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To: Members of the Executive Board

From: The Acting Secretary

Subject: The Rationale for, and Implications of, an SDR Allocation
in Present Circumstances

Attached for consideration by the Executive Directors is a paper on the rationale for, and implications of, an SDR allocation in present circumstances, which is tentatively scheduled for discussion on Wednesday, July 7, 1993. A summary and issues for discussion appear on pages 14-16.

Mr. Goldstein (ext. 37678) or Mr. Isard (ext. 36640) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

The Rationale for, and Implications of,
an SDR Allocation in Present Circumstances

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(In consultation with other Departments)

Approved by Michael Mussa

June 9, 1993

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I. Introduction

In its communiqué of April 30, 1993, the Interim Committee requested the Executive Board "to assess the long-term global need for a supplement to existing reserve assets, the potential economic and monetary effects of an allocation, and the future of the SDR as a reserve asset." In connection with the first two parts of that request, this paper addresses the economic and monetary rationale for, and implications of, an allocation in present circumstances. Most aspects of these issues have been discussed on previous occasions and can be reviewed briefly in this paper. 1/ The future of the SDR as a reserve asset is considered in a companion paper, while the legal aspects of SDR allocations, the pattern of use and holdings of SDRs, and the role of the SDR in the diversification of foreign exchange reserves are addressed in background papers.

The paper does not address the proposals that have been made for a post-allocation redistribution of SDRs. This issue has been reviewed extensively by the Executive Board in the past. 2/ A number of the redistribution proposals have been motivated by the desire to make additional liquidity available, under strict Fund conditionality, to provide further support to countries undertaking sound stabilization and transformation programs. Alternative redistribution schemes raise many operational issues, including the important question of who would bear the credit risk associated with the on-lending of SDRs. However, the issues relating to post-allocation redistribution are not inextricably linked to the issue of SDR allocation, and the question of post-allocation redistribution could be further considered on the basis of a staff paper to be issued shortly and in the light of Executive Directors' consideration of an SDR allocation.

The paper is organized as follows. Section II considers the projected growth in the demand for reserves and also examines data on the present reserve holdings of member countries. Section III addresses the potential benefits of allocating SDRs, focusing on the cost savings for individual countries, the systemic effects of alleviating the need for import compression in important parts of the world, and the implications of the composition of reserves for systemic stability. Section IV considers the implications of an SDR allocation for inflation or deflation. Section V addresses the prolonged net use of SDRs and considers the issue of reimposing a reconstitution requirement as a mechanism to reduce prolonged net use. Section VI provides a summary and lists some issues for discussion.

1/ For more extensive discussions of many of the issues, see SM/92/106, "International Liquidity and the SDR Mechanism" (May 27, 1992).

2/ See SM/92/106, "International Liquidity and the SDR Mechanism" (May 27, 1992) and SM/89/45, "Further Considerations on Issues Relating to Post-Allocation Adjustment in the Distribution of SDRs" (February 24, 1989).

II. Projected Reserve Demands and Present Reserve Holdings

The relatively stable relationship between holdings of international reserves and the volume of world trade, together with the outlook for continuing expansion of world trade, implies that the global demand for reserves is likely to expand by several hundred billion SDRs during the period through the end of 1996, when the sixth basic period comes to a close. As an illustrative scenario, Table 1 provides reserve projections for the end of 1996 based on the projected levels of imports under the World Economic Outlook baseline scenario (May 1993), combined with the assumption that reserve/import ratios will remain at their 1992 levels for each of the two listed groups of countries. 1/ Column 3 of the table projects that the industrial countries will increase their nongold reserve holdings by more than SDR 100 billion, and the developing countries, by more than SDR 150 billion. 2/

There is always some fluctuation in actual (and presumably in desired) ratios of reserve holdings to imports, as well as uncertainty concerning the future growth of imports. Hence, there is necessarily some prospective error in the projections of demands for nongold reserves reported in Table 1. Over the years, however, there has been sufficient stability in reserve to import ratios and in the trend rate of growth of world trade that an expansion of the global need for reserves of the broad order of magnitude indicated in Table 1 may be projected with a high degree of confidence. Recognizing that reserve-to-import ratios and trade volumes have fluctuated somewhat more for developing countries than for industrial countries, the order of magnitude of the likely growth of demand for reserves to be held by the group of developing countries may also be projected with reasonable confidence. Such confidence is important in considering a possible SDR allocation because, as discussed below, the developing countries and the countries in transition generally face significantly higher costs of acquiring and holding reserves than the economic opportunity costs of creating reserves through SDR allocation.

