremely limited access to borrowed reserves. These ratios hide the magnitude of the problem because of the decline in their denominator, namely, imports. Moreover, when the need for resources from private markets is most pressing, the cost of such resources dramatically rises and their availability is severely limited. While this is often due to domestic macroeconomic difficulties and mismanagement, it may also occur owing to unforeseen global shocks or contagion effects. Consequently, countries are forced to adopt severe policies of import compression and trade and payment restrictions to deal with reserve stringencies.

The limited availability and high cost of reserves for many countries threatens to derail their implementation of comprehensive structural adjustment programs or their attempts at monumental economic transformation. Clearly, limited access to reserves imposes policies that lead to very low rates of economic growth and increase the economies' vulnerability to external shocks.

Furthermore, it is clear that structural adjustment programs and comprehensive economic transformation measures require broad-based domestic support. This support is seriously threatened by excessive import compression and dramatic output decline. While this is true for all adjusting economies, it is perhaps most strikingly apparent in the countries of the former U.S.S.R., where reserves are practically nonexistent and reforms are contingent on the authorities' ability to deliver consumption goods.

In addition, it should be recalled that reserve shortages and their consequent policies have spillover effects on other countries. Indeed, the economic stagnation and decline in Latin America was a major factor in the deterioration of the U.S. external position in the first half of the 1980s, and the severe reserve shortages in Eastern Europe contributed to the collapse of trade among the former members of the Council for Mutual Economic Assistance. Similarly, practically nonexistent reserves in the countries of the former U.S.S.R. threaten to disrupt interrepublican trade as well as trade with many developing countries. Hence, in light of the spillover effects and the systemic importance of regional shortages in reserve holdings, it can be argued that a global need for reserve supplementation exists. This is further underscored by the reluctance of private creditors to provide resources to many developing and formerly centrally planned countries, as well as by budgetary pressures in many industrial countries, which have made many official bilateral creditors far less willing to lend. As a result, a modest SDR allocation appears to be justified, especially if it is coupled with an appropriate post-allocation redistribution mechanism.

There are two potential downside risks to an SDR allocation; it could stimulate global inflation and allow some countries to delay the implementation of necessary adjustment measures. First, a modest SDR allocation in the range of SDR 30 billion to 40 billion would be unlikely to have a serious effect on inflation, especially as there is no reason to believe that it would alter the macroeconomic policies of major industrial countries. Second, linking post-allocation redistributions of SDRs with Fund conditionality should ameliorate the moral hazard problem. Moreover, a conditional redistribution of SDRs could reduce the risk of inflation, since the SDR allocation would occur in the context of macroeconomic adjustment. Also, a post-allocation redistribution would enable a modest SDR allocation to provide meaningful additional reserves to those countries that presently have very low levels of reserves.

In sum, while there may be some downside risks to a modest SDR allocation, these risks can be adequately addressed through a conditional post-allocation redistribution mechanism. Furthermore, these risks are more than offset by the potential gains of

greater growth and continued sustainable adjustment and economic transformation in countries that currently have very low reserves. Finally, given the long-term nature of these countries' need for reserves and the limited ability or willingness of private and official creditors to provide necessary resources, this need could best be satisfied through a modest SDR allocation, rather than through an increase in Fund access limits. Indeed, the use of resources from the General Resources Account imposes a short-term foreign exchange repayment constraint that may not provide a sufficient interval for the renewal of the growth process to take firm hold.

Mr. Mwananshiku made the following statement:

This chair has in the past consistently supported an SDR allocation. The staff paper for the current discussion leaves little room to make additional arguments in support of this position. Our primary contention--which is at the core of the staff paper--has been that SDR allocations are needed to supplement international reserves in a large group of member countries. The staff has estimated a growing demand for international reserves, amounting to about SDR 300 billion in the period 1992-96, which calls attention to the critical constraints facing most Fund members in meeting their growing demands. Given the current limited access to international financial markets, a number of countries are forced to compress imports and pursue restrictive trade regimes in order to economize on reserve holdings. The experience in African countries has contributed to decline in economic growth and living standards. Countries in other regions have faced similar problems.

Using an SDR allocation to ease the liquidity constraint on such countries could be in the interest of the global economy. It should be stressed that, if the allocation is to address the problem of import compression and facilitate improved economic performance, the focus cannot be on reserve accumulation alone. The use of the allocated SDRs cannot be generalized. For sub-Saharan Africa, a primary aim of the SDR allocation and distribution would be to ameliorate the import constraint, especially as it relates to increasing the level of investment. This means some additional spending must be contemplated. For some countries, the emphasis on reserve accumulation may be appropriate.

The potential impact of any SDR allocation is tied to the amount to be allocated relative to the need. It is doubtful that the size of the SDR allocation discussed in the staff paper would be adequate.

The modest size of the SDR allocation proposed by the staff relative to the estimated need for reserves should allay any fears

about its inflationary impact. It is even unlikely that a larger allocation--which we could support--would set off an inflationary spiral. It is plausible to consider that rates of inflation in the major countries would be influenced by their domestic policies rather than by an SDR allocation. As the ethos of adjustment is now well established in many developing countries, the availability of a relatively small amount of additional SDRs would be unlikely to cause them to pursue inappropriate policies. Few countries, if any, question the importance of a stable macroeconomic framework.

We support an allocation of SDRs in the sixth basic period. Given the projected increase in demand for reserves, that allocation should be much larger than the amount of SDR 30 billion suggested in the staff paper.

