FOR AGENDA

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EBS/90/87

CONFIDENTIAL

May 7, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Legal Aspects of the Selection of Currencies Under Article V, Section 3(d)

Attached for consideration by the Executive Directors is a paper on the legal aspects of the selection of currencies under Article V, Section 3(d) which, together with the paper on the calculation of amounts of currencies under the Fund's operational budgets (EBS/90/66, 3/30/90), has been tentatively scheduled for discussion on Friday, May 18, 1990. Conclusions appear on page 16.

Mr. Gianviti (ext. 8329) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Legal Aspects of the Selection of Currencies Under Article V, Section 3(d)

Prepared by the Legal Department

Approved by François Gianviti

May 4, 1990

This paper examines the legal basis for the selection of currencies for purchases from the Fund under Article V, Section 3(d) of the Articles of Agreement, and, in particular, the role of quotas in the selection process.

I. Historical Background

The concept of an operational budget emerged in the early 1960's in light of a more widespread convertibility of currencies, which allowed the Fund to use a broader currency basis for its transactions. As a result, there was a need to establish a general policy on the use of currencies in purchases and repurchases, and in 1962 the Executive Board adopted a statement entitled "Currencies to be Drawn and to be used in Repurchases" that served as the basis for the Fund's selection of currencies until the Second Amendment. 1/

In the 1962 statement a distinction was made between the use of members' currencies in purchases ("drawings") and repurchases: "With respect to the question of the selection of currencies for a particular drawing or drawings in general, account has been taken of the balance of payments and reserve position of the countries whose currencies are considered for drawing, as well as of the Fund's holdings of these currencies." The third consideration (introduced by "as well as") was presented as a moderating factor, to avoid substantial sales of a currency when the Fund's holdings of that currency were low, "irrespective of the balance of payments and reserve position of the country concerned." With respect to repurchases, according to the statement, "[i]ncreasingly . . . weight has been given, in suggesting the allocation of repurchases among the countries whose currencies can be received in repurchase, to the Fund's holdings of these currencies

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1/ See "Currencies to be Drawn and to be used in Repurchases," Decision No. 1371-(62/36), adopted July 20, 1962 (Selected Decisions, Eighth Issue, pp. 56-61).

compared to quotas. It would seem from the point of view of equity, and also with due regard to the liquidity position of the Fund, that great weight should be given to this criterion. But consideration should also be given, when appropriate, to the prevailing balance of payments position." 1/

The Fund continued to select currencies in accordance with the 1962 statement until the Second Amendment of the Articles of Agreement, when Article V, Section 3(d) was introduced to establish an express legal basis for the Fund to adopt policies and procedures relating to the selection of currencies to be sold to members making purchases from the Fund. 2/ Article V, Section 3(d) provides in pertinent part:

> "The Fund shall adopt policies and procedures on the selection of currencies to be sold that take into account, in consultation with members, the balance of payments and reserve position of members and developments in the exchange markets, as well as the desirability of promoting over time balanced positions in the Fund."

At the same time, a symmetrical provision governing the use of currencies in repurchases was included in the Articles. This provision is Article V, Section 7(i):

> "All repurchases under this Section shall be made with special drawing rights or with the currencies of other members specified by the Fund. The Fund shall adopt policies and procedures with regard to the currencies to be used by members in making repurchases that take into account the principles in Section 3(d) of this Article. The Fund's holdings of a member's currency that is used in repurchase shall not be increased by the repurchase above the level at which they would be subject to charges under Section 8(b)(ii) of this Article."

Therefore, the principles in Article V, Section 3(d) are taken into account for the selection of currencies both in purchases and in repurchases.

1/ Ibid., p. 61.

2/ Proposed Second Amendment to the Articles of Agreement of the International Monetary Fund: A Report by the Executive Directors to the Board of Governors, Part II, Commentary on the Proposed Amendment of the Articles of Agreement, Chapter D, Section 4, p. 20.

II. Analysis of Article V, Section 3(d)

Article V, Section 3(d) may be analyzed as follows:

(1) "The Fund shall adopt policies and procedures on the selection of currencies . . . ."

The Fund has adopted such policies and procedures in the form of guidelines. 1/ The terms of such guidelines have given the Fund considerable flexibility in their application. 2/

(2) ". . . currencies to be sold . . . ."