The last two columns of Table 1 consider the implications of an allocation of SDR 36 billion, a figure suggested in the Managing Director's

1/ Implicitly, the WEO scenario reflects a need for some developing countries to compress imports in order to build reserves. To that extent, in the presence of an SDR allocation, the expansion of imports and reserve demands would tend to be larger than the projections reflected in the table, other things equal.

2/ The projected increase in global nongold reserves is roughly SDR 310 billion for the sixth basic period as a whole (end-1991 through end-1996); this is near the low end of the range of SDR 300 billion to SDR 400 billion that was projected in SM/92/106, based on an earlier baseline scenario that portrayed a stronger outlook for the world economy. The projected growth percentages for imports and nongold reserves from 1992 through 1996 are 27.5 percent for the industrial countries and 50 percent for the developing countries.

Table 1. Projected Demands for Nongold Reserves and Implications of an Allocation of SDR 36 Billion

(Values in billions of SDRs; shares in percent)

	1992 <u>Reserves</u>	Projected 1996 <u>Reserves</u> ^{1/}	Projected <u>Change</u>	Reserves Received through <u>Allocation</u>	Share of Projected Change Met by <u>Allocation</u>
Industrial countries	396.7	505.7	109.0	22.5	20.7
Developing countries ^{2/}	314.9	472.6	157.7	11.8	7.5

Sources: IMF, World Economic Outlook and International Financial Statistics.

^{1/} For each of the two country groups, nongold reserves have been projected to increase from 1992 to 1996 by the same percentage as imports of goods and services under the May 1993 baseline scenario of the World Economic Outlook.

^{2/} Conforms with the country classification in International Financial Statistics, except that the states of the former Soviet Union are not included.

Statement several months ago. 1/ Such an allocation would amount to a small percentage of the projected growth in the global demand for reserves over the period through the end of 1996, raising the share of SDRs in global nongold reserve holdings from 3.0 percent at end-1992 to a projected 5.8 percent. 2/ This would still be well below the peak of 8.4 percent that prevailed after the first activation of the allocation facility, and also below the 6.5 percent share that prevailed after allocation during the third basic period. Without any new allocation, the share would decline to a projected 2.2 percent at end-1996, and 37 of the current members of the Fund would still have not participated in any SDR allocations. Failure to create SDRs during three successive allocation periods would not be compatible with the objective in the Articles of making the SDR the principal reserve asset in the international monetary system.

For the proposed allocation of SDR 36 billion, column 4 of Table 1 shows the increase in reserves that each group of countries would receive, while column 5 indicates the share of the projected increase in reserve demand met by allocation. The smaller share for the developing countries reflects the faster projected rate of import growth for these countries, as well as the fact that their share of aggregate Fund quotas is less than their share of world reserves. Because, as previously noted, the projected growth of demand for reserves by developing countries is subject to some uncertainty, the conclusion that an allocation of 36 billion SDRs would satisfy only 7.5 percent of the increased need for reserves of these countries is similarly subject to some uncertainty. Nevertheless, one can be quite confident that such an SDR allocation would likely satisfy only a modest fraction of the increased demand to hold reserves by the entire group of developing countries.

Turning next to a quantitative assessment of the adequacy of present reserve holdings, Table 2 provides data on the ratios of nongold reserves to imports of goods and services for several groups of countries, both for end-1992 and for selected years since 1970. It will be recalled that, in the Executive Board's last discussion of an SDR allocation during April 1993, Directors asked that reserve ratios be expressed relative to imports of goods and services rather than merchandise imports alone. 3/

As can be seen from Table 2, the reserve/import ratios differ considerably across the main country groups. Notably, the ratio for the industrial countries is much lower than that for the developing countries. This reflects, inter alia: the relatively greater ability of the industrial countries to quickly supplement their reserve holdings, should the need

1/ See "Statement by the Managing Director on the Need for and Modalities of an SDR Allocation: Executive Board Meeting, April 19, 1993."