We hope that a consensus can be reached among the industrial countries to also support a post-allocation redistribution of SDRs. Some of the well-to-do developing countries might join in this endeavor. We favor a method of redistribution that would not constrain the discretionary use of reserve holdings. However, to the extent that broad support is gathered in favor of a redistribution process to take place in the context of Fund-supported adjustment programs, it should be stressed that such a redistribution should not be limited to countries with stand-by and extended arrangements--as suggested by the Hashimoto proposal--but should also include countries with enhanced structural adjustment arrangements.

The focus of conditionality need not be on tightening performance criteria with respect to reserve levels in the short term. On the contrary, the primary goal should be for programs to be pragmatic, emphasize sound restructuring policies, and make appropriate allowance for increased investment and diversification.

A question remains as to whether prolonged net use of SDRs is undesirable. The staff paper did not give much guidance on this issue, apart from the suggestion that prolonged use could be associated with weak macroeconomic policies. Perhaps the staff could elaborate on the extent to which "inappropriately prolonged use" has been a problem in the past.

One of the reasons for abrogating the reconstitution provision was that it made the SDR less attractive relative to other reserve assets. We see no compelling reason to go back to this requirement. Moreover, the discussion of reconstitution and penalty charges for using SDRs creates a sense of ambivalence toward the role of the SDR as a reserve asset. The way to enhance

the role of the SDR in the world economy is to have it used more widely, with the least restrictions possible.

Mr. Che made the following statement:

We welcome the current discussion on international liquidity and the SDR mechanism. We concur with the staff's assessment of the global need for reserves and find the case presented in the staff paper for a moderate SDR allocation reasonable. As stated on previous occasions, this chair supports the resumption of SDR allocations and emphasizes the need to enhance the role of the SDR in the international monetary system. Nevertheless, the staff paper reflects a number of our concerns.

Although it is clear that a "generalized" shortage of reserves has not been observed in the past decade, this does not eliminate the fact that certain groups of countries have suffered severe reserve stringencies as a result of adverse external shocks, weak macroeconomic policies, or rapidly rising costs of holding reserves. Indeed, a considerable decline in the ratio of non-gold reserves to imports has been experienced by countries in sub-Saharan Africa and Eastern Europe as well as other regions in the past two decades. At end-1991, the reserve ratio of sub-Saharan African and Eastern European countries was below the combined ratio of developing countries as a whole, and the reserve ratio of the small low-income countries was only half of that overall ratio.

In adjusting their economies, many of these countries, especially those facing limited access to the international financial market and the high cost of holding reserves, have struggled to restore their reserve ratios at the expense of import compression and lower growth. Such an outcome is obviously adding to--instead of reducing--the constraints on the adjustment process. Moreover, this outcome affects neighboring countries and the rest of the world. This is particularly worrisome at the present juncture, when both the number and economic importance of the reserve-lacking countries are growing substantially. The need to provide these countries with additional reserves at a lower cost to aid their adjustment efforts is urgent, and such a move would benefit the world economy as a whole.

At the previous review of the SDR mechanism in September 1988 (EBM/88/139 and EBM/88/140), this chair voiced concerns about the inclination in the structure of international liquidity toward the private market. This remains a matter for concern. It is not surprising that countries in need of liquidity are increasingly resorting to the private international financial market, given the flexibility and efficiency it offers in the absence of sufficient

expansion in the official market. Nevertheless, one important feature of official resources that cannot be duplicated in resources obtained from the private market is the potential availability of such resources when most needed by countries facing severe domestic and external conditions with little access to private financial markets. There is a risk that this feature will be lost by relying substantially on the private market, and that fact is not offset by the flexibility and efficiency of the private market. Therefore, it is in the interest of virtually all countries to strengthen the official safety net by making more official resources available.

While SDR allocations are an important means to address these problems, progress in the resumption of such allocations has been disappointing. No one can deny the potential downside risk associated with an allocation that could lead to more payments imbalances rather than more reserve holdings. However, this risk should not be overly exaggerated, especially in the case of a moderate allocation, such as the one proposed by the staff. Furthermore, the risks should be looked at together with the benefits of such an allocation. If the benefits outweigh the risks, there is no reason those benefits should not be realized.

Based on considerations along these lines, we would support an SDR allocation during the sixth basic period with an appropriately designed post-allocation redistribution mechanism. As to the size of the allocation, we would be in favor of an allocation of SDR 30 billion; but, if there is a broad consensus among Directors, we could also go along with a larger allocation.

Mr. Arora commented that he had a feeling of dèjà vu with respect to the current discussion. Directors' positions on the question of an SDR allocation had not changed since 1988. Indeed, the opposition to such an allocation had drawn additional support from unexpected sources.

Nevertheless, he remained optimistic that in time an SDR allocation would be made, Mr. Arora continued. Directors would recall that for an extended period many members of the U.K. Parliament had opposed the movement to expand voting rights in that country, owing to fears that an extension of such rights to the working class would lead to reckless behavior and the spread of subversive political ideas. The argument put forward by several Directors for the current discussion, that an SDR allocation would lead to increased spending and a delay in the adjustment process, was based on a similar view of the poor as being innately irresponsible.

While there was some validity to the argument that the Fund should enhance the conditional resources available to members by increasing Fund quotas, participants in the Board's discussions on the Ninth General Review

of Quotas knew that it was extremely difficult to raise quotas, Mr. Arora went on.