Article V, Section 3(d) applies only to currencies to be sold by the Fund. As noted, the use of currencies in making repurchases is covered by Article V, Section 7(i), which in turn refers to the principles of Article V, Section 3(d).

(3) ". . . policies and procedures . . . that take into account . . . ."

This phrase emphasizes the Fund's latitude in the formulation of policies and procedures under Article V, Section 3(d). 3/ It means

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1/ See Decision Nos. 6273-(79/158) G/S and 6274-(79/158), adopted September 14, 1979 (Selected Decisions, Fourteenth Issue, pp. 156-58) and Decision Nos. 6772-(81/35) G/S and 6774-(81/35), adopted March 5, 1981 (Selected Decisions, Fourteenth Issue, pp. 161-64). Decision No. 6774-(81/35) replaced Decision No. 6274-(79/158).

2/ See, e.g., Paragraph 4 of Decision No. 6774-(81/35), adopted March 5, 1981 (Selected Decisions, Fourteenth Issue, p. 164). This paragraph states: "The guidelines in this decision will be applied in a manner that will allow the Fund to retain the flexibility necessary to ensure that (i) the use of currencies can be adapted to the needs and circumstances of members and of the Fund, and (ii) the transactions and operations of the Fund can be executed expeditiously and in a manner that pays due regard to the convenience of members. Considerations that are relevant under (i) may include the need for members to purchase certain currencies in order to stabilize exchange markets, the effects of the use or receipt of currencies on the Fund's financial position, the Fund's liquidity, and the fact that in respect of the issuer of a reserve currency the ratio of its Fund position to its gold and foreign exchange holdings may not provide an appropriate measure of the amounts of the currency that might be used by the Fund. Considerations under (ii) may include the need to avoid the use of an excessive number of currencies in single transactions and operations." The same text appeared in Paragraph 4 of Decision No. 6274-(79/158), adopted September 14, 1979 (Selected Decisions, Fourteenth Issue, p. 158).

3/ As noted, the Fund's flexibility is also reflected in the guidelines adopted by the Executive Board.

first that the Fund is not required to attach particular effects to one or several of these elements. It means also that, while the three elements specified by the provision may not be disregarded, they are not exclusive. 1/ Other elements may be used as well, provided they are used in combination with the three specified elements, and that they meet the intrinsic purposes of the operational budget. 2/ In this respect, the guidelines have emphasized the flexibility necessary to ensure that the use of currencies can be adapted to the needs and circumstances of members and of the Fund, and that the Fund's transactions and operations can be executed expeditiously and in a manner that pays due regard to the convenience of members. 3/

An example of the flexibility retained by the Fund under Article V, Section 3(d) may be found in the decision that the U.S. dollar will be included in the operational budgets on the basis of ad hoc proposals. This decision does not mean, nor could it mean, that the elements established by Article V, Section 3(d) are disregarded for the U.S. dollar. Rather, it recognizes the unique place of the U.S. dollar as the predominant trading, reserve, and intervention currency of the international monetary system. 4/

(4) ". . . that take into account . . . <u>the balance of payments and reserve position of members</u> . . . ."

The Fund is required to judge whether the balance of payments and reserve position of a member country is sufficiently strong for the inclusion of its currency in the Fund's operational budget and the use of its currency in the budgeted amount. The rationale for this element is that if the Fund sold the currencies of members whose balance of payments and reserve positions are relatively weak, there would be a further deterioration in their reserve positions, which could result in a request for use of the Fund's resources by these members.

1/ See the statement of the General Counsel at EBM/75/34 (3/21/75), p. 16: "The intention of the revised text was not to set up an exclusive set of elements to be taken into account."

2/ Such supplemental elements must be distinguished from the supplemental policies that the Fund may adopt pursuant to Article V, Section 7(h) in order to sell its currency holdings of members with overdue financial obligations to the Fund.

3/ See paragraph 4 of Decision No. 6774-(81/35), adopted March 5, 1981 (<u>Selected Decisions</u>, Fourteenth Issue, p. 164).

4/ See paragraph 2.c. of Decision No. 6772-(81/35) G/S, adopted March 5, 1981, (<u>Selected Decisions</u>, Fourteenth Issue, p. 161) and "Principles for Calculating Amounts of Currencies Under the Fund's Operational Budgets," EBS/89/201 (10/17/89), p. 9.