2/ These shares include the Fund's holdings of SDRs. Excluding the Fund's holdings, which were enlarged by payments associated with the recent round of quota increases, the end-1992 share was 1.8 percent.

3/ See "Concluding Remarks by the Chairman: SDR Allocations, Executive Board Meeting 93/58--April 19, 1993".

Table 2. Ratios of Nongold Reserves to Imports of Goods and Services 1/

(In percent)

	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1992</u> <u>2/</u>
Industrial Countries	13.3	12.9	13.0	13.4	15.4	13.3
Developing Countries	21.0	31.4	24.7	29.4	31.4	36.6
Countries with recent debt-servicing difficulties	16.7	24.8	20.4	20.7	19.4	31.0
Small low-income economies	17.8	12.6	10.4	12.0	10.8	15.3
Countries in transition <u>3/</u>	...	...	...	...	...	12.3
Former Soviet Union	...	...	...	...	...	4.6

Sources: IMF, World Economic Outlook and International Financial Statistics.

1/ End-of-year reserves as ratios of imports of goods and services during the year. Imports include interest payments on debt where data are available. Imports for states of the former Soviet Union (FSU) exclude intra-FSU trade. Country groups are consistent with those used in the World Economic Outlook.

2/ Data for some countries are staff estimates.

3/ Includes Bulgaria, former Czechoslovakia, Hungary, Poland, Romania, former Yugoslavia, and 12 states of the former Soviet Union. Albania, Mongolia, Georgia, Tajikistan, and Turkmenistan are not included in the table.

arise, through their ready access to official and private sources of liquidity; the lower variability of payments imbalances for the industrial countries, relative to the developing countries; and the greater recourse of industrial countries to more flexible exchange rate arrangements. The potential for the industrial countries to borrow from official or private sources provides them with the ability to finance balance of payments deficits or foreign exchange intervention on a scale much larger than their official reserve holdings, and accordingly results in a demand for reserves by these countries that is lower relative to imports than that of the developing countries. Moreover, access to large official lines of credit allows industrial countries to quickly supplement their reserves during periods of exchange market pressures without the difficulties that can be associated with "signalling" their need for reserves by borrowing from private sources of credit during such periods. Thus, the relatively low ratio of reserves to imports for the industrial countries is unlikely to be an indication of reserve inadequacy.

For the developing countries, including the group of countries that incurred external payments arrears or entered into official or commercial bank debt-rescheduling agreements during 1986-90 (i.e., the countries with recent debt servicing difficulties), the ratio of reserves to imports at the end of 1992 was higher than in earlier years. Most of the recent increase in the ratio of their reserves to imports is accounted for by the growth of reserves of a few developing countries that have recently experienced large capital inflows. ^{1/} The cost of acquiring and holding these reserves, however, has not been particularly low, as the interest that countries have had to pay to holders of the claims that are counterpart to these capital inflows has substantially exceeded their earnings on the reserve assets. Moreover, the existence of a large stock of liquid claims as the counterpart of these capital inflows raises concerns about the need to hold increased reserves as an offset to these claims.

While developing countries as a group now have a relatively high reserve-to-import ratio, within this broad group the subgroup of 45 small low-income economies has a reserve-to-import ratio that is very low and has been very low for many years. At the end of 1992, these countries held nongold reserves amounting to roughly eight weeks of imports, compared with 19 weeks for developing countries on average. For the countries in transition, nongold reserves averaged 6 1/2 weeks of imports at the end of 1992. Within this group, the states of the former Soviet Union held nongold reserves amounting, on average, to less than 2 1/2 weeks worth of imports (excluding intra-FSU imports).

^{1/} General policy concerns relating to the causes and implications of these large capital inflows will be discussed in an upcoming Board seminar. See SM/93/113, "Recent Experiences with Surges in Capital Inflows" (May 21, 1993) and Guillermo A. Calvo, Leonardo Leiderman, and Carmen M. Reinhart, "Capital Inflows and Real Exchange Rate Appreciation in Latin America," IMF Staff Papers, Vol. 40 (March 1993).