The staff paper for the current discussion put forward very persuasive arguments supporting the need for a modest SDR allocation, Mr. Arora stated. In that respect, the staff had been careful to avoid suggesting that such an allocation should be linked to development assistance, in particular by proposing a reconstitution requirement and penalties for the prolonged use of SDRs.

He deeply appreciated the contributions Mr. Filosa, Mr. Landau, and Mr. de Groote had made to the current discussion, Mr. Arora said. In addition to the historical background information provided by Mr. de Groote, it was important to bear in mind that, while there was no empirical evidence of a generalized liquidity shortage, there was a persistent maldistribution of liquidity among members. It would be shortsighted of the Fund to fail to recognize the systemic threat emanating from that maldistribution. For example, the decade since the previous SDR allocation had been characterized by almost no growth in Latin America as well as economic stagnation and starvation in Africa. More recently, the countries of the former U.S.S.R.--including Russia--were faced with the unprecedented challenge of trying to transform their formerly centrally planned economies with virtually no reserves. In the current circumstances, it would be absurd to suggest that the current maldistribution of liquidity did not pose a systemic threat to the international monetary system.

With respect to the current distribution of reserve assets, it was important to note that international financial markets were not infallible, Mr. Arora commented. Indeed, massive intervention from all the major powers had been needed to address the serious misalignments among the foreign exchange rates of several currencies in the mid-1980s. In the context of such market failures, it clearly would not be prudent to suggest that all members could solve their own reserves problems through the international markets. Moreover, although the countries most in need of reserve assets did not have sufficient income or output to have a dramatic impact on the world economy, the Fund should not be insensitive to the widespread human suffering in those countries.

Some Directors had criticized the staff for advocating a modest SDR allocation to strengthen the position of the SDR as a reserve asset, on the one hand, and suggesting that conditionality should be applied to such an allocation, on the other hand, Mr. Arora noted. While he agreed that that line of argumentation appeared to be inconsistent, the staff was correct to take a pragmatic approach in addressing the concerns of the major shareholders by adding built-in safeguards to the allocation process. Such safeguards could detract from the character of the SDR as a reserve asset in the short term, but they would provide certain assurances with respect to how SDRs were used, in particular with respect to the longer term, when the question of international liquidity would be revisited.

The basis for all the arguments that had been put forward against an SDR allocation was the premise that an international institution, like the Fund, should not have the resources at its disposal to ensure orderly adjustment processes throughout the world, Mr. Arora remarked. While an SDR allocation did not entail a transfer of resources among countries, it clearly represented a viable means to meet the increased demand for reserves in developing countries, particularly at the present juncture, when inflationary pressures and levels of capacity utilization were low. Although such allocations did entail some transfer of control from the currency centers to an international organization, it would be in the interest of all countries and the development process as a whole to move toward the establishment of an international system that could be managed on the basis of consensus and cooperation.

Based on those considerations, he strongly supported the staff proposal, Mr. Arora concluded. He would not comment on the issues related to a post-allocation redistribution mechanism for the current discussion, as the primary focus of attention at the present stage should be on arriving at a consensus to support an SDR allocation during the sixth basic period.

Mr. Mohammed made the following statement:

It has been almost three years since the previous comprehensive review of the SDR mechanism. For the current discussion--as at the previous review--an agreement on a new SDR allocation is unlikely to follow from the strength of the economic argumentation. The legal arguments pertaining to the interpretation of "long-term global need" reveal a fundamental difference of perception, which derives in part from the view held by some Directors of the international monetary system as concerned essentially with the industrial countries and their liquidity needs and offering to the rest of the world only access to conditional funds. In line with the reiteration of history for the current discussion, perhaps it should be recalled that all the early official progenitors of the SDR, such as the several variants of the "currency reserve unit" schemes, were restricted to the major industrial nations, and it was only the valiant efforts of a former Managing Director that led to the transformation of the reserve unit concept into the global SDR arrangement. It is perhaps one of the ironies of history that it is precisely the concept of a "global" need that is currently being deployed as an argument against the continued allocation of SDRs.

It is not surprising that this chair supports the qualitative arguments advanced in the staff paper, which are entirely persuasive. As to the quantitative analysis, I join other Directors in asking the staff to continue exploring ratios additional to those connecting reserves to imports. I have in mind the implications of the rapid liberalization of capital controls that have come

about in a number of developing countries in recent years; transactions that were previously included in current accounts, such as workers' remittances, have begun to appear as capital account transactions, when workers abroad decide to send maintenance payments into foreign currency accounts held by their resident families within the domestic banking system. Examinations of trade or even current account ratios from an historical perspective may thus overlook an important dynamic affecting the future demand for reserves as more and more countries proceed to liberalize their foreign exchange controls and move their currencies toward convertibility. This progress is clearly promoting the basic purposes of the Fund, and it would be a pity if this progress was slowed down--or made unduly costly--by requiring such countries to build up reserves through net import compression in order to offset the added vulnerability to which they become exposed as they move to open up their capital accounts.