This element is a combined concept, 1/ the two components of which may offset each other; for instance, the Fund may make net reductions in its holdings of the currency of a member with a strong reserve position, even though the member has a moderate balance of payments deficit. 2/

(5) ". . . and developments in the exchange markets . . . ."

The justification for this second element is that developments in the exchange markets may signal an improving or deteriorating payments position earlier than other quantitative indicators, such as changes in reserves. Thus, for example, weaknesses in the balance of payments and reserve position of a member may be disregarded in whole or in part on the ground that recently the member's currency has demonstrated strength in the exchange markets.

(6) ". . . as well as the desirability of promoting over time balanced positions in the Fund."

The third element, known as the "harmonization principle," seems to be a reflection of the third consideration in the 1962 statement ("as well as of the Fund's holdings of these currencies"), but, in its formulation, it resembles the text of Article XIX, Section 5(a)(i) on the designation of participants to provide SDRs. 3/

The word "desirability" indicates a course of action that is to be followed if possible. "Promoting" and "over time" indicate the objective and the time frame of the course of action. Thus, there is no requirement, nor indeed any expectation, that a balance exists at all times, or even at any given time. Imbalances under a particular budget are not inconsistent with the harmonization principle, if, on average, over a longer period, a balance can be achieved. By failing to specify the period of time over which balanced positions in the Fund should be promoted, the provision leaves a measure of flexibility for the Executive Board to adapt the pace of harmonization to the needs and circumstances of members and of the Fund.

1/ See paragraph 2 of Decision No. 6273-(79/158) G/S, adopted September 14, 1979 (Selected Decisions, Fourteenth Issue, p. 155).

2/ See paragraph 1 of Decision No. 6774-(81/35), adopted March 5, 1981 (Selected Decisions, Fourteenth Issue, p. 163).

3/ Article XIX, Section 5(a)(i), second sentence: "Participants shall be designated in such manner as will promote over time a balanced distribution of holdings of special drawing rights among them."

A member's "position in the Fund" 1/ has been defined as its reserve tranche position plus any outstanding loans to the Fund by the member, or an institution of a member, under credit arrangements that are judged by the Fund to provide it, on a continuing basis, with the ability to finance uses of its resources by members on terms comparable to those applicable to the Fund's use of its currency holdings for this purpose. 2/ The effect of this definition is to reduce the use of the Fund's holdings of a member's currency by the amount drawn under such credit arrangements (e.g., the General Arrangements to Borrow).

The word "balanced" implies an equilibrium or a state of equality. In the absence of any specified standard against which "balance" should be measured, the expression "balanced positions in the Fund," read literally, would appear to mean that the respective levels of members' positions in the Fund should be balanced among themselves. These levels could be expressed in absolute amounts, but the practice of the Fund is to express members' positions in terms of quotas, since quotas represent the basic measure of members' rights and obligations in the Fund. Therefore, "balanced positions in the Fund" may be understood as "balanced in terms of quotas."

While, in theory, equality of members' positions in the Fund in relation to quotas would seem a natural objective of the harmonization principle, in practice, it has not been expressed in these terms. Rather, it has been said that "[t]he harmonization of members' positions in the Fund has, over a period of many years, been an attempt to "balance" members' positions in the Fund in relation to their gross holding of gold and foreign exchange reserves." 3/ Whether this

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1/ According to SM/89/182 (7/9/79): "There is evidence from the discussion of [Article V, Section 3(d)] that it was intended to mean a member's reserve tranche position, that is, the extent to which the Fund's holdings of the member's currency are below its quota" (p. 4). However, the paper concluded that the expression "might be interpreted in a broader or narrower way" (p. 5) and that "it would seem reasonable that loans under the GAB be included in a member's position and thus be taken into account in any determination whether its position was "balanced" in relation to the position in the Fund of other members, also bearing in mind that the rate of interest on GAB borrowing is below market rates of interest" (p. 6).

2/ See paragraph 2.d. of Decision No. 6772-(81/35) G/S, adopted March 5, 1981 (Selected Decisions, Fourteenth Issue, pp. 161-62). See also paragraph 3.a. of Decision No. 6274-(79/158), adopted September 14, 1979 (Selected Decisions, Fourteenth Issue, p. 157).