Table 3 provides additional information on countries with relatively low ratios of nongold reserves to imports of goods and services at the end of 1992. The table shows that 20 percent of the developing countries, and nearly 40 percent of the countries in transition, held nongold reserve levels amounting to less than 4 weeks worth of imports; that 34 percent of developing countries and 61 percent of the countries in transition had reserves equivalent to less than 8 weeks worth of imports; and that more than half of the developing countries and three quarters of the countries in transition had reserves no greater than 12 weeks worth of imports. The aim of maintaining reserves of at least three months of imports is at times used as a rule of thumb in Fund arrangements. Hence, there is a significant part of the Fund's membership that can be said to suffer from reserve stringency.

III. Systemic Effects of SDR Allocation

Article XVIII, Section 1(a) of the Fund's Articles of Agreement refers to promoting "the attainment of...[the Fund's] purposes" and avoiding "economic stagnation and deflation as well as excess demand and inflation in the world." An assessment of whether an SDR allocation would supplement existing reserve assets in a manner consistent with these objectives requires a comparison of the economic consequences of the alternative mechanisms that countries have available to satisfy their demands for reserves.

In the absence of SDR allocation, a country can increase its reserve holdings either through a net capital inflow from abroad or by generating a current account surplus. The former channel is typically viewed as obtaining reserves through "borrowing". The latter channel requires a compression of domestic demand relative to production in order to expand exports or compress imports.

For some of the major industrial countries, the growing demand for reserves can be met spontaneously through short-term borrowing at rates only marginally higher than the yields on reserve assets. Most member countries of the Fund, however, lack this preferred access to international capital markets and face borrowing rates significantly higher than the yields on reserve assets. 1/ Moreover, many of these countries are limited in their access to borrowing and must therefore resort to the compression of domestic demand and net imports, other things equal. This is not to deny that some

1/ For quantitative information on interest rate spreads and the estimated net costs of holding reserves acquired through borrowing, see SM/92/106, "International Liquidity and the SDR Mechanism" (May 27, 1992). For industrial countries other than the most favored borrowers, and for the developing countries with general access to international financial markets, the interest rate spreads, averaged across countries, have been in the ballpark of 1 percentage point (per annum) in recent years. For other developing countries, the spreads--when access is available at all--can be much larger.

Table 3. Distribution of Countries by Ratio of Nongold Reserves to Imports of Goods and Services, 1992 ^{1/}

Ratio of Reserves to Average <u>Imports per Week</u>	<u>All</u> <u>Countries</u>	<u>Industrial</u> <u>Countries</u>	<u>Developing</u> <u>Countries</u>	<u>Countries in</u> <u>Transition</u>
	<u>Number of Countries</u>			
Less than 4 weeks	34	3	24	7
4 to 8 weeks	27	6	17	4
8 to 12 weeks	32	6	23	3
12 to 16 weeks	20	4	15	1
16 to 20 weeks	15	2	12	1
20 weeks or more	32	1	29	2
Total	160	22	120	18
	<u>Percent of Countries</u>			
Less than 4 weeks	21.3	13.6	20.0	38.9
4 to 8 weeks	16.9	27.3	14.2	22.2
8 to 12 weeks	20.0	27.3	19.2	16.7
12 to 16 weeks	12.5	18.2	12.5	5.6
16 to 20 weeks	9.4	9.1	10.0	5.6
20 weeks or more	20.0	4.6	24.2	11.1

Sources: IMF, World Economic Outlook and International Financial Statistics.

^{1/} See notes to Table 2.

countries with inappropriate macroeconomic policies or inadequate structural policies have been able, by strengthening their policies, to achieve the compression of net imports (expansion of net exports) through a stimulus to production.