Previous speakers have mentioned the reserve needs of the 30 new members that have not participated in any SDR allocations, and the needs of new countries in the former U.S.S.R. and elsewhere who are starting out with almost zero reserves and have no track record to present to private capital markets. The notion that these countries would be subject to disincentives in their adjustment and transformation process can easily be overplayed. Given the modest SDR allocation currently under consideration and the modest share countries in the adjustment process would have in that allocation, I wonder whether an allocation that amounts to less than one credit tranche--and even that spread over several years--could have much bearing on their adjustment efforts. Just as the industrial countries would not be likely to change their macroeconomic policy stance because of a modest SDR allocation, the adjusting countries would be equally unlikely to change their adjustment stance because of a small increase in their reserve holdings.

Based on this reasoning, I would not be prepared to dilute the reserve asset character of an initial SDR allocation by reviving a reconstitution requirement, imposing penalty charges, or applying conditionality; these types of provisions would detract from the objective of making the SDR the "principal reserve asset" of the international monetary system, as required by the Articles.

I would reserve the position of this chair on the possibility of subjecting a post-allocation redistribution of SDRs to conditionality. Future quota increases might prove to be even more difficult to legislate than recent ones. As Mr. Dawson pointed out, the increase in quotas under the Eighth General Review of Quotas was passed because of the massive debt crisis in Latin America, and the increase under the Ninth General Review of Quotas is seen as practical, in light of political considerations related

to the break up of the former U.S.S.R. The world may find it difficult to produce such cataclysms to justify future quota increases, and it is possible that an SDR allocation with retransfers might be seen as a more desirable alternative to running the gauntlet of a full-fledged quota exercise through the U.S. Congress.

Mr. A. R. Ismael made the following statement:

We welcome the resumption of discussions on international liquidity and the SDR mechanism.

As the records show, after numerous and extensive Board discussions since 1981 on the issue of SDR allocations during the fourth basic period and the relentless efforts of management to get the necessary support to recommend an SDR allocation to the Board of Governors, no new allocations of SDRs were made during the ten-year period 1981-91.

I endorse most of the arguments advanced by the staff and previous speakers in support of an SDR allocation during the sixth basic period. As we have stated on previous occasions, we consider that a resumption of SDR allocations is long overdue. The case for a new allocation of SDRs has been eloquently made by many previous speakers. Therefore, let me emphasize only that the magnitude of the global need for international reserves as projected by the staff for the period 1992-96 is a cause for serious concern, and we fear that a shortage of reserves will increase the hardships borne by developing countries that are implementing strong financial and structural adjustment programs.

As we have noted in the past, despite the progress achieved in the resolution of the debt problem, most of those countries have not yet regained access to international capital markets and have had to compress imports to meet their reserve needs. We are afraid that without an adequate cushion of reserves, which an allocation of SDRs can help to provide, the situation will get worse, with serious adverse consequences on medium-term growth as well as international trade. As one speaker has noted, the compression of imports by developing countries is also a compression of exports by industrial countries.

Moreover, we are currently faced with the additional needs of the states of the former U.S.S.R. and the countries of Eastern Europe. As the staff and Mr. Filosa have noted, these countries have barely any reserves. An allocation of SDRs at the present juncture would certainly contribute significantly to alleviating the burden of adjustment on them and help them to integrate more smoothly into the global economy. In the light of all these

factors, a substantial and unconditional allocation of SDRs is warranted.

We do not consider that a new allocation of SDRs will generate inflationary pressures in major industrial countries or lead developing countries to relax their adjustment efforts. Any potential risk of an inflationary effect of a new SDR allocation would be minimal so long as the industrial countries pursue their current stance of economic policies. As to the risk of weakening the adjustment efforts of developing countries, the advantages of maintaining strong adjustment efforts are far greater than relaxing them. After all, a large majority of developing countries are implementing adjustment programs supported by the Fund and the need for adjustment is widely accepted by most developing countries.

As the staff has pointed out, the issues related to a post-allocation redistribution of SDRs are complex and a thorough examination is necessary. Therefore, we can only offer preliminary comments for the current discussion. We agree that a post-allocation redistribution of SDRs should be made to support growth-oriented adjustment programs in developing countries. In this context, we agree with previous speakers that some form of conditionality could be considered.

Mr. Mirakhor stated that he agreed with the comments put forward by Mr. de Groote and Mr. Landau. With respect to the commonly held view that an SDR allocation would encourage the poorest countries to spend more, it was important to consider the implications of such spending. After all, the import compression of one country was, by definition, the export compression of other countries. For example, the severe compression of imports in Mexico in the early 1980s gave rise to a 12 percent reduction of U.S. exports.

He supported the thrust of the staff paper, which convincingly demonstrated the need for a new SDR allocation, Mr. Mirakhor said. The staff proposal was in line with the obligation of the membership, under Article VIII, Section 7 of the Articles, to cooperate with the Fund in making the SDR the principal reserve asset in the international monetary system. Also with respect to that obligation, his preference was for the new allocation to be unconditional, as placing any constraints on the new allocation would detract from the effectiveness of the SDR as a reserve asset.

Mr. Arora commented that he agreed with Mr. Mirakhor. While some developing countries might be encouraged by the new SDR allocation to increase spending, it was important to recognize that such spending was necessary, partly just to survive--as in the case of many African countries--and partly

to obtain needed imports from industrial countries. In those circumstances, such spending was not irresponsible.

The Deputy Director of the Research Department noted that much of the current discussion had focused on ways to define "long-term global need." As many Directors had correctly pointed out, there was no empirical evidence of a generalized reserve shortage. Indeed, such a shortage was not likely to emerge in the current circumstances, and a shortage of reserves in only a few countries or a few groups of countries was not sufficient justification for an SDR allocation. At the same time, however, it was the Fund's responsibility to ensure that the overall demand for reserves, such as in the states of the former U.S.S.R., the sub-Saharan African countries, and elsewhere, did not give rise to systemic problems.