3/ "Principles for Calculating Amounts of Currencies Under the Fund's Operational Budgets," EBS/89/201 (10/17/89), p. 5. See also "The Use of Currencies in the Fund's Transactions and Operations--The Promotion of 'Balanced Positions in the Fund,'" SM/79/182 (7/9/79), p. 6.

description accurately reflects the meaning of "balanced positions in the Fund" in Article V, Section 3(d) and in decisions of the Fund is examined in the next section.

III. The Role of Quotas in the Application of Article V, Section 3(d)

This section will first examine the meaning of "balanced" and the role of quotas in the application of the harmonization principle. It will then consider the harmonization principle in relation to the other elements of Article V, Section 3(d).

A. The meaning of "balance" and the role of quotas in harmonization

(1) The harmonization principle in the Fund's guidelines

While it has been stated that harmonization has traditionally been defined by reference to gold and foreign exchange reserves, rather than quotas, the harmonization principle has been applied in such a way under the Fund's guidelines that quotas, too, are taken into account. This "combined" approach to harmonization is reflected in the guidelines adopted by the Fund in 1979 and 1981 for the selection of currencies, and in the hybrid application of these guidelines that is currently in effect.

(a) The Executive Board approved the first set of guidelines pursuant to Article V, Section 3(d) in 1979. These guidelines cover both the transfer and receipt sides of the operational budget and reflect a complex approach to harmonization. They state that currencies should "be selected for use in purchases and repurchases . . . in such a way as to promote, over time, the equalization of the ratios of members' positions in the Fund . . . to their gold and foreign exchange holdings." 1/ At the same time, the 1979 guidelines qualified this approach by specific reference to quotas. They provided that the equalization of the ratios of members' positions in the Fund to their gold and foreign exchange holdings normally should not be carried beyond the point at which the Fund's holdings of a member's currency would be "substantially below" the average level, expressed as a percentage of quota, of the Fund's holdings of the currencies of members that do not have purchases outstanding and whose balance of payments and gross reserve position is sufficiently strong to be sold by the Fund under Article V, Section 3(d). 2/ Therefore, in the application of the harmonization principle, a balanced ratio of

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1/ See paragraph 3.b. of Decision No. 6274-(79/158), adopted September 14, 1979 (Selected Decisions, Fourteenth Issue, p. 157).

2/ See paragraph 3.c. of Decision No. 6274-(79/158), adopted September 14, 1979 (Selected Decisions, Fourteenth Issue, p. 157).

positions in the Fund to certain other reserve assets was given precedence over equality among reserve positions in relation to quotas.

(b) In 1981, the Executive Board adopted new guidelines that provided for a different approach to harmonization than the 1979 guidelines. 1/ The 1981 guidelines disregard quotas on the purchase (or transfer) side of the operational budget by defining balance only in terms of gold and foreign exchange holdings. In contrast, on the repurchase (or receipt) side of the budget, the 1981 guidelines call for balance to be measured in relation to members' reserve tranche positions. Therefore, balance takes a different meaning on the transfer side and the receipt side of the operational budget. A possible justification could be that balancing is a net process that depends on both the transfer and the receipt sides of the operational budget. However, this would not be consistent with the corresponding provisions of the Articles which require that the same principles be taken into account for the transfer and the receipt sides of the operational budget. In this respect, the 1979 guidelines follow more closely the language of the Articles. The 1981 guidelines were applied to operational budgets from June 1981 until December 1986. 2/

(c) Since December 1986, the practice of the Fund, while technically still based upon the 1981 guidelines, might be more accurately described as a hybrid of the 1979 and 1981 guidelines, where some portion of both the transfer and the receipt sides of the budget (e.g., one-sixth or one-third) is harmonized in accordance with the 1979 guidelines, while the remainder is harmonized under the 1981 guidelines. 3/ Thus, from December 1986 to December 1988, one-third of transfers and receipts were allocated to those members in the operational budget whose ratios of positions in the Fund to gold and foreign exchange holdings were greater or smaller than the average of all members that were included in the budget. The remaining two-thirds of transfers were allocated among members included in the budget in proportion to their gold and foreign exchange holdings, and the

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1/ See Decision Nos. 6772-(81/35) G/S and 6774-(81/35), adopted March 5, 1981 (Selected Decisions, Fourteenth Issue, pp. 161-64).