The provision of reserves through SDR allocation would reduce the cost of holding reserves for all countries other than the few preferred borrowers, and could also have important beneficial consequences for the world economy. For the majority of countries (other than the few preferred borrowers), holding reserves that have essentially been obtained on credit imposes a significant interest cost equal to the spread between borrowing rates and the rate of return on reserve assets. Holding reserves that have essentially been obtained through the compression of domestic demand and net imports also imposes a significant cost in terms of foregone consumption or investment. Although countries benefit from holding reserves and thus choose willingly to incur the costs of doing so, these costs could be saved if the reserves were made available through SDR allocation. 1/ 2/

To the extent that meeting the growth over time in the demand for reserves to hold through the creation of SDRs would be essentially free of economic opportunity cost to the world, not doing so can be viewed as imposing an unnecessary burden on most countries. This burden is particularly high for countries with limited access to credit markets, where reserve demands cannot be met by borrowing, and where the cost of import

1/ The differentials that countries face between borrowing costs on private capital markets and rates of return on reserve holdings are generally regarded as premiums that private lenders require to compensate for the risk that borrowers will not comply fully with the terms of loan contracts. The cost saving that takes place when reserves are acquired through allocation rather than borrowing reflects the absence of a risk premium in the SDR system: the rate of charge that is levied against a country's cumulative allocation of SDRs is identical to the rate of interest that is paid on a country's holdings of SDRs. The absence of a spread between the two rates would create the potential for undesired resource transfers if it was risky to hold SDRs. Several considerations, however, suggest that the risk of holding SDRs is low. First, members of the IMF have generally placed a high value on their relations with the Fund and have endeavored to meet their obligations to the SDR system, even in the face of extreme difficulties in meeting other payments. Second, the Fund is required to pay interest to holders of SDRs regardless of whether sufficient amounts of SDRs are received in payment of charges; any excess of interest due over charges received is created automatically, adding to the outstanding supply of SDRs. In this connection, as of January 31, 1993, unpaid charges amounted to SDR 46 million, compared with cumulative allocations of SDR 21.5 billion.

2/ While most countries would gain in this way from an SDR allocation, the reserve-currency countries might face a slight increase in the marginal cost of borrowing insofar as an allocation would reduce official demands for their liabilities.

compression is high. Some of these countries have entered into financial arrangements with the Fund, and have been able to build reserves with resources freed indirectly through the use of Fund credit. The need for reserves, however, is permanent, whereas the use of Fund credit is intended to meet temporary needs. In that sense, SDR allocation might appropriately reduce the use of Fund credit in countries with both temporary balance of payments needs and long-term needs for reserve growth.

From a broader perspective, the benefits from SDR allocation for the world economy could be substantially greater than the direct savings in the costs of holding reserves for individual countries. In particular, by reducing the need for a large group of countries--including most of the countries in Eastern Europe and the former Soviet Union, and many small low-income economies in other regions--to satisfy their growing demands for reserves through import compression, an SDR allocation could reduce the threats to the far-reaching stabilization and transformation efforts of these countries. Most of these countries have already experienced severe import compression in recent years and are not in a position to absorb the economic costs of building reserves by compressing imports further through negative or very low rates of economic growth. Nor is it desirable that they seek to further compress imports through reliance on trade restrictions. Moreover, it is not in the self-interest of the international community at large to risk the effects that would spill over onto the global economy from widespread failure of the stabilization and transformation efforts of the many countries that currently have low reserve holdings.

In this connection, when considering the long-term global need for reserve supplementation, it has long been accepted that the case for an SDR allocation does not require a situation in which reserve inadequacies are widespread among all or nearly all countries. Whether the criterion of global need is satisfied depends on the judgment that failure to supplement reserves would have an adverse impact on the performance of the world economy and the functioning of the international monetary system. 1/ Moreover, in a growing economy, a judgment must be made about the appropriate amount of reserve growth. SDR allocation on a large scale, approaching or even exceeding the projected growth in demand for reserves, could well imply significant costs, as well as prospective benefits, in terms of world economic performance (given the likely effects on national economic policies). Accordingly, it seems appropriate to keep the degree of any SDR allocation well within the bounds of the projected growth in the demand for reserves. For relatively moderate amounts of SDR allocation in a

1/ See the conclusions of SM/84/148, "Allocations of SDRs--Legislative History of the Concept of 'Global Need' to Supplement Existing Reserves" (June 27, 1984), pp. 15-16.