While Table 1 of SM/92/106 showed that the ratios of non-gold reserves to imports for most countries in 1991 were relatively high by historical standards, the quantitative data alone did not take into account important qualitative considerations that had a crucial bearing on whether or not a moderate SDR allocation was called for at the present juncture, the Deputy Director considered. For example, quantitative data alone did not take into account changes in the cost of obtaining reserves. All countries had to maintain a certain ratio of reserves to imports, but different countries had to do so by different means, all of which entailed certain costs. For example, Directors had agreed that preserving reserves by compressing imports entailed a very high cost, particularly at the margin, as imports became increasingly limited. Thus, in order to assess whether the current level of reserves was adequate, there was a need to look at not only the quantitative data on ratios of non-gold reserves to imports, but also at levels of imports and the policy measures being used to maintain reserves.

There was also a need to consider access to international capital markets, the Deputy Director continued. While experience showed that the private markets did reward appropriate policy performance eventually, it also showed that time was often required for countries to establish credible track records. Thus, a question arose as to whether the official sector should provide some support to countries in the early stages of adjustment, particularly in cases where there was a need for the authorities to establish--or change--their track record. As it was a basic responsibility of the Fund to support members' adjustment efforts, there was a need to consider various mechanisms related to reserves that could be used to ensure that countries would at least weigh the benefits against the costs involved in strengthening their adjustment efforts.

Payments variability was another important factor in assessing the adequacy of reserves, the Deputy Director went on. Because developing countries had higher payments variability than industrial countries, their ratios of non-gold reserves to imports should be relatively higher in normal circumstances, the Deputy Director stated. Therefore, it was a cause for concern when groups of developing countries had reserves ratios equal to--or lower than--the industrial countries.

In the light of the above-mentioned considerations, it was important for Directors to bear in mind qualitative factors, such as the level of imports and debt service, in determining the cost of obtaining reserves and the best way for members to achieve adequate levels of reserves in the context of the overall adjustment effort, the Deputy Director stated.

While many changes, including the move away from fixed exchange rates, had taken place since the SDR was created, the need for countries to hold sufficient reserves had not been eliminated, the Deputy Director of the Research Department considered. Theoretically, there was no need for reserves at all in a freely floating exchange rate system, but such a system did not exist at the present juncture. On the contrary, most exchange rates were adjusted through managed floating, such as under the exchange rate mechanism of the European Monetary System or the many different exchange arrangements among developing countries. Indeed, evidence indicated that actual reserve use and the demand for reserves had not declined since 1973.

The Director of the Research Department said that the staff paper for the current discussion represented a view that had been held historically by not only the Fund staff, but also many countries around the world. Although SM/92/106 was not intended as an advocacy brief, the staff considered that it would be desirable to put forward for consideration the best case that could be made for an SDR allocation at the current juncture. It was for Directors to assess whether or not that case was convincing.

While there were clearly sources of international reserves, aside from an SDR allocation, available to members, and those sources could likely meet most of the expected growth in the demand to hold reserves in the current five-year period, it was debatable whether--in the absence of at least a moderate SDR allocation--the markets could supply enough reserves to prevent reserve stringencies in some countries from having substantial negative effects on the performance of the world economy, the Director considered.

As to the provisions contained in the Articles, the effort to make the SDR the main reserve asset alone would justify an allocation of a limited number of SDRs, the Director noted. Mr. Goos was correct to point out that, in the light of developments in the international monetary system since the late 1960s, SDRs were no longer needed to solve the problems that had arisen when gold and the dollar were the only reserve assets. However, many countries were still encountering a variety of reserves-related problems. While it was entirely appropriate for a few members to indicate for the current discussion that they did not agree with the Legal Department's interpretation of the term "long-term global need," the Fund staff had to rely on that interpretation of the Articles, which was fully consistent with previous Board decisions to allocate SDRs in the period since 1971, as a basis for its work.

He agreed with Directors that the Fund should act like a central bank in assessing international liquidity, the Director stated. In that connection, it was important to note that central banks did take into account the

needs of specific regions and sectors in determining whether there was a need to expand liquidity. For example, the United States had 12 Federal Reserve banks precisely to ensure that regional concerns would be taken into account in the conduct of U.S. monetary policy. In 1974, a former chairman of the Federal Reserve Board (FRB) had determined that financial assistance to New York City would be desirable, because a financial collapse in that city would have had systemic implications for the U.S. economy as a whole. The so-called credit crunch in the United States was currently the subject of much debate in setting an appropriate course for monetary policy. Although large firms that had access to the commercial market did not face credit constraints, the relatively small or moderate-sized firms that were dependent on local banks--which were facing severe difficulties--had problems with respect to the supply of liquidity. The U.S. Treasury was currently making an active effort to persuade the FRB to adjust monetary policy in the light of the effects the credit crunch was having on specific enterprises and sectors.

On a global basis, the largest countries, which issued international reserves, did not face reserve stringencies, the Director of the Research Department noted. However, those countries accounted for only 10 percent of the world population. At the same time, measures of GNP, adjusted on the basis of exchange rates determined by purchasing power parity, showed that the combined GNP of the countries that had expressed concern about reserves shortages accounted for 60 percent of world output. Based on that consideration, it would be neither realistic nor appropriate to characterize the current rising demand for reserves as a small problem.