2/ From March 1986 to November 1986, the 1981 guidelines were modified slightly by distributing one-half of receipts to members whose ratios of reserve tranche positions to gold and foreign exchange holdings were above the average, in proportion to the amounts that were required to lower their ratios to the average. The other half was distributed in accordance with established practice in proportion to members' reserve tranche positions in the Fund. See "Operational Budget for March-May 1986," EBS/86/50 (3/4/86).

3/ Such combined use of the 1979 and 1981 guidelines is permitted by the principle of flexibility incorporated in both the 1979 and 1981 guidelines. All such variations in the application of guidelines are approved by the Executive Board when it adopts each operational budget.

remaining two-thirds of receipts were allocated in proportion to members' positions in the Fund. 1/

(d) Since December 1988, the practice of the Fund has remained the same except that the fraction of the operational budget allocated in accordance with the 1979 guidelines has been reduced to one-sixth of the amounts of transfers and receipts (instead of the prior one-third). 2/ This practice is reflected in the Fund's most recent operational budget for March-May 1990. 3/

2. Discussion

(a) The concept of "balance" as a ratio to gold and foreign exchange holdings may have been derived from the designation rules in Schedule F for the SDR Department: "Participants subject to designation under Article XIX, Section 5(a)(i) shall be designated for such amounts as will promote over time equality in the ratios of the participants' holdings of special drawing rights in excess of their net cumulative allocations to their official holdings of gold and foreign exchange" (Schedule F(a)). 4/

It should be noted, however, that there is no provision in the Articles of Agreement comparable to Schedule F that is applicable to the Fund's operational budgets. Moreover, the provision of the Articles for which Schedule F was adopted (Article XIX, Section 5(a)(i)) is substantially different from the provisions governing the operational budget, and the considerations that may be relevant to the SDR designation rules are not necessarily relevant to the operational budget. For instance, the 1979 guidelines, like Schedule F, exclude SDRs from the list of reserve assets against which balance should be measured, even though the justification for excluding SDRs in Schedule F is inapplicable to operational budgets. Also, there is no receipt side in the designation plan. Thus, notwithstanding the similarity between the provisions, it cannot be concluded that "balance" for purposes of the Fund's operational budgets was intended to be defined in the same way as in the designation rules in Schedule F.

1/ See "Operational Budget for December 1986-February 1987," EBS/86/268 (11/26/86).

2/ See "Operational Budget for December 1988-February 1989," EBS/88/245 (11/30/88).

3/ See "Operational Budget for March-May 1990," EBS/90/40 (3/5/90).

4/ In 1979, mention was made, but not supported, of an alternative approach for designation rules: "An alternative technique would be to distribute amounts of designation on the basis of participants' unused acceptance obligations in relation to their allocations." See Paragraph 3(b) of Summary and Conclusions approved by Decision No. 6209-(79/124) S, adopted July 24, 1979 (Selected Decisions, Fourteenth Issue, pp. 346-48).

When, in 1979, the Board considered the adoption of guidelines on the selection of currencies, the staff indicated that two different methods for promoting "balanced positions in the Fund" could be envisaged. 1/ These methods were presented as equally consistent with Article V, Section 3(d), and the Board was asked to decide on the basis of their respective advantages or disadvantages. While the preferred method was to harmonize positions in relation to gross holdings of gold and foreign exchange, an "alternative method would be an attempt to equalize reserve tranche positions in relation to members' quotas by equalizing the Fund's holdings of their currencies as percentages of their quotas. The rationale for this approach would be that quotas are the basic measure of a member's rights and obligations in the Fund and thus suggest themselves as a basis for the contributions members should make to financing the Fund's operations. Moreover, this method would appear equitable whether reserve tranche positions are regarded as attractive reserve assets, for which there is an element of competition among members, or as less attractive assets that members are less willing to acquire." 2/

According to the staff paper, the main rationale for harmonizing members' positions in the Fund in relation to their gross holdings of gold and foreign exchange was that "members' contributions to the financing of the Fund's operations should be equalized in relation to the resources that they have available for this purpose," because "if the Fund's use of a member's currency results in a change in the composition of a member's reserves, it was logical that the scale factor for determining the amounts of currency use should be the level of those reserves." 3/ At the same time, three reasons were given in the staff paper why quotas should not be used as the standard against which balance should be measured. 4/ First, quotas are unlikely to reflect short-run developments in members' balance of payments and reserve positions, and are not therefore indicative of a member's ability to finance a reserve position in the Fund. Second, the Fund's liquidity would benefit by a method that gives emphasis to the use of the currencies of members with large or rising reserves rather than to the Fund's holdings of members' currencies. Finally, the use of a member's currency in relation to the Fund's holdings, without regard to the level of reserves, would create difficulties for those members whose reserve tranche positions would become an undesirably large proportion of their reserves.