growing world economy, there is reason to be confident that the benefits will exceed the costs. 1/

In the case of the allocation during the third basic period, it was recognized that, if a need for reserve supplementation exists, an SDR allocation could be made even if the need could be met in other ways. Qualitative aspects of reserve supplementation in the form of SDRs were seen as relevant. For instance, it was noted that, while a member could supplement its reserves through the capital markets, a system in which countries add to their gross reserves by increasing their international indebtedness gives rise to a need for periodic refinancing. This difficulty does not arise when reserves are increased through SDR allocation. Moreover, the objective of making the SDR the principal reserve asset was invoked as a reason for responding to a need for reserve supplementation in the form of an SDR allocation. 2/

Experience since the third basic period has reinforced the view that, by inducing many countries to rely less heavily on borrowed reserves and other forms of privately supplied liquidity, an SDR allocation would have favorable systemic effects. Reliance on private sources of liquidity poses some risk, especially in periods following major macroeconomic or financial shocks. In this connection, many countries have encountered abrupt changes in the cost and availability of liquidity when unexpected events have triggered sudden shifts in market sentiment and created a strong need for additional reserves. Moreover, as events in European exchange markets over the past year have indicated, reserves acquired through a counterpart accumulation of liabilities to nonresidents--which do not increase a country's net asset position--provide much less security when market sentiment shifts than reserves acquired without borrowing. 3/

1/ For an early discussion of the appropriate scale of reserve supplementation, see J. Marcus Fleming, "Toward Assessing the Need for International Reserves," Princeton Essays in International Finance No. 58, February 1967, reprinted in Peter B. Kenen (ed.) The International Monetary System: Highlights from Fifty Years of Princeton's Essays in International Finance, San Francisco: West View Press, 1993.

2/ See SM/78/215, Rev. 4, "Report of the Executive Directors to the Interim Committee on Special Drawing Rights" (September 15, 1978) and EBD/78/214, Rev. 3, "Proposal by the Managing Director for an Allocation of Special Drawing Rights for the Third Basic Period" (October 23, 1978). These issues will be discussed more fully in the background paper to be issued shortly on legal aspects of SDR allocations.

3/ In this connection, a number of developing countries that have recently experienced surges in capital inflows may also be vulnerable to sizable reserve drainage if market sentiment shifts abruptly. See SM/93/113 "Recent Experience with Surges in Capital Inflows," (May 21, 1993), and Guillermo A. Calvo, Leonardo Leiderman, and Carmen M. Reinhart, "Capital Inflows and Real Exchange Rate Appreciation in Latin America," IMF Staff Papers, Vol. 40 (March 1993).

It may be noted, as well, that sources of liquidity from outside private credit markets played a major role in the policy response to the past year's exchange market turbulence in Europe. Indeed, the ability of the European countries to defend their exchange rates--including exchange rates between the currencies of countries where underlying fundamentals were relatively sound--would have been far weaker in the absence of the official credit lines available to supplement reserve assets. Without such credit lines, the European countries would have been much more dependent on private sources of credit, which can be much less reliable or more expensive in times of crisis.

Most developing countries and countries in transition do not have access to extensive official lines of credit. They also face greater uncertainties than the industrial countries in seeking credit from private sources in times of crisis. From this perspective, a moderate allocation of SDRs would operate in the right direction. Moreover, a sequence of moderate allocations that gradually raised the share of SDRs in total reserves might significantly reduce the need for countries to acquire reserves through capital inflows, and to rely so heavily on private sources of credit when reserve needs increase unexpectedly. Thus, over time, a continuing sequence of allocations would reduce the risk of systemic instability.

IV. Implications for Inflation or Deflation

One source of concern about allocating SDRs is the recognition that the provision of such resources has the potential to intensify global inflation. For moderate allocations of SDRs--in particular, allocations that meet only part of the growth in the demand for reserves--this concern is unwarranted, especially in present circumstances. Analogously, domestic monetary expansion on a moderate scale is not necessarily inflationary when the demand for money is also expanding.