Mr. Goos remarked that, while central banks would in some circumstances expand the domestic money supply to address regional problems, he wondered whether they had created long-term instruments to durably increase the overall supply of liquidity. He was not aware of any examples of such action. While the economic transformation of eastern Germany clearly had repercussions for the German economy as a whole, it would not be appropriate for the Bundesbank to increase money supply targets in a significant and durable manner, and the Fund staff had certainly not advised the German authorities to do so in the context of the previous Article IV consultation with Germany (EBM/91/120, 9/11/91).

The Director of the Research Department recalled that there had been a substantial increase in the German money supply at the time of unification. Over the past two years, the Bundesbank had substantially exceeded its stated targets for monetary growth. Three or fours years hence, the additional liquidity that had been introduced into the German economy would become permanent. Nevertheless, it was clear that fiscal policy had played a central role in the case of Germany, and the staff certainly did not intend to suggest that SDR allocations should be seen as an alternative to strong adjustment programs backed by conditional credit. In that respect, a moderate SDR allocation combined with appropriate redistribution mechanisms could be used to address the serious reserve stringencies that existed--or might be expected to emerge--in a broad range of countries. As in the case

of Germany, such an allocation could be used as only part of the solution; the implementation of appropriate adjustment and monetary policies was also necessary.

Mr. Arora noted that the rise in German interest rates had a systemic impact on all of Europe. Therefore, it would be difficult to argue that the problems related to German unification were being addressed in a purely domestic way.

Mr. Goos remarked that the overall money supply in Germany had not been increased. While deutsche mark balances had been used to substitute for existing east German mark balances, the Bundesbank had maintained its targets for monetary growth; it had not introduced additional liquidity into the economy. The fact that German growth rates had exceeded the Bundesbank targets did not say anything about the overall monetary policy stance. The staff and other Directors would likely agree that, in the current circumstances, it would not be appropriate to use monetary policy to resolve the problems in eastern Germany.

Mr. Peretz commented that the usual practice of the Fund was to advise member countries to rely on fiscal, not monetary, policy as a tool to address the problems of specific sectors or firms.

The Director of the Research Department noted that there was an important difference between support for members' adjustment efforts and conditionality. The need to address the problem of reserve stringencies should also be seen as a separate issue. In addition to the need for the Fund to support economic adjustment programs through the provision of conditional financial assistance, there was a need for the Fund to support adjustment programs by ensuring the availability of reserve assets.

The concern expressed by Directors that a redistribution of 30 billion SDRs to developing countries could raise world interest rates by 1/4 of 1 percentage point, which was roughly consistent with the estimates contained in the World Economic Outlook, was based on the presumption that developing countries would spend the redistributed SDRs over a relatively brief period, thereby increasing pressure on the savings investment balance, the Director said. That eventuality would be a potential cause for concern only in the context of an overly large allocation of SDRs, in excess of the projected increase in demand, or a large-scale unconditional redistribution of SDRs.

The staff had not focused on the need to strengthen the SDR as a reserve asset, because it did not consider the strength of the SDR to be a central problem, the Director continued. Indeed, the fact that the five largest holders of SDRS, which currently held about 75 percent of all SDRs, were reluctant to enter into voluntary transactions led to doubts about whether the return on SDRs was too low. At the present stage, the central problem was that some groups of low-income countries in general lacked access to international capital markets. For those countries, the marginal

cost of acquiring and holding reserves was substantially above world market interest rates as represented by the SDR interest rate. In the context of even a moderate SDR allocation, those countries would see the cost of borrowing or spending SDRs as substantially below the cost of other types of reserves. The rational economic decision--even if the SDRs were spent at the present juncture and repaid later at 5-10 percent above the SDR interest rate--would be to spend the additional SDRs. The way to resolve that problem was to correct the principal defect in the distribution of SDRs among members.

Over time, the cost to the low-income countries that had only limited--or no--market access of acquiring and holding SDRs would grow in line with the general increase in the level of world prices, which was determined by the inflation rates of industrial countries, the Director went on. The demand of those countries to acquire and hold reserves was growing, and while their reserve holdings had gone up over the past five years, they had been paying a substantially higher cost for those reserves than other countries. In that connection, it was important to bear in mind the high social costs those countries faced in trying to maintain their reserves positions. Based on those considerations, it would be appropriate to consider providing such countries with some fraction of the expected increase in the demand for reserves to hold at a cost that would correspond to the true cost to the world economy of creating such reserves.

Another problem was the need to point out the nominal cost of holding reserves compared with the true social cost, the Director added. As the market interest rate was 20 percent and the SDR interest rate was only 7 percent, some countries would likely spend the additional SDRs unless the redistribution of SDRs was made conditional on raising the average level of reserve holdings. As the provisions of the Articles precluded the application of conditionality to the allocation of SDRs, it was necessary to consider a redistribution mechanism that would direct SDRs to the countries most in need under the above-mentioned conditions.

He differed with some Directors on whether a reconstitution requirement would weaken the monetary character or usefulness of the SDR, the Director commented. For example, some forms of revolving credit, such as commercial credit cards, carried a reconstitution requirement in that the balance had to be paid monthly; that requirement did not hinder their liquidity value.