1/ "The Use of Currencies in the Fund's Transactions and Operations--The Promotion of 'Balanced Positions in the Fund,'" SM/79/182 (7/9/79), pp. 6-7.

2/ Ibid., p. 7.

3/ Ibid., p. 7.

4/ Ibid., pp. 7-8. See also "Principles for Calculating Amounts of Currencies Under the Fund's Operational Budgets," EBS/89/201 (10/17/89), pp. 7-8.

In a more recent staff paper issued in 1989, the harmonization of members' positions as "an attempt to 'balance' members' positions in the Fund in relation to their gross holdings of gold and foreign exchange" was justified as follows: "The main rationale of this approach is that members' contributions to the financing of the Fund's operations should have a direct relationship to the resources that they can make available for this purpose. In other words, because the Fund's use of a member's currency generally means a change in the composition of its gross reserves, rather than in any change in the overall level of external reserves, it would seem logical that the basis for allocating the amount of use of currency should be the level of those reserves. This form of harmonization is also a natural extension of the principle of selecting members which are sufficiently strong to have their currencies sold by the Fund on the basis of their comparatively strong balance of payments and reserve positions." 1/

(b) An examination of the reasons given in the 1979 and 1989 staff papers for defining "balanced positions" as a ratio to gross reserves rather than a ratio to quotas shows that these reasons consist of policy considerations that weigh the advantages and disadvantages of different ways of applying the harmonization principle, but fail to provide an analysis of the intended meaning of the provision. Moreover, it was recognized in the 1989 paper that defining the harmonization principle in terms of quotas rather than in terms of gross reserves was equally compatible with the text of the provision. As for the guidelines adopted by the Executive Board, they have combined both approaches to give effect to the harmonization principle, or used them respectively on the transfer and receipt sides of the operational budget. Thus, it cannot be said that quotas are irrelevant to the selection of currencies for the Fund's operational budgets.

The legislative history of Article V, Section 3(d) shows that the stated purpose of the provision was to remove any possible doubts on the legality of a currency budget, which, until then, was not expressly authorized by the Articles. 2/ There was no indication of an intention to discontinue the practice of taking into account the level of the Fund's holdings of members' currencies in accordance with the 1962 statement. Moreover, during the discussions that led to the adoption of the provision, the staff pointed out the differences between the designation plan, where the transfer of SDRs "meant simply a change in the composition of reserves," and the operational budget, where sales of a member's currency "did not always create a reserve position for members and could reduce a liability to the Fund." 3/ In response to a

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1/ EBS/89/201, p. 5. See also "Calculation of Amounts of Currencies Under the Fund's Operational Budgets," EBS/90/66 (3/30/90): "reserve positions in the Fund have been considered a diversification of members' reserves into Fund-related assets" (p. 2).

2/ See the statement of the General Counsel at EBM/74/108 (9/4/74), p. 117.

3/ See the statement of the Treasurer at EBM/75/34 (3/21/75), p. 754.

question concerning the possibility of sales of a member's currency to "run down" its position in the Fund when this member had outstanding repurchase commitments to the Fund, the staff observed that "the revised text did include the concept of promoting over time a balanced distribution of reserve positions in the Fund." 1/ Therefore, during these discussions, the level of the Fund's holdings of a member's currency was regarded as a relevant criterion by itself, regardless of its relationship to the member's gross reserves, for the understanding of the harmonization principle.

It would, in fact, be difficult to deny the relevance of quotas to the selection of currencies. The rationale for including members' currencies in operational budgets is the Fund's cooperative character and the revolving nature of its resources. Each member is legally obligated to contribute to the Fund's financing up to the amount of its quota. In return, members are accorded the various rights of membership, such as voting and access to Fund resources, in proportion to their respective quotas. When currencies are needed, "strong" members make resources available to "weak" members and receive in exchange a claim on the Fund that can be drawn upon in the event of future balance of payments need. Because members' legal obligation to contribute to the Fund's financing is limited by the size of their respective quotas, it is logical that members' actual contribution to such financing should be computed in relation to quotas.