Global inflation can be intensified by events that reduce the supply of goods--such as bad harvests or disruptions to oil production--as well as by factors that influence the macroeconomic policy stances of the major industrial countries. The incidence of supply shocks, however, is clearly not affected by SDR allocation. Neither are the basic policy stances of the major industrial countries. In general, the monetary authorities in these countries automatically "sterilize" the effects of their foreign exchange transactions, including the receipt of SDRs, on domestic monetary aggregates. 1/ In the staff's view, there is no reason to expect that the central banks of large industrial countries would adopt a looser monetary stance simply as a consequence of a moderate allocation of SDRs.

1/ In this connection, SDRs received through allocation do not require sterilization, unlike SDRs or foreign exchange acquired through sales of domestic monetary instruments.

Of course, for countries other than those whose liabilities are held as international reserve assets, SDR allocation could, at the margin, reduce the need to acquire reserves through the compression of net imports, and could thereby add to the growth of domestic demand for goods and services. Even so, for a proposed allocation of SDR 36 billion over the final three years of the sixth basic period, and for the extreme case in which world demand for goods and services became less compressed over the period by the full amount of the allocation augmented by the usual multiplier effects, the increase in spending spread over three years would provide only a small stimulus to the world economy. ^{1/} An SDR allocation would also act in the direction of reducing pressures to compress imports through trade restrictions, so its effects on the international trading system would be favorable.

While a moderate-size SDR allocation would not pose an inflationary threat for the world economy, it could not be ruled out that an allocation might weaken policy discipline in some individual countries. This risk, however, would be limited through the oversight of the Fund in performing its regular surveillance functions, which would include, inter alia, an examination of the pattern of total reserve holdings following an SDR allocation. In general, countries could allow domestic demand to become less compressed following an allocation, but the appropriateness of doing so for any specific country would depend on the particular circumstances of that country. For countries where domestic activity was depressed, it might in some cases be appropriate to raise the planned growth path of reserves by less than the full amount of the allocation in order to ease the deflation of domestic demand. For other countries where reserves were low and domestic activity was not excessively weak, the most appropriate course might be to build reserves by the full amount of the allocation, and to continue expanding reserves over time at the same rate that would have been sought in the absence of allocation. To the extent that many of the countries in which reserve holdings are relatively low have chosen to make use of Fund credit, the conditionality attached to financial arrangements with the Fund may provide an effective vehicle for insuring that an SDR allocation would not have inappropriate effects on macroeconomic policies and reserve growth.

V. Prolonged Net Use of SDRs

Executive Directors in the past have expressed strong concerns about the potential for undesired resource transfers arising from the SDR system. One source of concern is the prospect that, for some countries, SDR allocations might exceed the growth in the demand for reserves to hold, thus inducing those countries to spend the excess on goods and services and, in effect, to acquire real resources that other countries did not desire to

^{1/} It may be noted, to provide some quantitative perspective, that the gross domestic product of the Group of Seven countries alone is projected to exceed SDR 36,000 billion cumulated over the three year period.

transfer. This potential for undesired resource transfers makes it important, as noted earlier, to limit the scale of SDR allocation to a moderate share of the projected growth in the demand for reserves. Beyond that, for countries that have financial arrangements with the Fund, the undesired resource transfers associated with a failure to build reserves adequately following an SDR allocation can be limited further through the conditionality attached to the use of Fund credit.

A second source of concern, in the past, was the potential for the use of SDRs, by itself, to generate undesired resource transfers. This potential has been eliminated by making the SDR rate of interest competitive with rates of return on other reserve assets. Indeed, it is generally recognized that countries that now hold SDRs in excess of their cumulative allocations chose to do so voluntarily. Thus, provided that allocations do not exceed the growth in demand for reserves to hold, the prolonged net use of SDRs does not impose a burden on countries with SDR holdings in excess of their cumulative allocations. Moreover, to the extent that many countries that have drawn down their SDR holdings also have entered into financial arrangements with the Fund that are subject to policy conditionality, the prolonged net use of SDRs is not necessarily associated with unsound macroeconomic policies or inappropriately low holdings of reserve assets other than SDRs.