He agreed with the assertion made by several Directors that the fact that some less-creditworthy countries faced higher costs of acquiring or holding reserves, owing to poor policy records and other problems, was not an indication of market failure, the Director stated. Indeed, the staff paper had made it clear that the intention of a new SDR allocation was not to direct additional SDRs to countries that would likely spend them. However, as the demand of such countries for reserves to hold would continue to rise, even given the associated high costs of reserves, it would be appropriate to consider a moderate SDR allocation combined with incentives for countries to enhance their reserves positions. Moreover, market failure

had occurred to the extent that private creditors did not have any means to distinguish between the intended purposes of the resources they lent to sovereign states. The Fund could determine how the proceeds of its financial assistance were utilized.

Some Directors had expressed concern that, as the severe economic problems faced by the formerly centrally planned economies and a number of low-income developing countries could not be solved by a moderate SDR allocation, those problems could be used again to justify future allocations, the Director recalled. Such a course of action clearly would not be appropriate. In that respect, there was a need to distinguish between the purpose of an SDR allocation to enhance reserves to hold and other types of Fund credit, which were intended to support programs of economic adjustment--although such resources had been provided to members in the past on the understanding that they likely would not be used. In that connection, resources distributed only on the condition that they not be spent under any circumstances, even if they had been reconstituted, would not be very useful; indeed, by definition, they would not be reserves.

The intention of a moderate new allocation of SDRs was to enhance reserve holdings on average, the Director stated. Such an allocation would address two main problems related to import compression. It would help countries that did not have reserves at all to acquire reserves, and it would reduce the need for import compression in cases where the decision had been made to maintain a minimum level of reserves rather than sustain imports in a time of crisis.

While Mr. Fukui's suggestions concerning possible ways to quantitatively measure the need for an SDR allocation were interesting, it would be extremely difficult to estimate the degree of import compression that was likely to occur in a number of countries, such as those in Latin America and Eastern Europe, the Director commented. In any event, it would be difficult to use quantitative data alone as a basis for assessing either how a post-allocation redistribution of SDRs might resolve problems of import compression or the size of allocation needed.

As several Directors had stressed, the most urgent issue concerning overall Fund resources was the coming into effect of the increase in quotas under the Ninth Review, the Director of the Research Department concluded. Nevertheless, the staff considered that it would be helpful to at least consider a moderate SDR allocation, so that the Board would be ready to take up in detail the issues related to an SDR allocation shortly after the increase in quotas under the Ninth Review came into effect.

Mr. Végh noted that the staff had made a dramatic argument in favor of the redistribution requirement based on the example provided by revolving commercial credit. Nevertheless, applying to SDRs such a requirement, which did not apply to other types of reserves, would negatively impact on the effort to make the SDR the main reserve asset. A similar effect would likely occur if plastic money was intended to replace all other monies. He

had related his arguments against a reconstitution requirement to his support for a conditional post-allocation redistribution of SDRs, because the application of conditionality would negate the need for a reconstitution requirement and vice versa. Therefore, it would be going to extremes to impose both of those elements on an SDR allocation.

Mr. Posthumus asked, with respect to the staff's projection of a global reserve need over the coming five or six years, whether the staff considered that a similar need had existed over the past five or six years.

As defining "long-term global need" was largely a matter of judgment, it might be helpful to consider situations in which such a need could arise, Mr. Posthumus considered. In that connection, it was important to note that the U.S. authorities had not expanded liquidity owing to the bankruptcy of New York City itself, but in light of the consequences that such a financial collapse would have had on the rest of the U.S. economy. Indeed, many countries had taken similar steps in light of the possible impact the stock market crash of 1987 could have had on their economies. In both of those instances, it was not the events themselves that had spurred the authorities to action, but the possible consequences of those events. From a global perspective, such an expansion of liquidity would be called for only if there was a collapse of confidence in the international capital markets or if countries reintroduced capital market restrictions sufficient to significantly weaken that important source of reserves supply. To the extent that the present sources of supply of reserves were not affected by the reserve stringencies in some groups of countries, there was no reason to consider that similar reserve shortages would emerge in other countries or that the international monetary system as a whole was in danger.

Mr. Goos said that, if Directors and the staff were confident that the Fund was equipped with sufficient liquidity to help resolve the problems faced by the states of the former U.S.S.R. in the medium term, there was no reason to try to add to the Fund's existing facilities or to create additional long-term liquidity.

The Director of the Research Department stated that conditionality and reconstitution requirements were separate, but related, issues. They should not be seen as mutually exclusive alternatives. Ultimately, it was for the Board and members' authorities to assess the magnitude of the problems related to prolonged use that could arise in connection with any SDR allocation. There was also a need to consider the separate issue of whether it would be desirable to make a post-allocation redistribution of SDRs conditional.

As the staff had indicated on several previous occasions, the need for an augmentation of reserves through an SDR allocation had arisen at various times in the 1980s, the Director continued.

The FRB had acted in light of the systemic implications of the New York City bankruptcy, rather than the financial collapse itself, as Mr. Posthumus

correctly pointed out, the Director recalled. Nevertheless, it should be noted that the effects of that collapse, which were substantial, were not uniform throughout the United States. While the interest rates on municipal securities issued in New England and the North Atlantic had gone up in a contagion effect, the interest rates on Nebraskan public debt had gone down as a result of the rush to quality.