The opposite conclusion, namely that quotas are not the relevant criterion for the application of the harmonization principle, appears to be that the strength of a member's reserves is relevant not only to the identification of the currencies to be selected for the operational budget, but also to the calculation of amounts to be used in the respective currencies. Under this approach, a member's reserves are used twice in the application of Article V, Section 3(d), first as part of the assessment of the member's balance of payments and reserve position, then separately, in a quantified and limited form, 2/ as the measure for balancing members' positions in the Fund. However, if, as explained below, all three elements of Article V, Section 3(d) were used not only to identify those members whose currencies are sufficiently strong for inclusion in the operation budget, but also to calculate the amounts of each currency selected, then it would not be necessary to define harmonization in terms of reserve strength since this factor would already have been taken into account under the first element of Article V, Section 3(d). Thus, if all three elements of Article V, Section 3(d) were used both to select currencies and to calculate amounts, balance could be defined exclusively in terms of quotas.

1/ See the statement of the General Counsel, ibid., p. 756.

2/ SDRs are not included in this calculation, and gold is valued at SDR 35 per ounce (see SM/79/182 (7/9/79), p. 9, footnote 1).

Moreover, in support of the proposition that "balanced positions in the Fund" means that members' positions in the Fund should be balanced in relation to their reserves, it has been stated that this understanding of the harmonization principle is "a natural extension of the principle of selecting members which are sufficiently strong to have their currencies sold by the Fund on the basis of their comparatively strong balance of payments and reserve position." 1/ If the harmonization principle is only an "extension of the principle" of strength, which is the first of the three elements to be taken into account, it means that the third element is but a repetition of the first one. There is, however, a rule of treaty construction known as the Rule of Effectiveness (Ut res magis valeat quam pereat), 2/ which directs that a provision of a treaty must be interpreted so as to give it a legal effect rather than none. Accordingly, when a series of words or expressions are used in a provision of the Fund's Articles, each word or expression must be presumed to have its own meaning. Thus, in the case of Article V, Section 3(d), where three elements are listed to guide the Fund in its selection of currencies, each element should be given a separate meaning. It follows that it would be inconsistent with the rule of effectiveness to define harmonization by reference to a concept that already appears in the first element (i.e., a member's reserve strength), when a separate meaning (i.e., quotas), suggests itself for this purpose. Therefore, it is concluded that quotas are not only relevant to the harmonization principle, but would also be justified as the basis on which harmonization would be measured.

B. Relationship among the three elements of Article V, Section 3(d)

Of the three elements that the Fund must take into account in selecting currencies for its operational budget, the harmonization principle is the only one that relates to quotas. In practice, as shown, even though quotas have not been regarded as the sole criterion for harmonizing positions in the Fund, the harmonization principle has incorporated quotas in the balancing process. In order to understand the role of quotas in the selection of currencies, it is, therefore, necessary to examine the relationship among the three elements of Article V, Section 3(d).

The harmonization principle differs from the first two elements in two important respects. First, unlike the first two elements, the third element is not formulated as an economic test, but as a goal or guiding principle, which is intended to ensure that the effects of the

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1/ "Principles for Calculating Amounts of Currencies Under the Fund's Operational Budgets," EBS/89/201 (10/17/89), p. 5.

2/ Mc Nair, The Law of Treaties, 1961, p. 384; Rousseau, Droit international public, Tome 1, 1970, p. 270.

Fund's selection of currencies and their amounts will be distributed in a rational and equitable manner over time.

A second difference between the first two elements and the third element is that Article V, Section 3(d) indicates that relatively greater importance is to be given to the economic tests set forth in the first two elements than to the harmonization principle found in the third element. The first two elements seek to establish which members' economies are sufficiently strong to permit the inclusion of their currencies in the Fund's currency budget, whereas the third element establishes the desirability of equity in such selection. Also, the economic tests are couched as strict requirements that are prerequisites for the selection of currencies, while the harmonization principle has been relegated to the position of a desideratum that is to be promoted only "over time." In addition, while the first two elements are linked by the connective "and," the third element is set apart from these two by a comma and the term "as well as," which was used in the 1962 statement to emphasize the lesser importance of the third element in relation to the first two for the selection of currencies in purchases from the Fund.