Nevertheless, if Directors feel that countries that have made prolonged net use of their cumulative allocations to date should be constrained from making substantial use of new allocations, they may wish to consider phasing in a new reconstitution requirement on total cumulative allocations. Through the reimposition of a reconstitution requirement, countries that had spent a high proportion of their previous cumulative allocations could effectively be required to hold a relatively high proportion of their new allocations. At the same time, countries with large initial holdings of SDRs relative to previous cumulative allocations, as well as countries that had never before received allocations, could be given more scope to use their new allocations. The reconstitution requirement would not need to be identical to the one that was abrogated in 1981. ^{1/} In this regard, if there is sufficient interest among Directors, the staff could prepare a paper addressing the appropriate modalities for such a requirement in light of both the experience with the previous requirement and the pattern of prolonged net use of SDRs.

VI. Summary and Issues for Discussion

This paper has addressed the range of issues that arise in assessing the global need for reserve supplementation--that is, in judging whether a failure to supplement reserves would have adverse systemic effects. It has

^{1/} Under Article XIX, Section 6(b), the rules for reconstitution may be reviewed at any time, with a 70 percent majority of the total voting power required for decisions to adopt new rules.

also considered whether an SDR allocation would supplement existing reserve assets in a manner consistent with the objectives specified in the Fund's Articles.

In the staff's view, there is presently evidence of a long-term global need for reserve supplementation, and given such a global need, the objectives specified in the Articles provide a strong case for a moderate size allocation of SDRs. These judgments are based on the following considerations. First, the global demand for reserves is projected to grow by several hundred billion SDRs during the remainder of the sixth basic period. Second, most developing countries and the countries in transition, which together account for the greater part of the total projected increase in the global need for reserves, will not be able to acquire the additional reserves that they will demand to hold, except at a cost that substantially exceeds the true economic opportunity cost to the world of creating additional reserves through an SDR allocation. Third, aside from the projected growth in the demand for reserves, many developing countries and countries in transition currently have very low levels of reserves relative to plausible standards of reserve needs. Fourth, failure to relieve the reserve stringencies of the substantial part of the Fund's membership currently engaged in stabilization and transformation efforts would increase the risk of widespread setbacks or failures in these efforts, which would have highly adverse spillover effects on the global economy. Fifth, a moderate size allocation would have virtually no effect on global inflation. Sixth, while large-scale allocation of SDRs, approaching or exceeding the growth in the demand for reserves, could well have detrimental effects by inducing some countries to pursue unsound economic policies and run large balance of payments deficits, this risk can be limited by keeping allocation to a scale that meets only a moderate share of the projected growth in reserve demands; moreover, the risk can be further limited through the exercise of Fund surveillance. Seventh, SDR allocation, by reducing the need for countries to acquire reserves through capital inflows and to rely heavily on private sources of credit when reserve needs increase unexpectedly, would meet the global demand for reserves in a manner consistent with increasing the stability of the international monetary system. And finally, SDR allocation would help comply with the objective of making the SDR the principal reserve asset in the international monetary system.

In formulating their own judgments, Executive Directors may wish to comment on the following questions:

1. Do Directors agree that SDR allocation, by alleviating the need for import compression by a large group of countries--including most of the countries in Eastern Europe and the former Soviet Union, and many small low income economies in other regions--could contribute to reducing the threats to the stabilization and transformation efforts of these countries?

2. Do Directors believe that the stances of monetary or fiscal policies in their countries would be affected by an SDR allocation, and if so, how?

3. Do Directors agree that, by reducing reliance on borrowed reserves, an SDR allocation would tend to reduce the risk of instability in the international monetary system?

4. What significance do Directors attach to the fact that an SDR allocation would significantly reduce the costs of holding reserves for countries that face borrowing costs significantly higher than the rates of return they earn on their reserve holdings, and for countries that must obtain reserves through compression of domestic demand and net imports?

5. Do Directors feel there is a need to reduce the prolonged net use of SDRs; in this connection, would Directors favor the reimposition of a reconstitution requirement?

6. What potential effects of an SDR allocation do Directors perceive as undesirable?

7. How do Directors, on balance, judge the global need for reserve supplementation and the case for a moderate size allocation of SDRs?