Thus, there was a need to determine at what point the potential effects of the current reserve shortage could be seen as sufficient to call for an SDR allocation, the Director of the Research Department concluded. While almost everyone would agree that the hypothetical events described by Mr. Posthumus would clearly call for reserve augmentation, he wondered whether any events--short of an imminent or ongoing collapse of international capital markets--could be seen as justification for an SDR allocation. Based on the Legal Department's interpretation and the previous decisions taken by the Board on SDR allocations, there was clearly a long-term global need for reserves at the present stage.

The Chairman made the following summing up:

> The discussion focused on three topics: the long-term global need for reserve supplementation and the case for an SDR allocation during the sixth basic period; the issues related to prolonged use of SDRs; and proposals for linking allocation, redistribution, and conditionality.
>
> In the discussion, the Executive Board was divided with a number of Directors supporting the staff's arguments in favor of a modest SDR allocation with a post-allocation redistribution associated with conditionality, and other Directors indicating that such an SDR allocation would not be warranted. A few Directors, that did not support the staff's arguments, would nevertheless favor traditional allocations of SDRs. The broad support required for a proposal to the Board of Governors for an SDR allocation was not achieved, but there was clearly support for keeping the need for such an allocation under active review.
>
> In evaluating the long-term global need for reserve supplementation, many Directors argued that a global need did not imply that all, or nearly all, countries needed to increase their reserves. Conversely, the fact that many individual countries or groups of countries needed to increase their reserves would not necessarily mean that a global need for reserve supplementation would exist. Moreover, if a long-term global need existed, an allocation of SDRs could be made even if that need could or would be met in other ways.
>
> These Directors supported the staff's analysis that there was a special urgency to consider measures for increasing the supply of international reserves for countries facing severe reserve

stringencies. Low reserve holdings in the states of the former U.S.S.R., the small low-income countries, and the sub-Saharan African countries were seen as having potentially severe adverse implications, not only for individual economic performances of those countries, but also more generally for the world economy. An SDR allocation was viewed by these Directors as a particularly cost-effective means of helping those countries rebuild their reserves.

Other Directors, however, rejected the staff's assessment of the long-term global need for reserve supplementation, as lacking a truly "global" dimension. These Directors stressed three considerations. First, many countries accounting for the bulk of world trade and financial flows faced no apparent difficulty in augmenting their reserve holdings in accord with their growing demand for reserves. Moreover, the rising ratios of non-gold reserves to imports for many developing countries did not in their view reveal an abnormal situation in the functioning of the reserve creation mechanism. Second, these Directors argued that the reserve deficiencies of many countries often reflected inadequate or inappropriate macroeconomic and financial policies, which should be corrected by policy adjustments supported by conditional liquidity. Such policy inadequacies do not justify the creation of liquidity through a global mechanism, such as an SDR allocation. Third, the use of the SDR system to deal with a regional problem could impair the reserve asset characteristics of the SDR. Several Directors argued that, given the current structure of the international monetary system, they could not see a case for an SDR allocation.

Many Directors stressed the importance of using the SDR system to create reserves to hold. In this connection, it was noted that many developing countries hold only a relatively small fraction of their cumulative SDR allocations. Some Directors were concerned with possible resource costs of prolonged net use of SDRs by some countries. However, it was broadly agreed that, in current circumstances, a moderate-sized allocation would not be a threat to world price stability.

Directors expressed differing views on the usefulness of measures to reduce prolonged net use of SDRs. There was no support for the use of a penalty interest rate for prolonged use of SDRs. Some Directors expressed interest in the possibility of reinstituting a reconstitution requirement, especially if such a requirement would broaden support for an allocation. Some Directors opposed the reintroduction of a reconstitution requirement on the grounds that it would detract from the reserve-asset character of the SDR.

A number of Directors supported the proposals discussed in the staff paper regarding post-allocation redistribution of SDRs. Those Directors that favored post-allocation redistribution argued that the beneficial effects of an SDR allocation could be enhanced if such redistribution was used to direct reserves to those countries with the greatest need. They also stressed that there is a need to increase both the conditioned resources and owned reserves made available to countries implementing structural adjustment programs. However, other Directors argued that these redistribution proposals were not consistent with the objectives of the SDR system, namely, to meet over time the growing need for reserves of the entire membership. In addition, some Directors objected to providing conditional liquidity through the SDR system and felt that the need for conditional liquidity should be addressed through quota increases.

Many Directors emphasized the importance of ensuing that consideration of an SDR allocation does not interfere with the process of approval of the quota increase under the Ninth General Review of Quotas. At the same time, the staff will pursue the requests to study measures to improve the quality of the SDR and to assess alternative quantitative measures of the need for and benefits of SDR allocations. These issues could be examined by the Board once the quota increase under the Ninth Review has been approved.

The Executive Directors then concluded their consideration of international liquidity and the SDR mechanism.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/92/78 (6/24/92) and EBM/92/79 (6/24/92).

2. SWITZERLAND - REPRESENTATIVE RATE FOR SWISS FRANC

The Fund finds, after consultation with the authorities of Switzerland, that the representative exchange rate for the Swiss franc under Rule 0-2(b)(i) is the midpoint between the buying and selling rate for the U.S. dollar in terms of the Swiss franc at 1:00 p.m. in the Zurich foreign exchange market, as communicated to the Fund by the Swiss National Bank.

Decision No. 10060-(92/79) G/S, adopted
June 24, 1992

APPROVED: March 12, 1993

LEO VAN HOUTVEN
Secretary