A third difference between the first two elements and the third element has been introduced by the guidelines adopted by the Executive Board for the implementation of Article V, Section 3(d). According to these guidelines, the selection process requires two stages. First, the economic tests are used to identify those members whose currencies are sufficiently strong for inclusion in the operational budget. Then, in a second stage, the harmonization principle is employed for the sole purpose of calculating the amount of each currency that should be included in the Fund's operational budget.

This distinction between identification and calculation is found in the rules governing designation for the SDR Department under Article XIX, Section 5(a)(i) and Schedule F. Under Article XIX, Section 5(a)(i), a participant is subject to designation if its balance of payments and gross reserve position is sufficiently strong. Once this determination is made, the Fund determines the amounts of SDRs for which the participant is designated in accordance with the rules set forth in Schedule F. 1/

However, it cannot be concluded that Article V, Section 3(d) was intended to operate in the same way as Article XIX, Section 5(a)(i). Although members' balance of payments and reserve position is used as a combined criterion in both provisions, this is the only element common

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1/ The designation rules in Schedule F may be amended by the Fund (Article XIX, Section 5(c)).

to both Article V, Section 3(d) and Article XIX, Section 5(a)(i). 1/ Indeed, the legislative history of the Second Amendment indicates that it was agreed not to extend the provisions governing the designation plan to the operational budget. 2/ Moreover, the structure of the two provisions differs. Article XIX, Section 5(a)(i) consists of two sentences. The first sentence of Article XIX, Section 5(a)(i) establishes the criterion that will subject a participant to designation, and the second sentence describes the manner in which designation shall be conducted. The structure of Article XIX, Section 5(a)(i) thus indicates that the provision is to be applied in two steps. In contrast, Article V, Section 3(d) consists of one sentence in which all three elements are listed, without differentiation as to purpose. Thus, while the present two-step practice of using the first two elements of Article V, Section 3(d) to select currencies and the harmonization principle to calculate amounts of currencies may be permitted by the flexible nature of Article V, Section 3(d), it is not mandatory that the provision be applied in this manner.

Indeed, Article V, Section 3(d) could operate as a single step in which all three elements would be used both to select members whose currencies are sufficiently strong for inclusion in the operational budget and to calculate the amounts of each currency needed for the budget. As indicated above, a one-step approach would avoid the redundancy of defining the third element of Article V, Section 3(d) by the same standard that already appears as part of the first element, and would thereby allow quotas to be used as the sole criterion against which balance would be measured. The same result is, of course, achieved in practice under the present two-step approach by identifying suitably strong currencies in accordance with the first two elements, and then allocating amounts of currencies under the third element in relation both to members' reserve strength and to quotas.

This raises the question whether, under a two-step approach, quotas could be used as the exclusive standard against which balance would be measured. While nothing in the Articles of Agreement would prevent such exclusive reliance on quotas, this approach nevertheless poses the theoretical risk that, by disregarding reserve strength in the second step, some members, particularly those with comparatively low reserves in relation to their quotas, might be included in the operational budget for amounts that would be excessive in relation to their reserves. Because of this risk, it would seem essential, under a two-step approach, to take into account members' relative reserve

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1/ Unlike Article V, Section 3(d), Article XIX, Section 5(a)(i) does not refer to "developments in the exchange markets" and its balancing test differs from that in Article V, Section 3(d).

2/ See EBM/75/73 (5/5/75), discussing Comprehensive Draft Amendment of the Articles of Agreement (DAA/75/2, 3/14/75; Cor. 2, 3/26/75; and Sup. 1, 4/4/75).

strength in the determination of amounts to be used in the respective currencies.

IV. Conclusions

The conclusions of this paper are the following:

1. Three elements must be taken into account in the formulation of the Fund's policies and procedures on the selection of currencies for purchases and repurchases from the General Resources Account:

- the balance of payments and reserve position of members;
- developments in the exchange markets; and
- the desirability of promoting over time balanced positions in the Fund.

2. These three elements are not exclusive. The Fund may also consider other factors that are relevant to the intrinsic purposes of the operational budget.

3. The respective importance of the three elements is determined by the Fund, but primary consideration should be given to the first two.

4. All three elements are relevant not only to the identification of currencies to be used, but also to the determination of the amounts to be used in the respective currencies.

5. Quotas are the relevant criterion for the determination of balanced positions in the Fund, both on the transfer and the receipt sides of the operational budget.